Using Performance Exams as Part of Your Pitch Book Strategy

Written by:
Erik Edson, Senior Audit Manager, Richey May & Co, LLP
Holly Singer, President, HS Marketing LLC

In an increasingly competitive capital-raising climate for start-up hedge funds, the use of performance examinations has become more and more common. A performance examination typically takes place when investment managers are considering launching a private fund structure and have traded their investment strategy in a separately managed account, or within their personal trading account. Future hedge fund managers want to showcase their historical performance or track record in their pitch book and other marketing material to demonstrate the success of their strategy in order to build credibility and ultimately encourage potential investors to invest in the planned launch of their upcoming fund. By engaging in a performance exam, a public accounting firm signs off on the past performance history and issues an opinion on the performance in order to legitimize the trading strategy's performance numbers. Typically, the CPA firm will perform procedures such as recalculating the rates of return and sending confirmation requests to the investment manager's broker.

In a typical performance examination report, potential fund managers will show both their gross rates of return as well as a hypothetical rate of return, which includes both management and incentive based fees. The returns presented are typically shown on a monthly and cumulative basis over the examination time period. Within the performance examination, managers also compare their strategy's rates of return to relevant benchmarks, such as the S&P 500 Index and one of the various hedge fund industry benchmarks, including Hedge Fund Research, Inc.'s HFRI Indices, in order to provide a framework to highlight their returns compared to those of the overall markets or their peers. Included with the performance examination returns are footnotes, highlighting the methodologies used to calculate the various returns, as well as the typical fees, such as annual management fees of 1.5% calculated on a monthly basis and annual incentive based fees of 20%. The calculation of returns net of various fees allows potential hedge fund investors to have a comparable basis for the returns they would have expected over that historical time period.

With a performance examination report issued by a public accounting firm, fund managers now have credible documentation of their track record in order to persuade potential investors. When it comes to presenting this performance information within a pitch book, fund managers would be wise to avoid common traps that inhibit effective communication with potential investors:

- **Trap #1: Leading with performance**
  Investors need to build a trusting relationship with you, not with your data. Focus on people before performance by telling your story first, making it personal yet succinct.

- **Trap #2: Showing rows and columns of data points without visual format or captions**
  Almost no one can distill a sea of returns or NAVs covering a page. Make it visual and easy to understand. First, graph your returns vs. both a passive and relevant hedge fund benchmark. Next, offer the key takeaway as a caption or headline, prominently displayed next to the graph.

- **Trap #3: Pitch books without required disclaimers**
  Many fund managers eager to "get to market" with their new deck may not have obtained compliance or legal review. However, each manager's own facts and circumstances may necessitate customized disclaimer language and placement of disclaimers in terms of front vs. back of pitch book and proximity to any performance data. Even the disclaimer font size may need adjustment. It's best to seek applicable review and apply requested edits prior to sharing the presentation with prospects.

A performance examination report issued by a respected CPA firm, along with a well-designed pitch book presentation incorporating a compelling message, will present a strong and persuasive case for potential investors to commit to your fund. For more information on how a performance exam and pitch book strategy can benefit your start-up hedge fund, please contact Daniel O'Connor at danny@richeymay.com or Stephen Vlasak at svlasak@richeymay.com. You may also visit our website at www.richeymay.com.

Alternative Investments

RICHEY MAY & CO

Alternative Investment Client Snapshot

We serve alternative investment clients that range in size from $1M to $2.5B and have clients in over 36 states. We work with funds utilizing a wide variety of strategies, including, but not limited to, the following: arbitrage, ABS, catastrophic bonds, convertible arbitrage, cryptocurrency, currency, day trading, derivative funds of funds, distressed debt, emerging markets, energy trading, event driven, fixed income, foreign currency, global macro, funds of funds, high yield, long/short, merger arbitrage, mortgage backed securities, reinsurance, risk arbitrage, situational, and structured finance.

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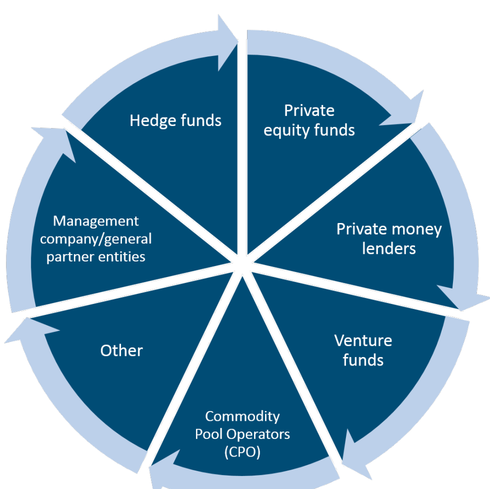
- Valuation consulting
- Surprise exams
- Fund document reviews
- Performance examinations
- Offshore Cayman filing requirement (FAR form assistance
- Individual tax returns

FUND STRUCTURES

- Fund of funds
- Master-feeder
- Mini-master
- Domestic fund
- Foreign fund
- PFIC
- '40 Act
- REIT



Cayman Island Office

Our Cayman Island office allows us to conduct audits of pooled investment vehicles, such as hedge funds, registered under the Cayman Island Monetary Authority (CIMA) Mutual Funds Law.

CAYMAN ISLANDS MONETARY AUTHORITY

Memberships

AICPA

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Accomplishments

Inside Public Accounting

- 2013 & 2014 Best of the Best Firms
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Stephen Vlasak, CPA

Director of Business Development
720.407.5549

svlasak@richeymay.com

9605 S. Kingston Ct., Suite 200
Englewood, CO 80112
www.richeymay.com