5 Five Common Challenges Emerging Managers Underestimate

The good news about these challenges is that if you have them, it likely means you are growing. The bad news is that these problems, if unchecked can delay your rate of growth or in extreme cases can even prevent it altogether.

1 Average Pricing Can Get Difficult – Quickly.

Using Average Pricing is the obvious and easy choice to reduce tracking error and simply your trade flow process. But many managers are surprised to find out how difficult, time consuming, and even error prone using APS can be when adding markets to the strategy or taking new investments.

From 100 MPH to Zero

Unlike equity markets where average price systems (APS) are ubiquitous and second nature, futures markets have many pitfalls that can bring a manager's expansion plan to a screeching halt under the right circumstance. In fact, under-estimating futures APS complexity frequently happens to even larger managers, particularly long-short equity PMs who might assume that APS in the futures and options space is as simple as it is for other asset classes.

Different markets have different rules about the ifs, whats, and whens of average pricing. What's worse, different brokers interpret these rules differently, meaning that adding new markets to your trading strategy might be a completely different process for the same strategy at two different brokers. Managers often are surprised to learn that the APS process that works at one broker has to be shelved because they take on a new managed account with a broker who interprets the rules differently.

The futures industry is slowly adapting but many managers still can't keep up. The CME Group recently clarified it's transparency requirements (rule 533) for Average Pricing, but in the short term this actually imposed additional problems for some managers who trade multiple groups a day.

Price Isn't Everything

Pari-Persu is more than just averaging the trade price. To achieve true cost averaging, you need to make sure that the clearing, execution, and exchange fees are also distributed. If a trading strategy uses multiple venues (such as two or more brokers with different rates or a mixture of voice and electronic), it can often be difficult to manage average price allocations. Even then, your fund accountant or administrator might have a tough time reconciling multi-venue averages because each booked trade might represent two or more fee schedules.

2 Trade Flow Isn't Just an Investor Requirement Anymore

Your trading volumes are way up and you've brought on a few new managed accounts to your preferred brokers. But the broker wants to *raise* your commission rates. What gives? While counter-intuitive, this uncommon situation does happen and when it does it is usually with managers who have underestimated the toll of trade flow on their broker partners. If supporting your trading activity is labor intensive for your broker, adding more trades to the process might force them to make their own costly changes to support the business.

Traditionally, 80%-90% of a prime broker's account onboarding process has been spent on credit, legal, and compliance. Operational Due Diligence was more of a process between a manager and his investors than between him and his providers. But with increasing external and internal pressures, clearing brokers – especially the larger FCMs – are taking a much more active role in vetting the trade flow of CTAs before trading is allowed and accounts are opened.

3 The Fine Print on "Straight Through Processing"

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Straight Through to Where?

It pays to be specific. A deal keeping / risk solution might perform functions in the front, middle, and back office realms, but only in the context of its own eco system. What happens when you need to integrate your allocation workflow with your executing brokers? Does the solution have connectors for your risk management system, or is it only "straight through" if you use its own risk system? In fact, most "straight through" systems might produce content, but the devil in the details is how to get that content where it needs to go. Some Electronic Trading front ends sell allocation tools, but those tools only generate the allocation instructions. It is up to you to get your executors to take the output from your provider's tool and integrate it.

Scope Creep

An ugly secret of financial service providers is the monetization of "scope creep." There is nothing wrong with clearly defining the boundaries with your providers; agreeing to the appropriate scope of service protects you as much as it does your provider. They key is define your boundaries in a way that doesn't penalize growth. Does your allocation system allow you to add new brokers without additional cost? Are you entitled to your fund administrator's newer reports as they become available, or just the ones when you signed up?

4 Cyber-Security Can't be Outsourced

This is a provocative statement because relying on outside experts for Information Security is both commonplace and even encouraged for small to midsize businesses. In the 2017 FINRA Cybersecurity Symposium, the organization reiterated that using certain outside providers can be a prudent move.

However, no amount of outsourcing can eliminate cyber-security risk. Large investors know it, regulators know it, and criminals depend on you under-estimating this fact. The CFTC, FINRA, SEC, and other organizations provide templates for cyber-security documents, but the manager who merely fills out the template and forgets about it in a desk drawer is most vulnerable to reputational risk and cyber-theft.

Many cyber-criminals realize that the easiest way to break into large organizations is through "soft" targets. Managers might think that their emerging status doesn't put them on the radar grid of hackers, not realizing the reality that they possess a treasure trove of data hackers then turn around to gain access to others.

In over half the cases, it isn't even about computer viruses and technology. The most damaging cyber-security threats to emerging managers come from people impersonating your investors or bankers--- trying to get you to send them a statement with an account number on it or gleaning some piece of personal information about someone. It might seem innocuous, but threats like these can cause immeasurable reputational damage.

5 Catching Trade Breaks Doesn't Mean What it Used To

Everyone knows that getting a handle on trade breaks is critical to any COO's mandate—regardless of whether the process is automated vs. manual or done in house vs. outsourced.

Too many managers, however, don't have comprehensive enough controls. And many managers who rely on their administrators or accountants for these controls may be surprised to learn what *isn't* being routinely checked.

Merely checking that broker positions are in synch with the PM's trade blotter, for example, might miss problems with trading costs. Investors and auditors, aware of recent high-profile incidents regarding broker commission and fee mis-charge scandals, want better assurances that more checks and balances are in place.

Many due-diligence and audit processes will ding a business just as severely for having an inadequate control process as not having a control process at all. If you've answered "yes" to a diligence question asking if you have adequate safeguards to protect against reporting accuracies but then later in the process fail to address a comprehensive plan, your "yes" could turn into a red flag and prompt even further scrutiny on other processes.

This is not to say that every manager must think of every possible discrepancy and have an automated solution in place. Manual spot-checking, sampling, and using a combination of solutions in a control process is still a wide practice in even the largest organizations.

5 Avoiding Common Mistakes

Think about trade flow early in the process

No one needs the perfect process from day one, but surviving due-diligence, regulatory, and audit requires you to think strategically. Managers who have plans for how to take on new accounts and markets in advance see quicker and less expensive onboarding and expansion costs.

Don't take Average Pricing for granted

Even relatively minor changes might cause big headaches for your operations team. Bring your experts into the loop.

Select your vendors with growth in mind

The best partnerships don't address today's needs but rather next year's needs. Advances in technology should allow you to scale up your business without drastically increasing your administration, IT, or accounting costs, but only if you are smart enough to think of scale when you sign your contracts.

Make your organization think about security every day

Just because you have documented industry standard procedures or use outside experts to advise you on security doesn't mean that you won't be held responsible by your investors when problems arise. Consider using independent penetration tests and continuing education, even for small shops.

Smart procedures beat more procedures

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