

Setup – Fund Size and Start-Up

After dealing with perhaps months of preparation and dealing with all the drafting and infrastructure issues during fund formation, it is almost inevitable that managers (and some investors) are impatient to get things going. However, this “rush to launch” needs to be tempered by the reality that there is a practical “critical mass” of capital for a start-up fund. The justification for an undercapitalized launch is almost always to “start the track record.” The problem is that the expenses – which should be immaterial – can become a major drag on that very track record the manager is hoping to build.

This discussion explores the impact of expenses on track record; determining “critical mass;” thoughts about how to minimize their effect; plus some recommendations for operating a true incubation fund without third-party administration.

Expenses

Funds have 4 major expense categories: manager compensation, administration, legal, and audit. Accordingly, service provider costs are very significant to a fund in its start-up phase. Audit, admin and legal expenses which would be deemed negligible to a \$100 million fund can suddenly seem quite significant to the fund starting with \$5 million. Following is a rough estimate of likely minimal fees for a fund at the two levels. Note that the audit/tax and legal expenses in this table are bare-bones, lowest-cost estimates for simple funds – it may be difficult to negotiate fees in this range.

Category	\$5 million Fund	\$100 million Fund
Administration	0.80% (\$40K min chg)	0.10% (standard rates)
Audit & Tax	0.40% est \$20K	0.03% - est \$30K
Reimbursement of Formation Costs	0.20% est \$30K spread over 3 yrs	0.015% - est \$15K per year (formation plus ongoing legal)
Total	1.40%	0.145%

Furthermore, note that audit & tax are annual expenses that have to be spread over the months that exist in the current year (and which usually isn’t significantly less expensive for partial versus full years). Consequently, the effect of audit & tax costs can be even more significant if a fund starts late in the year. In the table above, for example, a \$5 million fund starting July 1 would have a 0.80% impact from a \$20,000 audit expense.

“Critical Mass”

So, what’s the minimum size for a start-up? It is up to the manager; however, a reasonable target from the expense perspective is the \$5 to \$10 million level, which is where third-party expenses might fall below the 1% mark. For smaller start-ups, managers should consider either subsidizing costs or establishing a true incubator fund, both described below.

A second and perhaps even more important consideration for critical mass is how much capital is needed to create portfolio diversification. Ideally, a fund should not commence investment activity unless the portfolio risk profile can be reasonably similar to what it would be once the fund is “up to size.” Portfolio compromises due to small size are accidents waiting to happen.

Minimizing the Effect of Expenses on the Track Record

Identical portfolio results in the two differently sized funds in the table above will result in track record differences of nearly 1% (1.40% versus 0.145%). If a manager starts a smaller fund, are there any ways of “adjusting” the track record? Obviously, the presentation of a track record is a marketing issue that needs to be vetted by counsel, but following are some observations:

- **Manager Compensation.** Because management fees and performance allocations are normally not dependent on fund size, APM will always accrue them to calculate the fund’s official pro forma return – regardless of whether they are waived for any individual investor or investors as a group. The logic here is that prospective investors considering investing in the fund will eventually pay those fees, so not including them on a pro forma basis (or not making a prominent disclosure that the track record is unrealistic) could lead to a claim of deceptive marketing practices. This is not to say that waiving manager compensation is not a good incentive to reward early investors – just that such waiver would not affect the official fund track record.
- **Subsidizing Third-Party Expenses.** On the other hand, third-party expenses are dependent on size and are time dependent in the case of expensing formation costs. Some sponsors of smaller funds elect to subsidize some or all of the fund third-party expenses during start up in order to minimize the effect of small fund size on initial investors. This is a decision that should be explored with counsel. With proper disclosure, such an election may improve the fund’s official track record. Performance reports might be noted with something such as: “The fund manager paid certain third-party expenses until the fund reached \$__ million. Without that subsidy, the fund would have had lower returns.”

- **Delaying Formation Costs.** Formation costs are typically (1) capitalized and amortized over a period of time or (2) initially paid by the sponsor and then reimbursed on a non-recourse installment basis. Can these be delayed? With amortization, a delay in commencement would rarely be approved by the auditor; however, the latter process is a simple contract, so it may commence at a point in time in the future. Note that it is important to disclose in the offering documents the relevant calendar or asset-size threshold that will trigger commencement of the reimbursement or amortization.
- **Other Considerations.**
 - **Independence.** Note that APM is engaged by the fund. While we may, for a limited period of time, accept payments from a sponsor, we remain engaged by the fund and our primary reporting responsibility is to the fund.
 - **Approval by Counsel and Auditor.** Since the topic relates to putting one’s best foot forward for marketing purposes and involves the presentation of financial statements, it is essential that any decisions be thoroughly discussed with your legal counsel and audit firm.

Incubator Funds

If a manager really wants to build a track record with an under-sized fund, APM suggests that consideration is given to having a zero expense factor. Simplifying fees and eliminating expenses will also eliminate some of the complexity that would otherwise require an administrator.

- **Formation Costs.** Since the manager will likely be the largest investor in an incubator fund, it should consider paying the formation costs out of its own pocket. In addition to reducing expenses and helping the track record, it will be attractive from a marketing point of view.

Incubator Funds *continued*

- **Simplicity.** Do not charge initial investors an incentive allocation for some fixed period such as the remainder of the calendar year. Permit additions *only at month-end*. Charge all management fees monthly. This simplifies things to where the manager should be able to calculate the fund and investor returns on a simple spreadsheet.
- **Audit.** Determine if it is possible to delay an initial audit until size permits the cost or the inclusion of strangers requires it. Keep in mind that (1) in our opinion, no investor should invest in an unaudited fund, and (2) that audit costs will likely be higher if you're not using an administrator.

In order to permit the easiest takeover of your fund administration, keep copies of the following:

- each monthly statement
- a realized gain/loss report for each monthly period
- an unrealized gain/loss report with cost basis for each month-end
- a monthly report that reconciles your records to the broker statement

Other thoughts:

- Many brokerage statements report on a settlement basis or may have cut-offs that are not month-end. Accordingly, when trading records are reconciled each month, ensure that valuation is based on trade-date as of each month-end. Keep a reconciliation sheet that shows the adjustments between the settlement basis statement and the trade date valuation.
- Will the fund ever have any long-term holding periods? If not, discuss the possibility of a Internal Revenue Code § 475(f) election with your tax advisors. This eliminates wash sale issues. While all positions are marked to market for tax purposes at year end and all income is ordinary, it can be simpler than tracking tax items.
- Keep in mind that waiving fees or reducing them is an effective way to encourage early investment.
- One unavoidable expense is the filing of a partnership tax return.

Final thoughts

The reason that APM has a cancellation clause in the administration contract for undercapitalized start-ups is not a direct money issue, since the admin contract has a minimum charge. The problem is that, in our experience, the vast majority of undercapitalized funds end in failure.

This material has been prepared by ALPS Price MeadowsSM for general informational purposes only. It does not constitute tax, legal or investment advice, and is presented without any warranty as to its accuracy or completeness or whether it reflects the most current developments. ALPS Price MeadowsSM does not provide tax, legal or investment advice. You are urged to consult your own tax, legal and investment advisors.