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Feehan Investment Management: Hedge fund or mutual fund?

Robert Pozen and Matthew Doherty wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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Feehan Investment Management (FIM) was a registered investment adviser to U.S. equity mutual funds, with $10 billion[[1]](#footnote-1) in assets under management (AUM) at the end of 2018. FIM advised two long-only equity mutual fund products, U.S. Large-Cap Value Fund and U.S. Mid-Cap Growth Fund.

In 2014, FIM had established a quantitative research group, or “quant group,”[[2]](#footnote-2) to incubate a long/short equity strategy (i.e., a strategy that involved buying equities that were expected to increase in value and short-selling equities that were expected to decrease in value). This investment strategy employed machine learning and web scraping[[3]](#footnote-3) to detect consumer sentiment and brand awareness, and used these alternative data sources to glean relevant qualitative information, such as the success of a new product launch or an increase in brand awareness. FIM then combined this information with other more traditional quantitative methods, such as technical analysis (i.e., using patterns in market data and charts to identify trends), to determine whether to buy or sell short the stocks, in anticipation that their detected patterns would be reflected in future stock prices.

By January 2019, the quant group had finished its third year of a pilot program with its long/short equity strategy. Over the three years, FIM’s long/short strategy achieved an annualized return of 6.5 per cent—despite FIM’s heavy reliance on shorting stocks (50–60 per cent of FIM’s portfolio represented short positions). While the new strategy had only slightly underperformed the small-cap index, the Russell 2000, which had an annualized return of 7.3 per cent, it had significantly outperformed the average hedge fund index,[[4]](#footnote-4) which had an annualized return of 3.55 per cent (see Exhibit 1).

Based on the three-year track record, chief executive officer (CEO) Megan DeAndrade decided to open this strategy to outside investment. However, she had another decision to make: the appropriate fund structure for this strategy.

Feehan Investment Management

FIM was founded in 1965 by Ricardo DeAndrade, in response to a growing trend of active investment management during the 1960s. Ricardo started FIM from a small office in Cumberland, Rhode Island, a town just outside Providence, and he would later relocate its offices to Boston’s Back Bay neighbourhood. Ricardo started FIM by managing and marketing its sole mutual fund, the U.S. Large-Cap Value Fund, to Rhode Island’s public and private pensions.

Throughout the 1970s and 1980s, FIM had achieved success in both performance and asset growth. FIM expanded its investor base beyond that of pension assets and started to garner interest from defined contribution plans in the corporate sector. Simultaneously, the bull market in the 1980s created increased excitement in the mutual fund industry, so in 1992, FIM launched its second mutual fund, the U.S. Mid-Cap Growth Fund.

FIM had seen its AUM skyrocket from $20 million in 1965 to $10 billion at the end of 2018. Roughly 80 per cent of FIM’s assets were held by retail clients, with an average fund account balance of $155,000. The remaining 20 per cent comprised high-net-worth accounts and a handful of institutional investors. Distribution of FIM’s mutual funds was done primarily through banks and financial advisers that could sell FIM’s two mutual funds through online platforms such as Vanguard or Charles Schwab.

In spite of his legendary value investor status, Ricardo was not the only reason for FIM’s success. While Ricardo was the face of the firm, he had made many important strategic team additions that were instrumental to the success of FIM. One important addition was his daughter and FIM’s future CEO, Megan, who had managed the U.S. Mid-Cap Growth Fund from its inception in 1992.

Megan DeAndrade’s Rise

Megan always wanted to follow in the footsteps of her father. She had attended Johns Hopkins University for her undergraduate degree and received her MBA from MIT Sloan School of Management in 1989. Megan had been interning at FIM throughout college and during her MBA years, so after completing her studies, she was ready to “hit the ground running” (i.e., assume her responsibilities). As the bull market continued through the early 1990s, Ricardo decided that it would be a good time to launch a growth fund and that it would be a great experience for Megan to manage the new fund.

At the time, Ricardo had underestimated the investor appetite for a growth strategy in FIM’s fund and he also hadn’t anticipated the success that Megan would have at the helm. FIM’s U.S. Mid-Cap Growth Fund grew from $500 million AUM in 1992 to more than $6 billion AUM at the end of 2018. Many people attributed Megan’s success in managing the growth fund to her analytical approach and her ability to predict the rapid adoption rates of emerging technologies, such as cloud computing and online advertising.

In 2012, Ricardo turned 72 years old, and FIM’s board had become aware that his outside interests were taking up more of his time than in prior years. Ricardo had handed off the daily portfolio management of the value fund to Kate Messinger, an analyst who had worked with him for years. Ricardo had also become a part-owner of a professional basketball team in 2010, and some FIM’s board members thought he spent more time at the arena than at FIM’s headquarters. FIM’s board of directors had suggested that Ricardo step down as CEO of FIM and named Megan CEO in 2012.

While this changing of the guard seemed to be a natural progression, this move had reputational implications. Ricardo had become known as one of the grandfathers of value investing. He had become famous for quotes such as “price is what you pay, value is what you get” and “it’s time, not timing, that makes money in the market.” FIM’s board was aware that losing Ricardo’s oversight might lead to substantial redemptions in FIM’s Large-Cap Value Fund. Nevertheless, FIM’s board was excited to see the direction that Megan would take their firm, especially given how much the investment management business was changing—as evidenced by more and more assets starting to be garnered through such strategies as passive index funds[[5]](#footnote-5) (see Exhibit 2).

Meeting between Megan DeAndrade and Jake Danforth

Megan assumed her role of CEO, making much-needed cultural and organizational changes to FIM based on her learnings from business school. Examples of these changes included more consistent and quantifiable peer review systems, a centralized research platform where idea generation was discussed collaboratively, and improving the matching program benefits in FIM’s retirement plan. Megan made another major change in 2014, when she established a quantitative strategies group within FIM, a move that was met with some resentment from FIM’s “old guard.” The genesis of this “quant group” was the increased media attention and investor appetite for such products, combined with Megan’s newly formed relationship with a fellow alumnus of MIT Sloan, Jake Danforth.

Danforth had an undergraduate degree from Tufts University in computer science and had graduated from MIT Sloan in 2010. Throughout business school, Danforth was focused on two things: machine learning and ocean surfing. Danforth was tall with blond hair and a weak beard; he was an avid surfer, often travelling to Narragansett, Rhode Island, to “catch the waves” at 4 a.m. before classes started. After graduation from MIT Sloan, Danforth took a job at National Aeronautics and Space Administration (NASA) to work in its machine learning group. Shortly thereafter, however, he realized he could earn a lot more money in the world of equity investing, especially given this field’s need for his skill set.

In 2013, after being introduced by a professor at MIT Sloan, Megan and Danforth met for lunch at Lavo in New York City. Although Danforth was still at NASA, he was interested in making a move to equity investing, where he could use his technical skills to predict patterns in stock prices. Megan explained to Danforth her ambition to start a quantitative equity investing group at FIM. She also wanted to know whether he could recommend any former classmates to help spearhead the group. Danforth responded:

I think that’s a great idea, especially given the rise of attention in quant investing. I am hoping to leave NASA soon to join a fund where I can focus on machine learning as it relates to equity investing. I actually have an idea for a very specific small-cap ($500 million–$2 billion market capitalization) strategy that I think will be profitable and scalable given the proliferation of non-traditional data sources in the equity markets. I’d love to tell you more about it and maybe this could be a good fit for both of us.

Danforth continued to explain his idea for this strategy. By the time Lavo’s famous fried Oreos arrived at their table for dessert, Megan and Danforth had shaken hands, and FIM’s quantitative strategies group was born. Danforth officially joined FIM in the summer of 2014 and began incubating the strategy.

FIM’s New Long/Short Strategy

Danforth’s strategy was based on web scraping, which essentially meant using “big data” to derive patterns and trends. The strategy would scrape the web, including investing blogs, television transcripts, and social media (e.g., Twitter, Instagram, and Reddit) to analyze consumer trends and glean information that would guide the strategy to execute trading decisions. Through the use of this non-traditional data source, Danforth’s strategy could detect brand deterioration or appreciation, new product excitement and adoption, and consumers’ sentiments toward specific companies. Using this information, along with other more traditional quantitative investing techniques, Danforth’s strategy would buy or short-sell the stocks in the market in expectation of better-than-anticipated earnings announcements or revisions in company guidance. Furthermore, his strategy employed machine learning to apply different weightings on the various sources of data based on their reputation and reliability of content.

For example, the strategy might scrape a Reddit video-gaming blog looking for sentiments regarding Take-Two Interactive Software, Inc.’s (ticker symbol: TTWO) new video game release, NBA 2K19. If the model picked up highly weighted contributors expressing better-than-anticipated sentiments (using previous version releases as a proxy) regarding the adoption and excitement of the new game, and other technical factors also supported the attractiveness of the stock, the strategy would buy TTWO’s stock.

Throughout the incubation period, the quant group realized that the strategy experienced the most success investing in small-cap ($500 million–$2 billion market capitalization) and mid-cap ($2 billion–$10 billion market capitalization) stocks, due to the dearth of sell-side analyst[[6]](#footnote-6) coverage and media attention. Alternative data sources had proven to be most relevant for investing in these types of companies where information pertaining to their product adoption was sparse. While this strategy focused on consumer sentiment, it was not limited to investing only in consumer discretionary stocks. The strategy was also applicable to telecom and technology stocks. The strategy’s portfolio consisted of three core components: directional long positions (30–40 positions) and directional short positions (20–30 positions), together with an opportunistic option overlay[[7]](#footnote-7) to hedge against market-wide tail risks.

In December 2015, FIM’s long/short strategy went live with a pilot program containing $10 million in internal funding. By the end of 2018, the strategy had accomplished significant success when compared with the average hedge fund returns over these three years. Megan was excited for the future of this strategy and had faith in Danforth’s ability to scale the strategy if and when the assets grew. But she had one key question left to resolve: Which fund structure should FIM use to implement this strategy—a hedge fund or an alternative mutual fund (also known as a liquid alternative fund)?

Regulatory Considerations

To help inform her decision, Megan asked FIM’s chief operating officer (COO), Ross Caple, to draft a memo comparing the two fund types. Caple outlined this comparison in a brief overview of the regulatory regimes for mutual funds (including liquid alternative funds) versus hedge funds.

As Caple explained, from a regulatory perspective, traditional (also referred to as long-only) mutual funds and liquid alternative funds were subject to the same set of legal requirements: both were mutual funds registered with the U.S. Securities and Exchange Commission (SEC). However, liquid alternative funds employed more strategies that were typical of hedge funds, such as short selling and using leverage.

Use of Financial Products

Based on Megan’s experience managing a long-only mutual fund adviser, she was aware of the regulatory differences between hedge funds and mutual funds (including liquid alternative funds). The *Investment Company Act of 1940* (the *1940 Act*) restricted mutual funds with respect to leverage and short selling—but without prohibiting either tactic (see Exhibit 3 for an overview of The *1940 Act* along with other relevant Federal Securities Acts). While uncovered short selling was a common investment technique used by hedge funds, mutual funds were allowed to sell short only when the short sale was covered by a liquid long position or a segregated cash account. According to the *1940 Act*, mutual funds were restricted in the amount of leverage they could take on, whereas hedge funds had no restriction on the amount of leverage they could use. Therefore, if FIM wanted to structure this strategy as a hedge fund, it would need to be eligible for an exemption from the *1940 Act*, under either section 3(c)(1) or 3(c)(7).

The Number and Type of Investors

These two *1940 Act* exemptions depended largely on the type and number of investors in the fund. To qualify for exemption from the *1940 Act*, the fund needed to have either fewer than 100 accredited investors,[[8]](#footnote-8) under section 3(c)(1), or unlimited investors, as long as they were all qualified purchasers,[[9]](#footnote-9) under section 3(c)(7). However, even if all investors were qualified purchasers, hedge funds could not have an unlimited number of shareholders. For a hedge fund to maintain its exemption from becoming a public reporting company under the *Securities Exchange Act of 1934* (the *1934 Act*), it needed to have a total of fewer than 2,000 total shareholders.

In conclusion, if FIM wanted to structure this strategy as a hedge fund and qualify for exemptions from both the *1934 Act* and the *1940 Act*, it needed to either keep its number of investor below 100, if they were all accredited investors, or below 2,000, if they were all qualified purchasers.

Redemptions, Liquidity, and Reporting

Under the *1940 Act*, mutual funds needed to offer daily liquidity to their investors who must be able to redeem at the fund’s net asset value (NAV). Due to these requirements, 85 per cent of an equity mutual fund’s assets needed to be liquid at all times. By contrast, hedge funds were exempt from the *1940 Act* and were therefore not subject to these requirements; however, they often had lock-up periods[[10]](#footnote-10) of one year or more. Hedge funds could also choose to invest in more illiquid securities since they were not subject to daily redemptions.

Under the *Securities Act of 1933* (the *1933 Act*), mutual funds were required to use a standardized methodology for reporting their performance on a monthly basis. If they made only private offerings, hedge funds were exempt from the *1933 Act.* Therefore, they could choose when to report their performance and could include whatever information they chose. Furthermore, all registered investment companies were required to report their portfolio holdings to the SEC each month. Every registered fund needed to file an “N-PORT” form with the SEC no later than 30 days after the end of each month, and the SEC released these filings to the public 60 days after the fund’s most recent fiscal quarter.[[11]](#footnote-11) Hedge funds were not required to comply with this reporting requirement.

Governance and Taxation

Mutual funds needed to abide by stricter governance rules than hedge funds. Mutual funds were required to have boards with a majority of independent directors, while hedge funds did not need to meet this requirement. Hedge funds were almost always structured as limited partnerships, where the fund manager was the general partner and the investors were all the limited partners.

From a taxation standpoint, both mutual funds and hedge funds were pass-through institutions. A tax pass-through meant that the fund paid no corporate tax at the entity level; instead, the fund passed all dividends, interest, and capital gains on to its owners.

Compensation

While the *1940 Act* regulated the behaviour of the fund as an entity, the *Investment Advisers Act of 1940* (the *Advisers Act*) regulated the behaviour of the fund manager. All advisers to mutual funds—and to any hedge funds with more than $150 million AUM—were required to register under the *Advisers Act*. The *Advisers Act* laid the foundation for one of the most significant differences between hedge funds and mutual funds: performance fees. Rule 205-3 of the *Advisers Act* allowed hedge funds to charge asymmetric performance fees if all of their investors were qualified clients.[[12]](#footnote-12) Conversely, if managers of mutual funds charged performance fees, they needed to be symmetric under the *Advisers Act*. For example, if a mutual fund charged a performance fee of 10 basis points when it outperformed an index by 20 per cent, it must also reduce its management fee by 10 basis points when it underperformed the same index by 20 per cent.

Megan asked Caple to provide some standard fee terms for FIM’s new strategy if it were to be structured as a hedge fund (see Exhibit 4). Caple suggested the following terms:

*Base fee*: Annual management fee equal to 1.5 per cent of AUM

*Performance fee*: 20 per cent of net profits above a 5 per cent annual return hurdle[[13]](#footnote-13)

Caple also highlighted that if FIM structured this new long/short strategy as an alternative mutual fund, its management fee would likely be 1 per cent of AUM (see Exhibit 6). While this management fee was less than the management fee for a hedge fund structure, it was far greater than the average management fee of FIM’s existing long-only mutual funds, which charged between 50 and 60 basis points per year.

FIM’s Investment Committee Meeting

It was a cold day in Boston when FIM’s Investment Committee met to discuss the future fund structure of its new long/short strategy. In attendance were Megan (CEO), Zann Guglin (chief financial officer), Caple (COO), Kristin Sperry (chief marketing officer), and Danforth (head of Quantitative Strategies).

Megan began the meeting:

Thank you everyone for coming, I know we’ve been discussing this amongst ourselves all week but I wanted to get everyone on the same page as it relates to what fund wrapper to structure our new L/S [long/short] strategy in. Does anyone have any thoughts?

Caple was the first to break the silence:

I’d like to start by saying that while this strategy is certainly different from our traditional mutual funds, the strategy itself is well within the guidelines laid out by the *1940 Act*. The *1940 Act* allows us to use options for hedging, allows the investment in illiquids as long as 85 per cent of the fund is liquid and allows us to short stocks as long as we have a tri-party agreement and pledge collateral. I don’t see a reason that this can’t be structured as an alternative mutual fund from a regulatory standpoint.

“I’d like to jump in here, Ross,” said Guglin.

I don’t think we are debating whether or not it can be structured as a liquid alternative, it’s whether or not we want it to be. If we structured this as a hedge fund we’d have the benefit of stickier capital, no limits on leverage or the need for custodial arrangements, and not to mention the economics surrounding the fee structure [see Exhibits 7A and 7B]. If this is successful, it could be a significant commercial opportunity for FIM.

“I think the key phrase that you just used is *if this is successful*,” exclaimed Sperry from the other end of the table.

We want to be mindful of the probability of success when it comes to fundraising. We have earmarked potential AUM of $500 m [million] for the hedge fund strategy, but what if we can only raise half of that? We also want to think about the potential conflicts of interest managing both entities, for instance, how would we allocate hot IPOs [initial public offerings]? What if the growth fund wanted more shares because of their size but the performance fees make it attractive to allocate more to the long/short strategy?

“I agree, Kristin,” said Caple.

If we structured this as a hedge fund we would only be able to market this to accredited investors or ultra-high-net-worth individuals, which makes up a small fraction of our investor base. Furthermore, if we are questioning the ability to raise $500 m for the hedge fund structure, we should also consider the impact to the firm if we were only able to raise half of the liquid alternative structure as well. However, from a distribution standpoint we have all the necessary infrastructure pieces in place to hit the ground running with the mutual fund strategy. If it were structured as a hedge fund we would essentially need to start from scratch from a distribution standpoint.

Sperry replied:

Well, to be clear, we could market this to whoever we would like. We could advertise on Instagram if we wanted, due to the recent changes from the *JOBS Act*.[[14]](#footnote-14) However, we would only be able to accept qualified purchasers, to your point. Also, I agree, the distribution for the hedge fund is outside of what we are familiar with; however, I suppose the question is whether the potentially attractive fees make it worth the effort to create a new sales platform for this structure.

“Jake, where do you stand on this?” asked Megan.

Danforth responded, “Well, to be honest, the structure itself is not going to impact my ability to execute this strategy that much.” Danforth explained:

Even though the *1940 Act* restricts my use of leverage, that is not a big part of the strategy, if at all. The most important things to me are the ability to use options and short stock, which it seems that I can do in either structure. The one thing I would like to avoid, though, is disclosing my short positions. Also, from a fee perspective, it seems the liquid alternative angle is the worst of both worlds, more restrictions and less fees. Just my two cents. It seems I would be able to manage this regardless of the structure.

Sperry jumped back in:

I’m not sure it’s the *worst* of both worlds. From a marketing perspective it’s the *best* of both worlds. It’s an alternative strategy that we can market to a retail base that is craving access to hedge fund-like investments that they are normally shut out from. Not to mention the fees that they would pay are double what we get from our long-only products.

Sensing that a decision needed to be made, Megan wrapped up the meeting. “Ok, thank you everyone for your input. I’ll keep everyone filled in on the decision and let you all know the next steps shortly.”

Decision Time

After the meeting, Megan was uncertain which fund structure to use. Hedge fund fees and locked-up capital sounded attractive, but would FIM realistically be able to raise enough assets from institutions that were qualified purchasers—especially given FIM’s lack of historical relationships with these types of investors? What would be the cultural implications and conflicts of interest to have a hedge fund exist within a mutual fund complex?

Megan walked back to her office, sat in her chair, and pondered both sides of the decision. She was aware of the importance of this decision, which could have cultural, reputational, and economic ramifications for the future of FIM.

EXHIBIT 1: Hedge Fund index versus Equity Indexes, Annualized Returns ending December 31, 2018

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Annualized Net Returns | | | | |
| Term | HF Index | S&P 500 Index | Russell 2000 Index | FIM L/S |
| 10 years | 5.95% | 13.10% | 11.95% | – |
| 5 years | 2.71% | 8.48% | 4.40% | – |
| 3 years | 3.55% | 9.24% | 7.34% | 6.50% |

Note: HF Index = Hedge Fund Index; S&P 500 = Standard & Poor’s 500; FIM L/S = Feehan Investment Management long/short strategy

Source: Barclay Hedge Fund Index, S&P 500, Russell 2000, “Stock Prices for Equity Indexes,” Bloomberg L.P., accessed May 17, 2019.

EXHIBIT 2: Active versus Passive Assets Under Management, 2008–2018

|  |  |  |
| --- | --- | --- |
| Aggregate U.S. Equity AUM | | |
|  | Active | Passive |
| 2008 | 1.8 | 0.7 |
| 2009 | 2.3 | 0.8 |
| 2010 | 2.6 | 1.0 |
| 2011 | 2.5 | 1.1 |
| 2012 | 2.7 | 1.3 |
| 2013 | 3.6 | 1.9 |
| 2014 | 3.8 | 2.2 |
| 2015 | 3.6 | 2.3 |
| 2016 | 3.7 | 2.8 |
| 2017 | 4.2 | 3.6 |
| 2018 | 4.2 | 3.9 |

Note: AUM = assets under management

Source: Active Equity AUM, Passive Equity AUM, Morningstar Inc., accessed May 17, 2019

EXHIBIT 3: the Structure of U.S. Federal Securities Laws

The *Securities Act of 1933*: This act sets forth the disclosures required in the prospectus delivered to investors when companies or funds make a public offering of securities, and delineates when the offering is not considered public. The act—also known as the “Truth in Securities” law—requires that investors receive financial information when securities are being offered for public sale.

The *Securities Exchange Act of 1934*: This act regulates the U.S. trading markets for public securities, including anti-fraud provisions, establishes criteria for public companies, and delineates their periodic reporting obligations. The act granted the U.S. Securities and Exchange Commission (SEC) broad authority to regulate all aspects of the securities industry.

The *Investment Company Act of 1940*: This act defines an investment company, including its exemptions from registration, and establishes a detailed regulatory framework to be followed by registered investment companies.

The *Investment Advisers Act of 1940*: This act defines investment advisers, including their exemptions from registration, and establishes a detailed framework for the relationship of registered investment advisers to their clients.

These four acts are administered by the SEC, which has the power to define the terms, issue rules, and enforce the requirements of these four acts.

Source: Created by the authors.

EXHIBIT 4: Feehan Investment Management’s Potential Hedge Fund Term Sheet

|  |  |  |  |
| --- | --- | --- | --- |
| **Anticipated AUM** | $500,000,000 |  |  |
| **Minimum Investment** | $1 million | **Legal Counsel** | TBD |
| **Management Fee** | 1.5% per annum | **Custodian** | TBD |
| **Performance Fee** | 20% of net profits above 5% annual return hurdle | **Administrator** | TBD |
| **Subscriptions** | Monthly on first business day | **Auditor** | TBD |
| **Redemptions** | 1-year lock-up | **Vehicle** | FIM L.P. |
| **Marketing Strategy:** Market to endowments, pensions, institutional investors. Leverage relationships with third-party allocators and fund of funds to garnet assets. | | | |

Note: AUM = assets under management; TBD = to be determined; FIM L.P. = Feehan Investment Management Limited Partnership

Source: Created by the authors.

EXHIBIT 5: Hedge Fund Hurdle Rate Example (in US$ millions)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Fund AUM | $500 |  |  |  |
|  | **Hurdle Rate (5%)** | **FIM L/S Fund Performance** | **AUM** | **Performance Fee** |
| Year 1 | $525 | (10%) | $450 | $ |
| Year 2 | $550 | 30% | $585 | ? |

Note: AUM = assets under management; FIM L/S = Feehan Investment Management long/short strategy; A hurdle rate establishes a minimum return (e.g., the federal funds rate plus 200 basis points) that the fund must exceed before the performance fee is earned. This rate is usually a benchmark interest rate such as the rate for 5- or 10-year U.S. Treasury bills. The underlying concept is that an investor could earn this rate with relatively low risk, and the hurdle rate represents the opportunity cost of investing that money elsewhere. The hurdle rate above is calculated as 5 per cent of the initial investment ($500 million) per year, with no compounding. Given that the fund did not outperform 5 per cent in year one, its performance fee would be $0.

Source: Created by the authors.

EXHIBIT 6: Feehan Investment Management’s Potential Liquid Alternative Term Sheet

|  |  |  |  |
| --- | --- | --- | --- |
| **Anticipated AUM** | $1,000,000,000 |  |  |
| **Minimum Investment** | $1,000 | **Legal Counsel** | TBD |
| **Management Fee** | 1% per annum | **Custodian** | TBD |
| **Performance Fee** | None | **Administrator** | TBD |
| **Subscriptions** | Daily | **Auditor** | TBD |
| **Redemptions** | Daily | **Vehicle** | *1940 Act* fund |
| **Marketing Strategy:** Leverage existing investor base. FIM’s existing investor base is made up of 80% retail investors that are looking for diversification and alternative investments, marketing channels already in place. | | | |

Note: AUM = assets under management; TBD = to be determined; FIM = Feehan Investment Management; *1940 Act* = *Investment Company Act of 1940*

Source: Created by the authors.

EXHIBIT 7A: Revenues for each fund type based on Projected Assets under management, the Management Fee, and the Performance Fee

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Hedge Fund** | | | **Alternative Mutual Fund** | | |
| AUM | $ 500,000,000 |  | AUM |  | $1,000,000,000 |
| Management Fee | 1.50% | $7,500,000 | Management Fee | 1% | $10,000,000 |
| Return above Benchmark | Performance Fee | Total Revenue  (Perf Fee + Mgmt Fee) |  |  |  |
| 1% | $1,000,000 | $8,500,000 |  |  |  |
| 2% | $2,000,000 | $9,500,000 |  |  |  |
| 5% | $5,000,000 | $12,500,000 |  |  |  |
| 10% | $10,000,000 | $17,500,000 |  |  |  |

Note: AUM = assets under management; Perf Fee = performance fee; Mgmt Fee = management fee

Source: Created by the authors.

EXHIBIT 7B: Revenues for each fund type based on 50% of Projected Assets, the Management Fee, and the Performance Fee

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Hedge Fund** | | | **Alternative Mutual Fund** | | |
| AUM | $250,000,000 |  | AUM |  | $500,000,000 |
| Management Fee | 1.50% | ? | Management Fee | 1% | ? |
| Return above Benchmark | Performance Fee | Total Revenue (Perf Fee + Mgmt Fee) |  |  |  |
| 1% | ? | ? |  |  |  |
| 2% | ? | ? |  |  |  |
| 5% | ? | ? |  |  |  |
| 10% | ? | ? |  |  |  |

Note: Note: AUM = assets under management; Perf Fee = performance fee; Mgmt Fee = management fee

Source: Created by the authors.

1. All currency amounts are in US$. [↑](#footnote-ref-1)
2. A quant group referred to a team that used statistical and mathematical methods to derive investment strategies. [↑](#footnote-ref-2)
3. Web scraping was the process of extracting data from websites, and could be used to derive patterns in large data sets. [↑](#footnote-ref-3)
4. The hedge fund index referred to the Barclay Hedge Fund Index (Ticker: BGHSHEDG). [↑](#footnote-ref-4)
5. Passive index funds were investment funds designed to track an index or portfolio. [↑](#footnote-ref-5)
6. A sell-side analyst was an equity research analyst who worked for a brokerage firm and produced research and/or placed recommendations on stocks and other securities for the use of the brokerage firm’s clients. [↑](#footnote-ref-6)
7. This opportunistic option overlay consisted of consistently rolling six-month, 10 per cent out of the money SPY and IWM puts (a put option with a strike price 10 per cent lower than the market price of the underlying asset) to hedge against significant market downturns. SPY and IWM are both ETFs (Exchange-Traded Funds) that can be used to track their respective indexes, the S&P 500 index and the Russell 2000 index. Both SPY and IWM are highly liquid securities, which make them attractive for hedgers. [↑](#footnote-ref-7)
8. As per the *(1940 Act)*, an accredited investor was defined as one of the following: (1) an individual with net worth, or joint net worth with a spouse, in excess of $1 million; (2) an individual with income in excess of $200,000, or joint income with a spouse in excess of $300,000; or (3) a bank, insurance company, registered broker–dealer, or investment company, or employee benefit plan with assets in excess of $5 million. [↑](#footnote-ref-8)
9. As per the *1940 Act*, a qualified purchaser was defined as one of the following: (1) a person, or company owned by two or more persons who are related as siblings or as spouses, with at least $5 million in investments; (2) any person, acting for his or her own account or the accounts of other qualified purchasers, who owns and invests on a discretionary basis at least $25 million in aggregate investment; or (3) a trust that was not formed for the specific purpose of acquiring the offered securities, in which the trustee and each contributor meet either of the two previous criteria. [↑](#footnote-ref-9)
10. A lock-up period was a window of time during which investors were not allowed to redeem or sell their shares in an investment. [↑](#footnote-ref-10)
11. U.S. Securities and Exchange Commission, *Investment Companies Reporting Modernization*, January 17, 2017, accessed July 1, 2019, www.sec.gov/rules/final/2016/33-10231.pdf. [↑](#footnote-ref-11)
12. As per the *Advisers Act*, a qualified client was defined as a person or company that had at least $750,000 under the management of the investment adviser; or a person or company that had a net worth of more than $1.5 million; or a person or company that was a qualified purchaser. [↑](#footnote-ref-12)
13. This 5 per cent annual return handle was known as a “hurdle rate.” For more information on hurdle rates, refer to Exhibit 5. [↑](#footnote-ref-13)
14. The *JOBS Act* referred to the *Jumpstart Our Business Startups Act*, which intended to encourage the funding of small businesses in the United States by relaxing some of the regulations that impacted small firms. One of the changes from the *JOBS Act* was to allow hedge funds to market their funds to the general public, not just accredited investors. This amendment did not, however, change the restrictions on the type of investors hedge funds could accept while still maintaining exemption from section 3(c)(1) or section 3(c)(7) of the *1940 Act*. [↑](#footnote-ref-14)