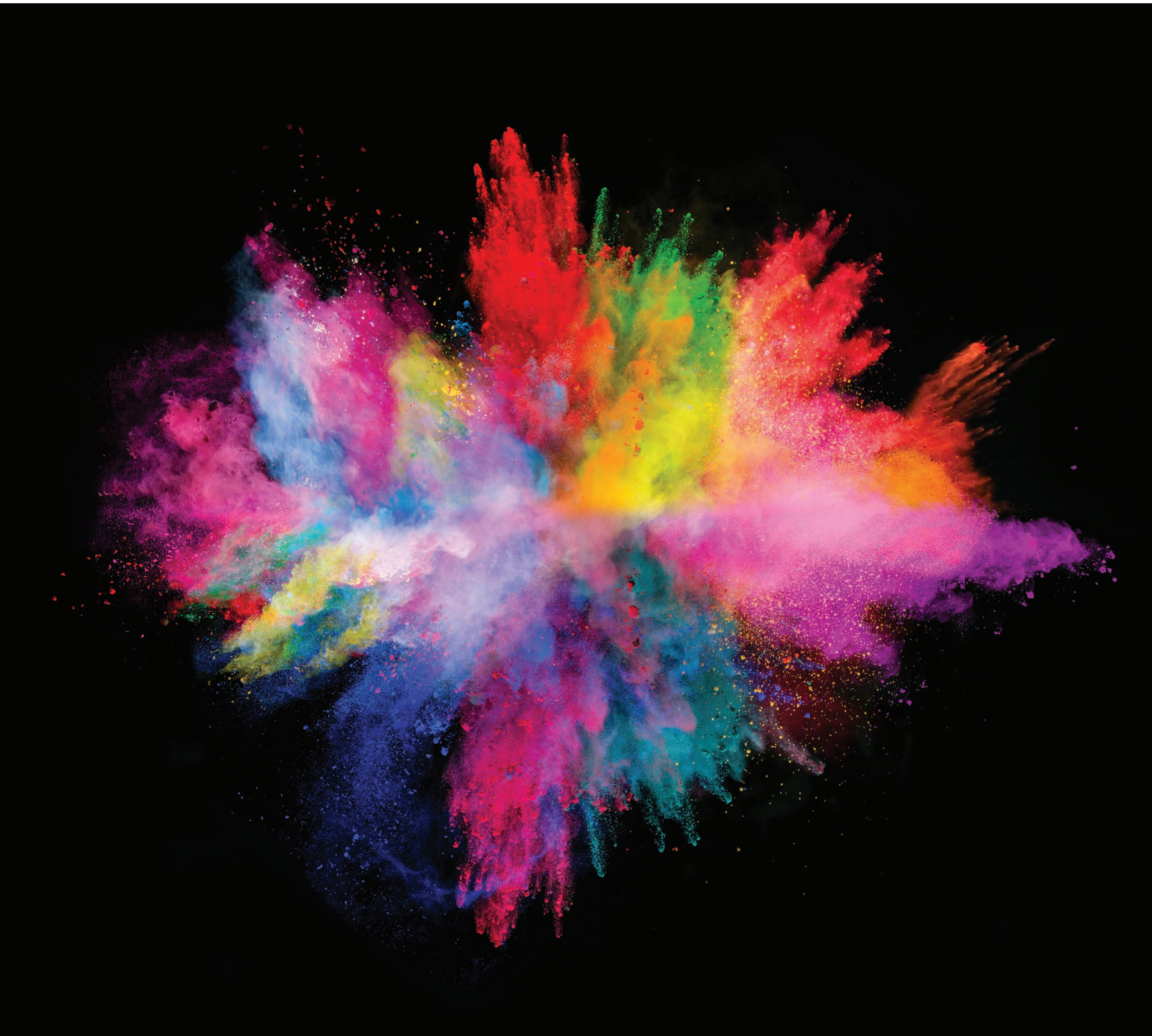
Alive&Kicking

AIMA/GPP Emerging Manager Survey 2017
The next generation of hedge fund firms



Contents

Foreword

Imagine for a moment that the hedge fund industry contains three parallel sectors, divided not by investment strategy or geography but by size of firm. One includes firms managing $1bn or more in assets - there are 703* of these accounting for 88%* of the total hedge fund industry AUM. This group's star managers feature regularly in the pages of The Wall Street Journal and the Financial Times. Many of its constituents are big institutionalised businesses and its clients include some of the largest institutional investors in the world, such as sovereign wealth funds and public pensions. It contains only a little more than 10% of the industry in terms of numbers of firms but manages close to 90% of the assets.

Much attention focuses on the "billion-dollar club" and firms close to attaining this status. Industry research and performance indexes tend to be skewed to the larger firms. Consultants' lists of approved hedge funds are dominated by the larger brands. The second sector contains firms managing between $500m and $1bn – there are 319* of these managing 6%* of the total hedge fund industry AUM. Its investor base includes large institutions but family offices and funds of funds are more prevalent. Many of its constituents are building brands and thinking about the steps they need to take to exceed the $1bn threshold.

Then come emerging managers - those that AIMA define as having AUM of up to $500m USD – there are 2052* of these, also managing 6%* of the total hedge fund industry AUM. These managers feature many entrepreneurs and start-up businesses. They are often the cradle for the industry's innovations. Yet much less is known about these smaller firms. Until this research, we did not know, for example, that the average break-even point for sub-$500m firms is about $86m – or that a third of these firms run profitable businesses with less than $50m in assets. This is a significant finding, since other surveys - of the industry as a whole – have suggested that the average breakeven figure is several hundred million dollars. Those data points were heavily influenced by the largest businesses in our industry. It stands to reason that a firm with hundreds of employees and institutional clients in numerous jurisdictions would cost substantially more to run than, say, a five-person outfit managing assets for a small number of clients (as well as its own money).

Our research also sheds new light on the impact of broader trends and themes on this segment of the industry, such as fee pressures, the impact of post-crisis regulations, demands for ever greater methods of alignment of interests, and the optimum mix between in- and out-sourcing.

Smaller hedge fund firms comprise an essential constituency for both our organisations. Sub-$500m firms make up about two-thirds of AIMA's fund manager members, while GPP is of course a leading prime broker for small and mid-sized hedge funds. We are pleased to be working together to provide insights into this important community, which reflect both the industry's past, when hedge fund firms were generally smaller and more reliant on investment from family offices and funds of funds, and its future.

Jack Inglis, CEO, AIMA

Sean Capstick, Head of Prime Brokerage, GPP

* Number of hedge funds and AUM sourced from Preqin, June 2017

Executive summary

Sample: We surveyed 135 small and emerging hedge fund managers worldwide with $16bn in combined AUM. Half of the sample are five years old or less. We also spoke to 25 institutional investors. About three-quarters of managers we surveyed fall into the big six categories: equity long/short; global macro; fixed income/credit; CTA/futures; event-driven; and multi-strategy. The rest include niche strategies such as risk premia, big data-driven investing, trade finance, long-only options, and special situations.

The findings are categorised into four areas: profitability; fees and expenses; operational challenges; and growth.

Profitability: Surveys of the industry overall have suggested that hedge fund firms need to manage several hundred million dollars in assets in order to break even. But those averages can be skewed by data from larger firms. Among respondents to our survey, the average breakeven point is around $86m, while around a third are able to break even with $50m in assets or less. By strategy, breakeven is highest for global macro hedge fund firms ($132m) and smallest for credit hedge fund firms ($77m).

At the same time, the costs of regulation continue to weigh on smaller firms, with almost 90% of respondents allocating up to one-fifth of their total expenditure to compliance, with this number expected to increase when firms adhere to MiFID II.

Fees and expenses: Our findings show that the 2&20 fee structure is less common among smaller managers. In terms of the management fee, only 14% charge 2% or more and about half charge 1.5% or less. For new fund launches, management fees among sub-$500m managers are now only 1.25% on average. In terms of performance fees, about two-thirds of smaller managers are charging less than 20%. About three quarters (77%) expect performance fees to remain unchanged over the next year; 11% expect a decrease and 12% expect an increase.

Methods of aligning interests between smaller managers and fund investors are growing. Close to 90% of funds have a high watermark – a peak value above which performance fees can be charged. Roughly one-in-three have hurdle rates – a further trigger for performance fees agreed between the manager and investor. And while less common, 8% of smaller managers say their flagship fund provides fee clawbacks to investors under certain conditions.

Operational challenges: Legal services are the most outsourced function - only 16% have this as an in-house resource. COO, marketing/IR, risk and compliance functions are more likely to be filled by in-house roles, with 88% or respondents having an in-house COO.

Growth: More than 80% of respondents plan to increase their headcount in the next 12 months. Half of those intend to increase staff numbers by up to 50% over the coming year. Plans for increases were particularly common amongst those managing equity long/short, event driven and multi-strategy funds.

Two-thirds of managers' primary method of capital-raising is via marketing and IR activity, followed by presenting at conferences (37.5%) and working with a third-party marketer (34%). A further 14% say they are pursuing seed funding.

Methodology

In conducting this survey, we reached out to small and emerging manager hedge funds (defined as those managing less than $500m in assets) to understand better how they are balancing fees and costs, whether they are outsourcing or hiring dedicated personnel, and how they are growing and differentiating themselves in the current environment.

In addition to the above, we surveyed various hedge fund allocators to help us understand better their views and expectations on the emerging manager universe.

1

Hedge fund manager survey with input from 135 hedge fund managers globally representing approximately $16bn in assets under management (AUM)

2

Input from global investors including pension plans, endowment and foundations, and fund of hedge funds, who allocate up to $79bn to hedge funds.

3

Input from AIMA's Next Generation of Managers Working Group during a series of round table meetings to discuss initial findings.

Demographics of respondents: emerging managers at a glance

$16bn

Total assets under management (AUM)

$133m

Average AUM

56%

Proportion that have been established within the past five years

49%

Proportion of hedge fund managers with more than one fund

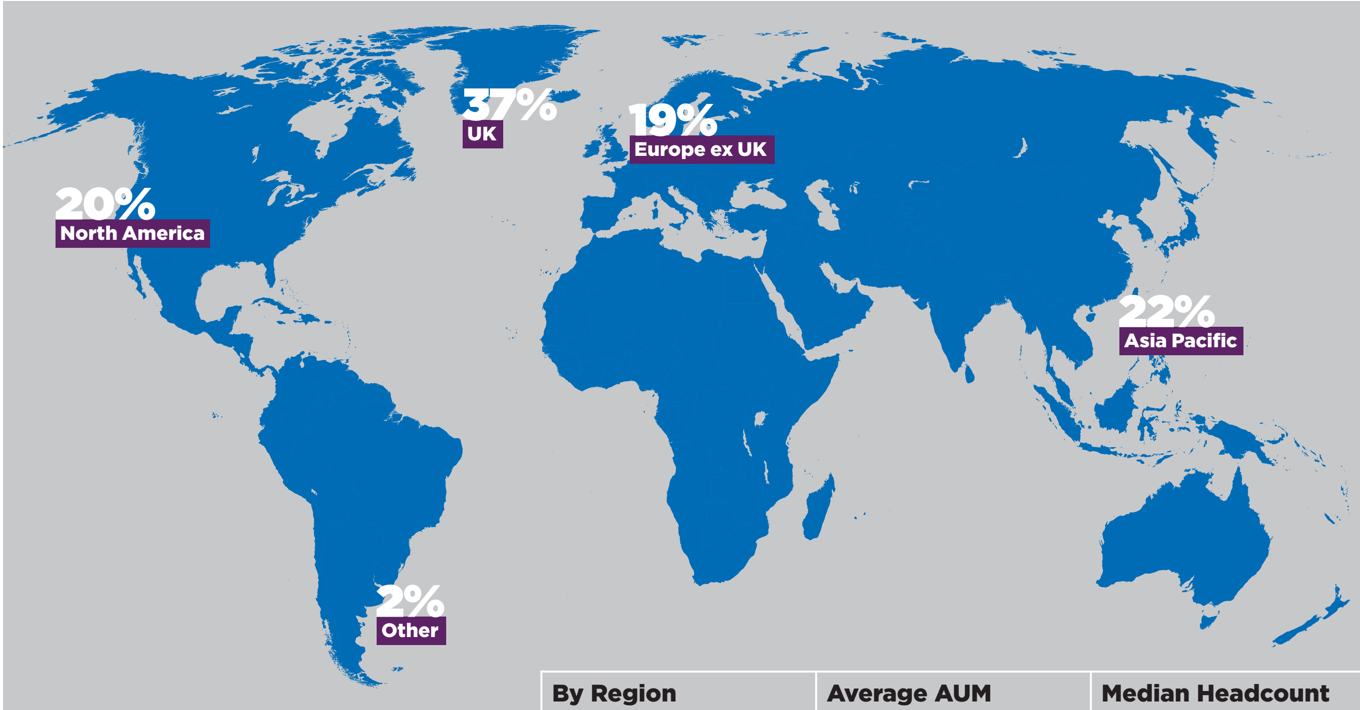
Across the 135 small and emerging managers who responded to this survey, 119 disclosed their AUM, the average AUM being $133m (with a median AUM of $97m). At the lower end of our scale, our smallest manager respondent has just $100,000 and currently has 4 employees while our largest manager respondent had total AUM of $482m with 15 employees, while our largest firm by headcount has a total of 100 people with AUM of $106m.

56% of the hedge funds surveyed have been established in the past five years, and have an average headcount of seven. The average number of employees for the total sample is eight.

When asked to select the best description of their firm, 49% would consider themselves to be a start-up or entering the transitional period from start-up to established firm.

Emerging manager respondents by region

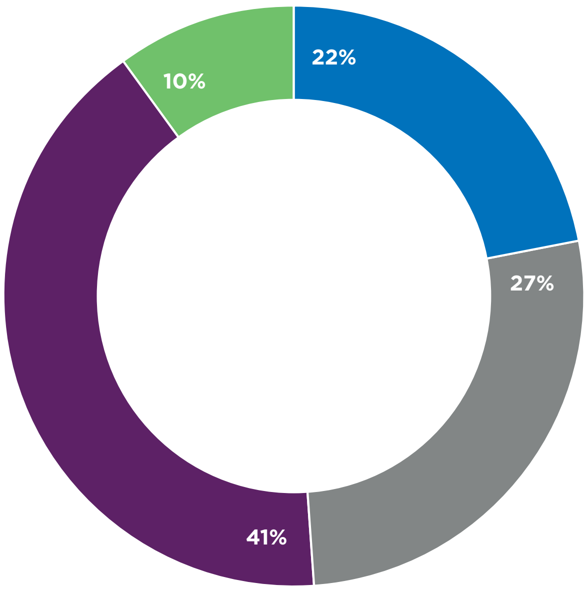
Figure 1: Regional breakdown or respondents by location, AUM and headcount



By Region	Average AUM	Median Headcount
North America	$ 145,068,000	5.5
Europe ex-UK	$ 117,086,000	5.5
UK	$ 133,405,000	8.0
Asia-Pacific	$ 134,582,000	6.0
Rest of the world	$ 141,285,000	7.0

Figure 2: Which of the following best describes your firm?

- Start-up
- Going beyond start-up and looking to establish ourselves
- Established with ambitions to grow the business beyond $500m AUM
- Established but are unlikely to be able to grow the business beyond $500m AUM



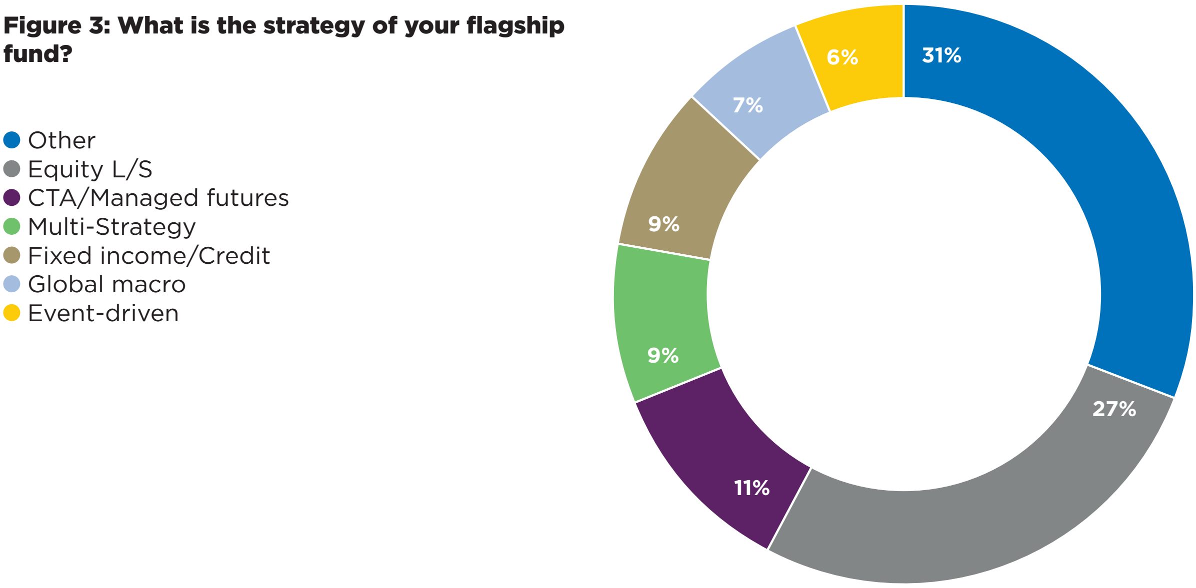
Emerging manager respondents by strategy

Mainstream hedge fund strategies still dominate, but there's a wide range of niche strategies

69% of respondents have flagship funds that fall into the six mainstream strategies we selected, namely equity long/short, global macro, fixed income/credit, CTA/managed futures, event-driven and multi-strategy. The lion's share (27%) of respondents have equity long/short funds, with CTA/managed futures being the next largest category (11%). Of the remainder, the 31% of respondents who have 'other' strategies reflects at least a perceived need for some emerging managers to be seen to be doing something different and carve out a niche strategy or provide a specific solution for their investor. Upon closer examination of these types of strategies listed in more than a quarter (28%) of this population could be categorised as part of the mainstream group of hedge fund strategies.

As shown in the table in Figure 3, the largest average hedge fund AUM is in the global macro ($177m) hedge fund universe, followed by event driven ($152m) and then multi-strategy ($148m); the latter group having the highest headcount (average 18, median 10).

Figure 3: What is the strategy of your flagship fund?



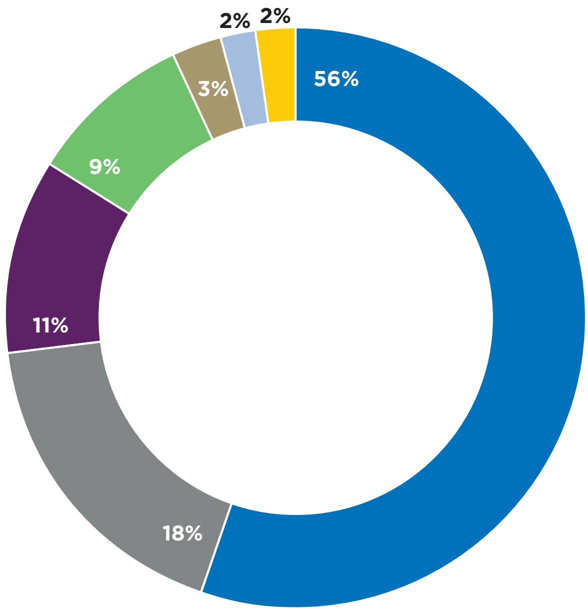
By Strategy	Average AUM	Median Headcount
Equity L/S	$128m	6
Global macro	$177m	9.5
Fixed income/Credit	$146m	9
CTA/Managed futures	$91m	5
Event-driven	$152	8
Multi-Strategy	$148m	10
Other	$23m	5

Emerging manager respondents by liquidity

The majority (56%) of emerging managers run strategies with monthly liquidity terms. Quarterly terms are the next most common, with 18% of respondents offering these terms. Only 11% currently offer daily liquidity on their fund product.

Figure 4: What are the liquidity terms that you offer in your flagship fund (How frequently can investors request a redemption)?

- Monthly
- Quarterly
- Daily
- Weekly
- Annually
- Semi-annually
- Closed



Demographics of respondents: allocators at a glance

25
Allocators responded

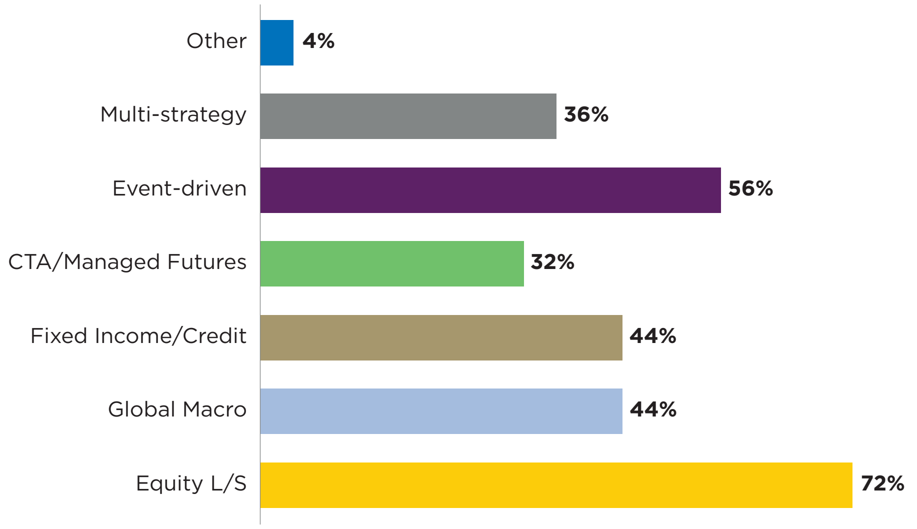
>$500bn
Total assets under management (AUM)

$79bn
Of which is allocated to hedge funds

44%
Proportion that allocate $1bn+ to hedge funds

Allocator respondents by strategy

Figure 5: What strategies were most prominent in your 2016 allocations?

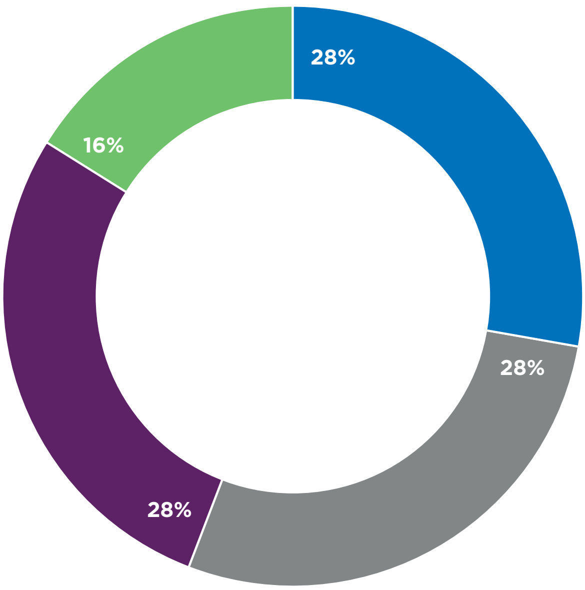


Allocator respondents by size of allocation

Out of the allocators who responded to this survey, 44% allocate more than $1bn to hedge funds. Each range of AUM is represented fairly equally, with 28% allocating up to $250m, 28% allocating from $251m up to $1bn and a further 28% allocating more than $2bn to hedge funds.

Figure 6: What is the total AUM you have to allocate to hedge funds?

- $1m-$250m
- $251m-$1bn
- $2bn+
- $1bn-$2bn



Profitability
Breaking even is doable

Making a profit is the key aim for any business. A crucial milestone to meet in delivering profit is being able to break even[1] in the first instance. As with any start-up business, this is especially pertinent. Businesses of all types that are starting out incur a high burn-rate on their working capital. Hedge funds are no different. That said, the firms that participated in this survey suggest that cost containment within these early years is achievable.

Figure 7: What is the breakeven AUM for your business?

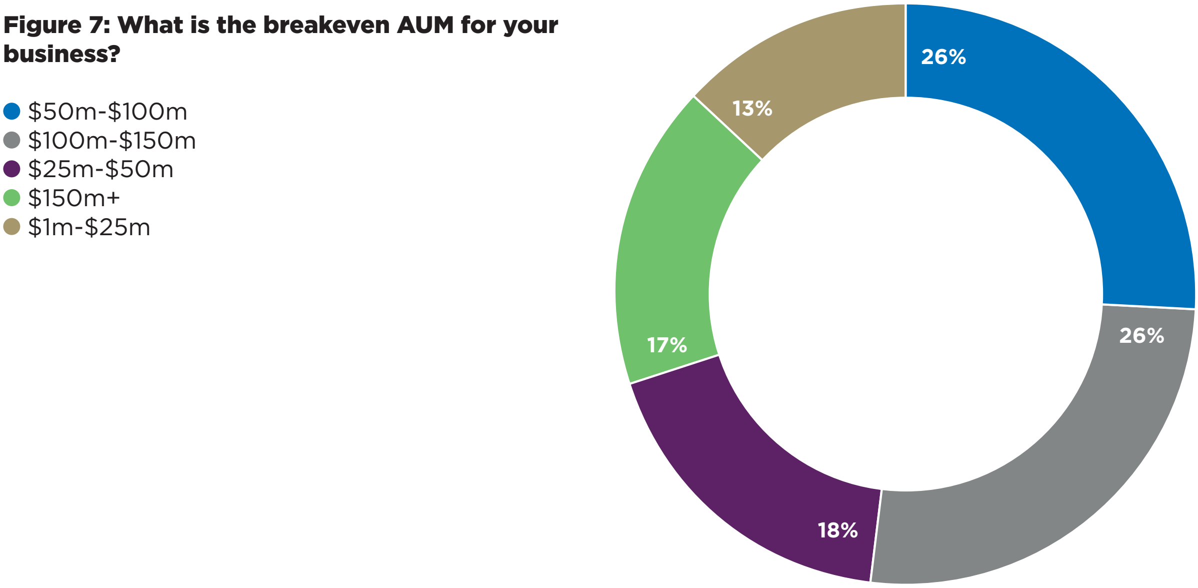
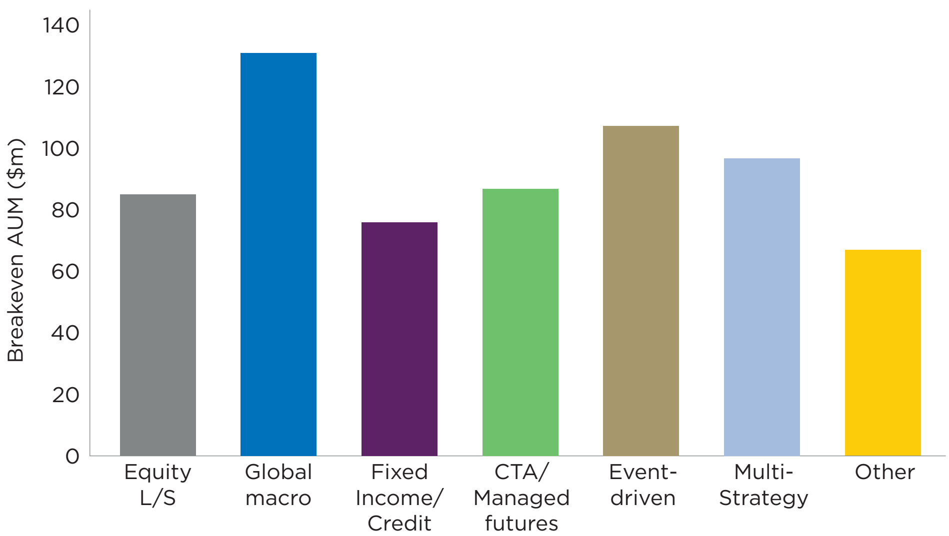


Figure 8: Average breakeven by strategy



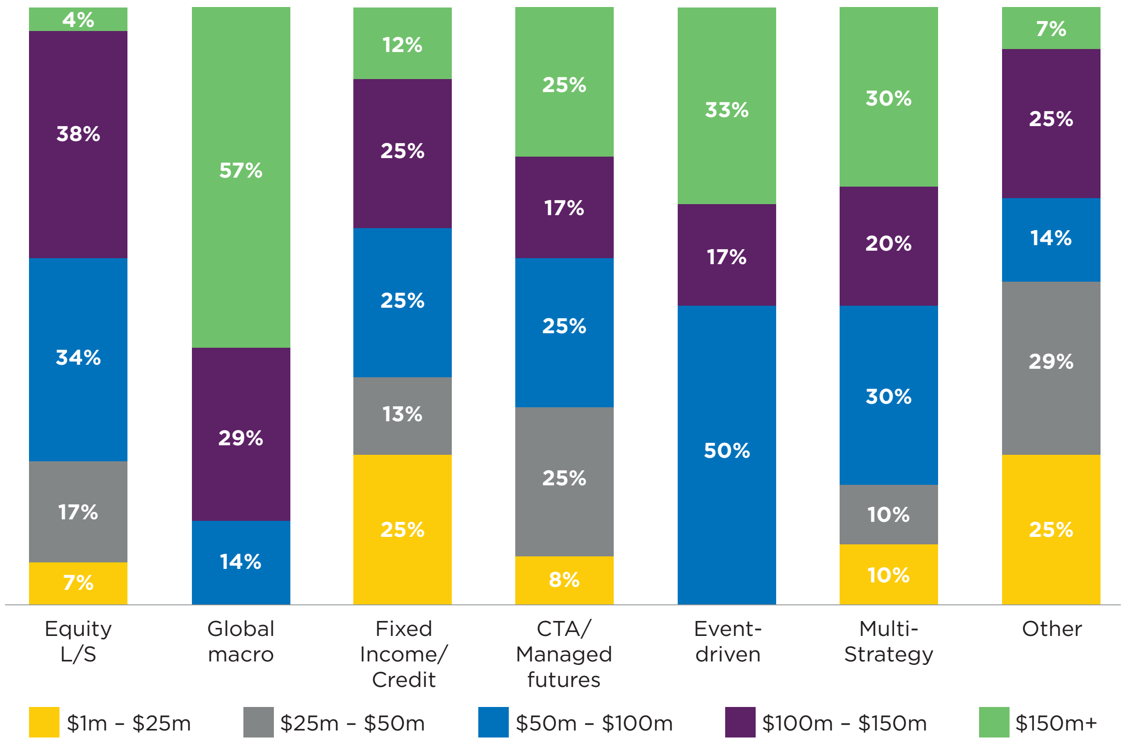
1 The amount of total revenue required to cover the total costs needed to operate the business.

Profitability

Across the firms that we surveyed, global macro managers stand out as the most expensive hedge fund business to operate, with an average breakeven of $132m. Making up the top three most expensive hedge fund businesses (according to their strategy) were event-driven strategies, which had an estimated breakeven of $108m, followed by multi-strategy hedge funds with an estimated break-even of $98m.

Each of these strategies have among the highest number of employees (or headcount) on average. The weighted-average, median headcount for global macro was the highest of all strategies with the average firm employing 12 people. In comparison, CTA/managed futures, which are typically more computer automated and systematic in nature and need less human capital, have a more competitive break-even level. The average CTA that responded to this survey had a staff size of just three people.

Figure 9: Breakeven point by strategy



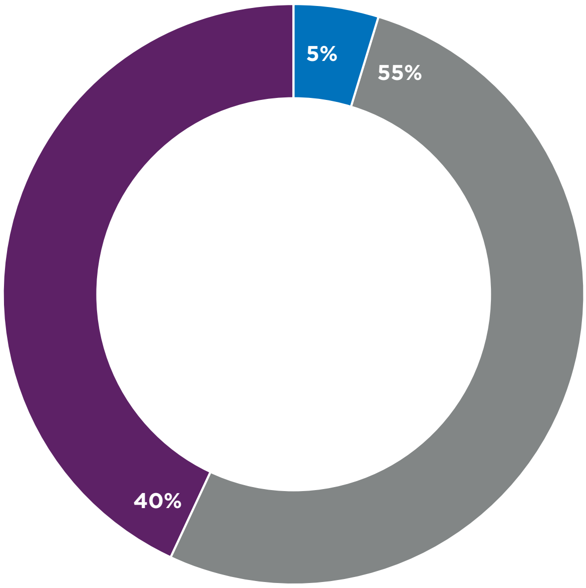
Will the breakeven point change?

An absolute majority (55%) of firms believe that their breakeven point will remain the same. In contrast, approximately 40% expect their breakeven level to increase while just under 5% expect it to decrease.

Despite the majority of respondents anticipating that their firm's breakeven is unlikely to change, one may be tempted to exercise some caution, especially for those managers who are required to be MiFID II compliant (starting from next year). Perhaps, another cost challenge that some managers may need to consider (particularly any UK based managers) is the impact that Brexit may have on their business and their ability to carry out business in any new regime outside of the EU.

Figure 10: How do you anticipate the firm's break-even point to change?

- Decrease
- Stay the same
- Increase



Fees and expenses

Fees

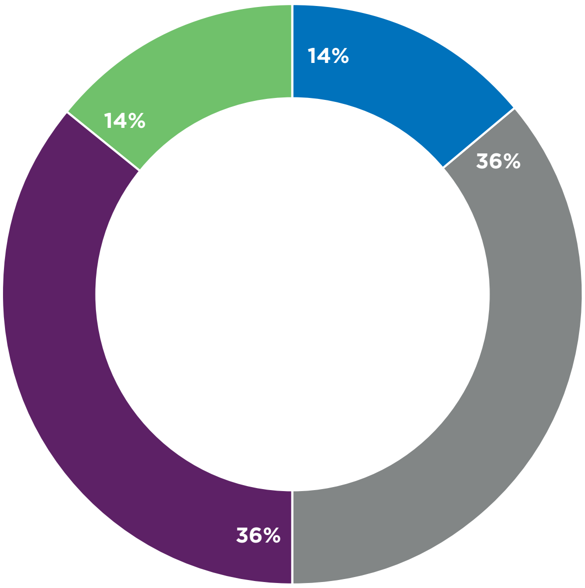
Across the industry as whole, hedge fund fees have been the subject of increasing scrutiny, but managers and investors are showing their willingness to work with various structures to align with investor demands better and help ensure that their businesses remain viable[2].

When we asked what the typical management fee[3] that small and emerging managers were charging to their investor, we observe fee pressure being most acute for start-up managers. In contrast, the findings from this survey reveal greater resilience from some of the more established managers. Overall, metrics to support the performance fee[4] seem more resilient.

Management fees: Half of emerging managers charge a management fee in excess of 1.5%, but pressure is beginning to show for start-ups

Figure 11: What are the management fees being charged by your flagship fund?

- 0%-0.99%
- 1%-1.49%
- 1.5-1.99%
- 2%+



While the 2% management fee is being tested, 14% of all respondents are charging 2% or more (predominantly the more established managers) while half are working off a management fee of 1.5% or greater, and 86% are charging a minimum of 1% of their AUM as a management fee.

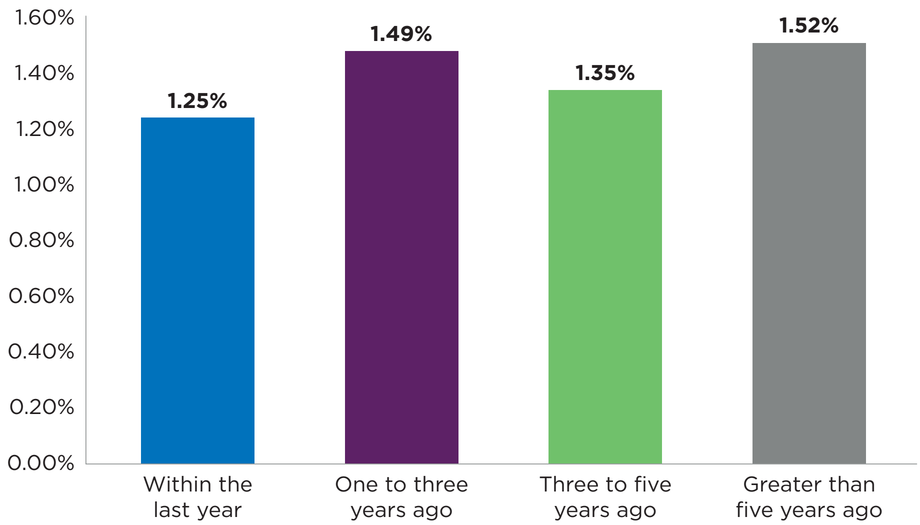
2 To read more on this discussion, please see AIMA's "In Concert, Exploring the alignment of interests between hedge fund managers and investors. (Oct 2016) www.aima.org.
3 A charge levied by the investment manager for managing an investment fund. The charge is based on a percentage of the fund's total net asset value at the time when the fee becomes payable.
4 Payment which is made to the fund manager in return for them generating positive returns, the performance fee is generally calculated as a percentage of investment profits, often both realised and unrealised.

The highest management fee, with the average rate being in excess of 1.5%, is being charged in the group of managers whose funds were launched more than five years ago. This perhaps tells us that as firms become more established, the larger firms are in a stronger position with respect to new inflows from end investors.

At the other end of the spectrum, we observe fee pressures being most acute among the hedge fund start-up respondents. The average management fee across this population is 1.25%. Some of the smallest managers are having to offer very competitive management fees.

Management fees: Half of emerging managers charge a management fee in excess of 1.5%, but pressure is beginning to show for start-ups

Figure 12: Average management fee based on the launch of flagship fund



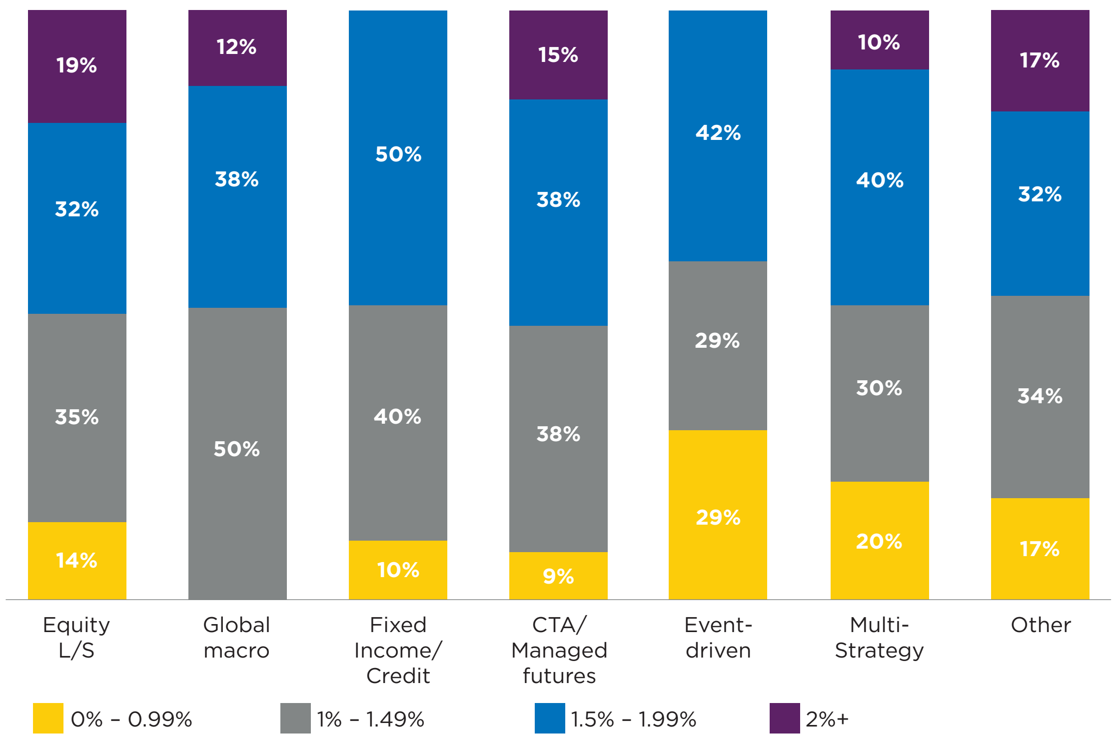
By Management Fee Range	Average AUM	Median Headcount
0%-0.99%	$ 69m	5
1%-1.49%	$ 146m	6
1.5-1.99%	$ 122m	5
2%+	$ 178m	8

Digging deeper into the management fee by strategy

Breaking the analysis down further, figure 13 below shows the average management fee charge (as per the representative hedge fund strategies that have contributed to this survey) to be between 1.4%-1.5% of the firm's total assets under management.

Hedge fund firms that pursue global macro investing charge the highest management fees with an average management fee charge of 1.53% (of total assets under management) while event driven strategies charge the lowest management fees, with an average charge of 1.25% of assets under management. In the case of the latter group, there were no hedge funds greater than five years established, while only one hedge fund launched in the past three to five years.

Figure 13: Management fee breakdown by strategy



Throughout the course of our conversation with managers who responded to this paper, they mentioned that they were experiencing pressure to justify their management fee as their AUM increases and have been asked to consider ways to compromise on this cost.

One such concession being considered is a tiered fee arrangement between the manager and investor. This is where investors pay a higher management fee to begin with to the hedge fund firm, but as the latter's business increases in size (as a measure of its total assets under management) and specific milestones are met, managers will reduce the management charge accordingly. Most investors are cognisant that emerging and start-up managers need their initial full management fee to keep the business going throughout the early stages.

What price for the next big allocation?

We asked our manager group whether they would be willing to adjust their management fee and, if so, what would be the size of investment (as a percentage of the fund's total assets under management) that would prompt them to do so.

Size of allocation: The findings show that the majority of respondents would adjust their management fee; 35% would adjust it in return for an allocation equivalent to 25% or more of the fund's current AUM and 16% in exchange for somewhere between 10%-24.99% of current AUM.

42% of respondents would not alter the management fee for an allocation of any size.

Figure 14: In return for what percentage of the flagship fund AUM would you adjust the management fee?

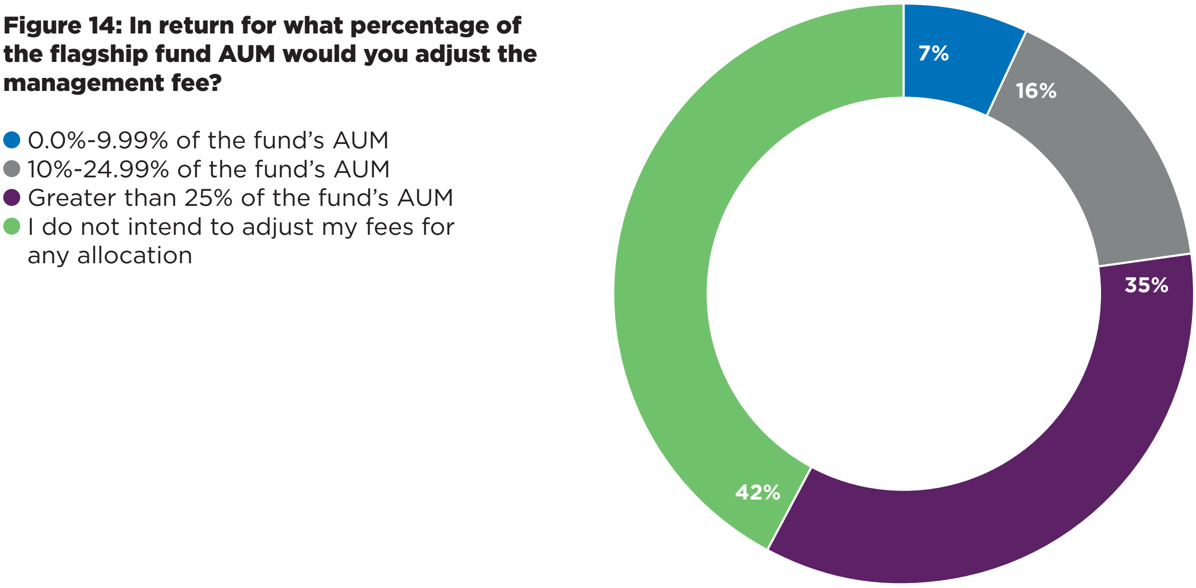
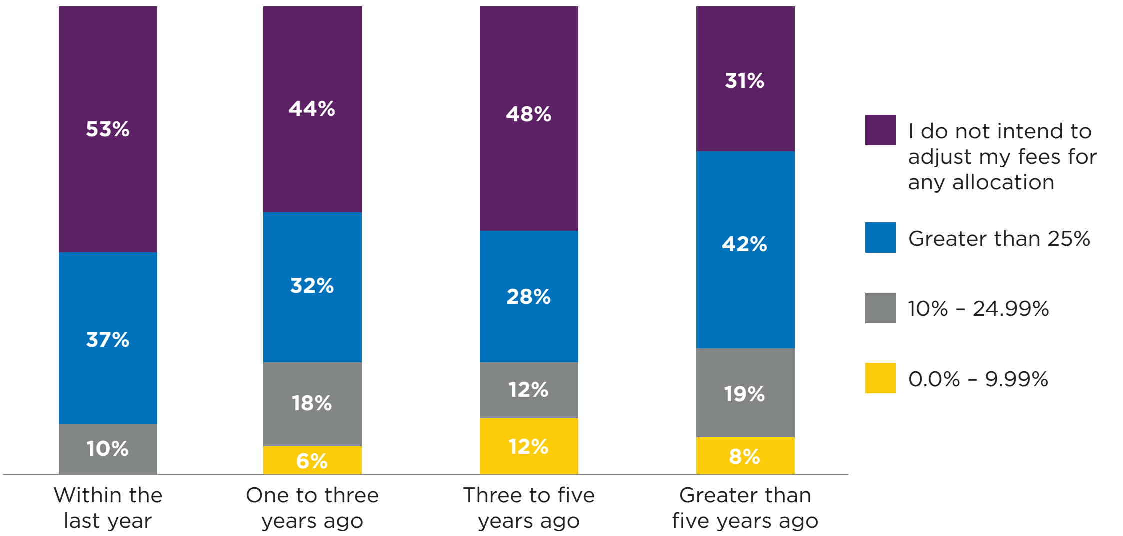


Figure 15: Willingness to adjust management fee for a proportion of the fund AUM by when launched



53% of those launching funds within the last year would not adjust fees for any allocation. This contrasts with those managers who have been in business for some time, where 42% of those with funds launched more than five years ago would adjust fees for a sizeable allocation greater than 25% of AUM.

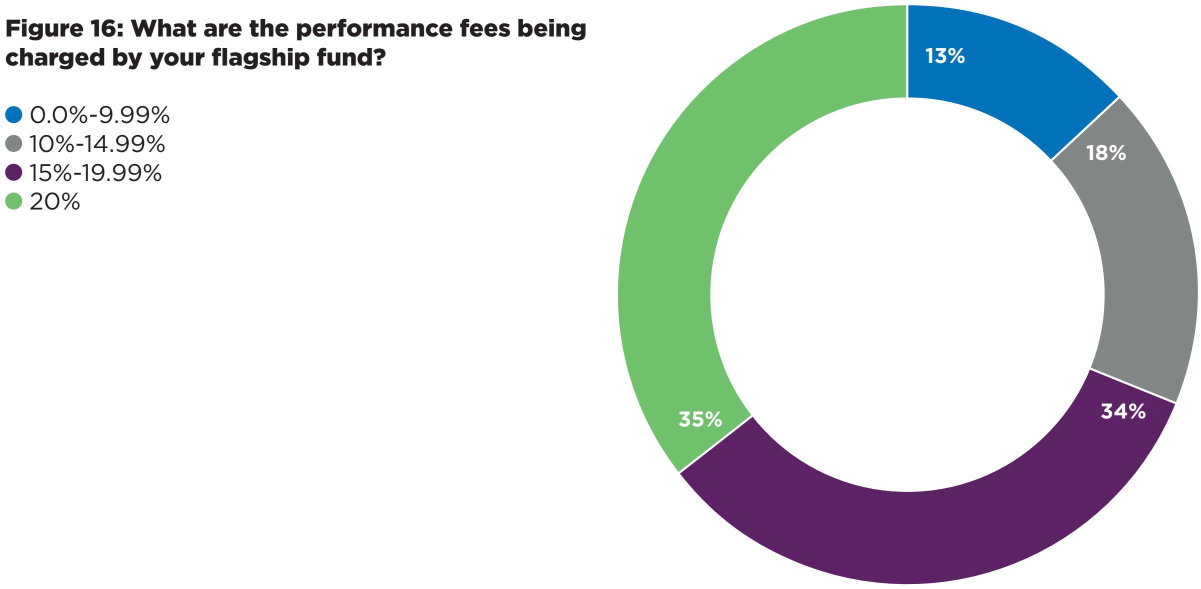
Fees and expenses

Performance fees: while there has been some pressure on management fees, incentive (or performance) fees are relatively unchanged

68% of the emerging manager respondents to the survey cite performance fees (incentive fees on performance) over 15% and over a third receive 20% or more from their investors. This clearly shows the trend of allocators looking for alignment with their managers – a willingness to pay for performance, the variable cost, while minimising the fixed costs of the management fee.

Asked whether they think that their performance fees are likely to come under pressure, almost 80% of our respondents anticipate having to make no change. 12% anticipate that they may increase their performance fee over the coming year. When we asked managers as to why some are considering to raise their performance fees, they suggested that this might be perhaps indicative of the changing fee environment where managers agree to a higher performance fee to offset potential management fee reductions being considered by investors[5].

Figure 16: What are the performance fees being charged by your flagship fund?

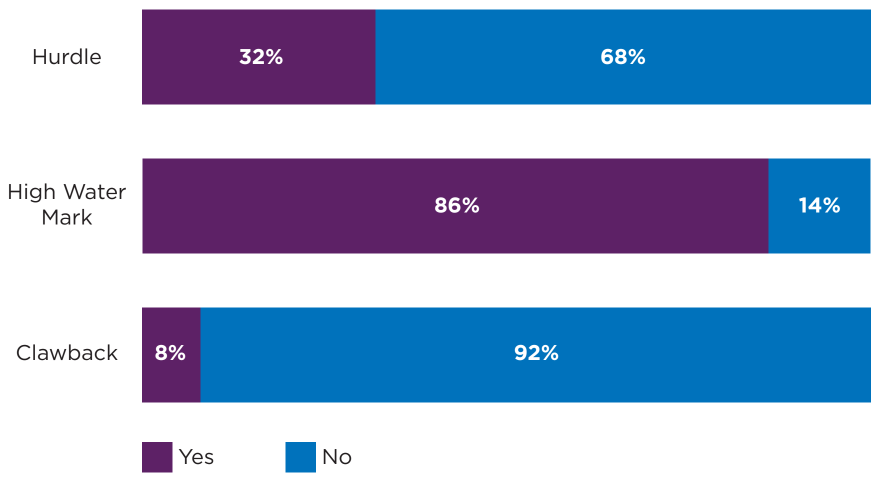


5 The AIMA "In Concert" paper explores how investors and managers are looking at new performance fee structures.

Fee structures are evolving to align manager and investor interests

We discussed with managers the other tools that are being considered to moderate performance fees, including deploying a high watermark, hurdle rate and clawbacks.

Figure 17: What pricing mechanisms does your flagship fund include?



Our analysis reveals that emerging managers are adapting their fee structures to meet with investor demands.

The majority of the respondents to this research (86%) reported to have a high watermark in place in their funds[6]. Close to one third are using a hurdle rate, while 8% have agreed to a clawback arrangement[7].

6 The basic premise of the high watermark is that if the fund drops in value, investors do not pay the performance fee again until the fund's value reaches its previous peak value.
7 A hurdle rate (sometimes called a preferred return or benchmark) means the fund is not allowed to charge a performance fee until a certain minimum return is achieved over an agreed level.

Fees and expenses

Figure 18: Average performance fee by strategy

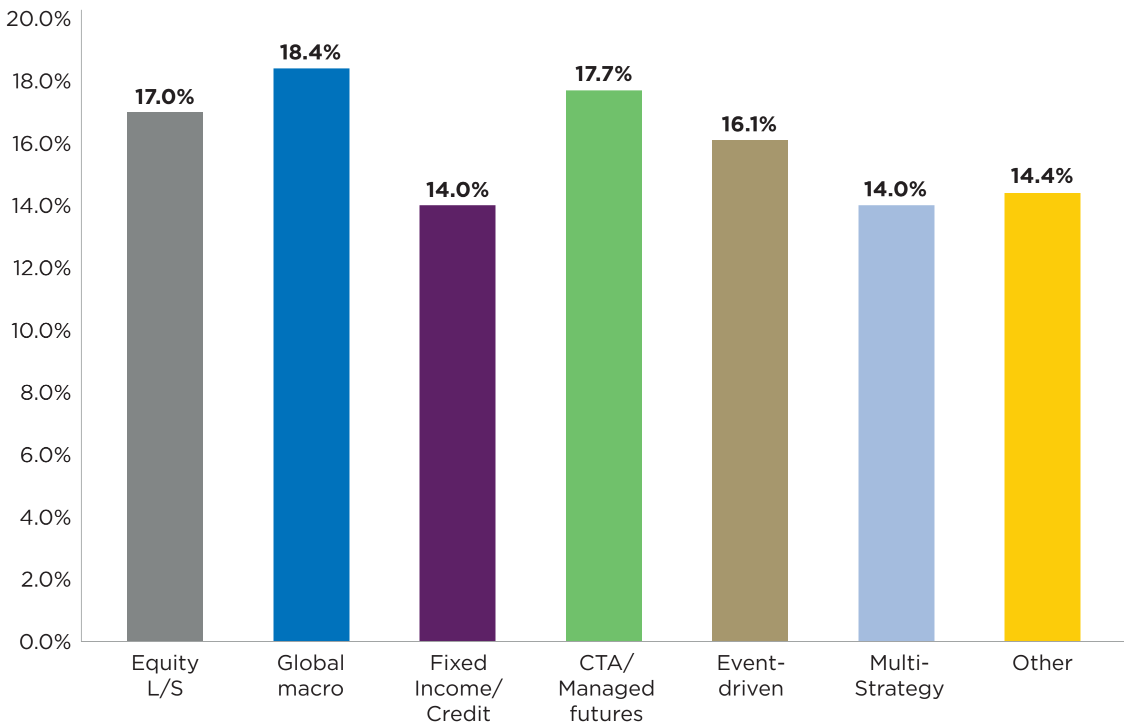
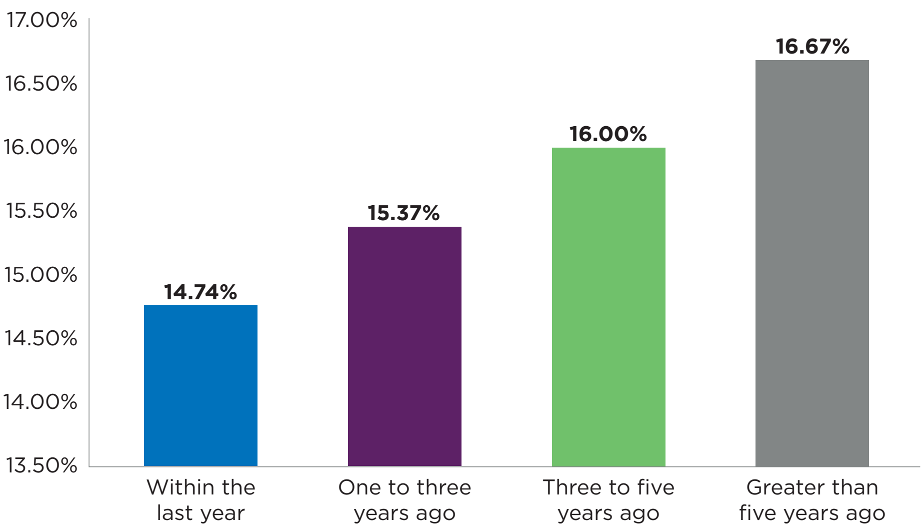


Figure 18 provides an overview of the average hedge fund performance fee charged across the hedge fund taxonomy that we surveyed. Hedge fund strategies that are commanding the highest performance fees include global macro, CTA/managed futures and equity long/short funds. Further, all of the funds within this group have been established a minimum of five years.

Perhaps this is indicative of the more traditional hedge fund strategies being able to maintain the 20% performance fee threshold which was set by their industry peers in previous years. Fixed income and multi-strategy hedge fund strategies have the lowest performance fees. The majority of funds within this group established their funds within the last five years.

Figure 19 shows that the average performance fee is higher (around 17%) for hedge funds launched by emerging managers over five years ago and that the younger strategies have not been able to command the historic, higher performance fees.

Figure 19: Average performance fee by when the flagship fund was launched



In Figure 20, we can see the majority of our respondents (77%) expect little change in their performance fees going forward.

Figure 20: Over the next year, how do you expect performance fees of your flagship fund to change?

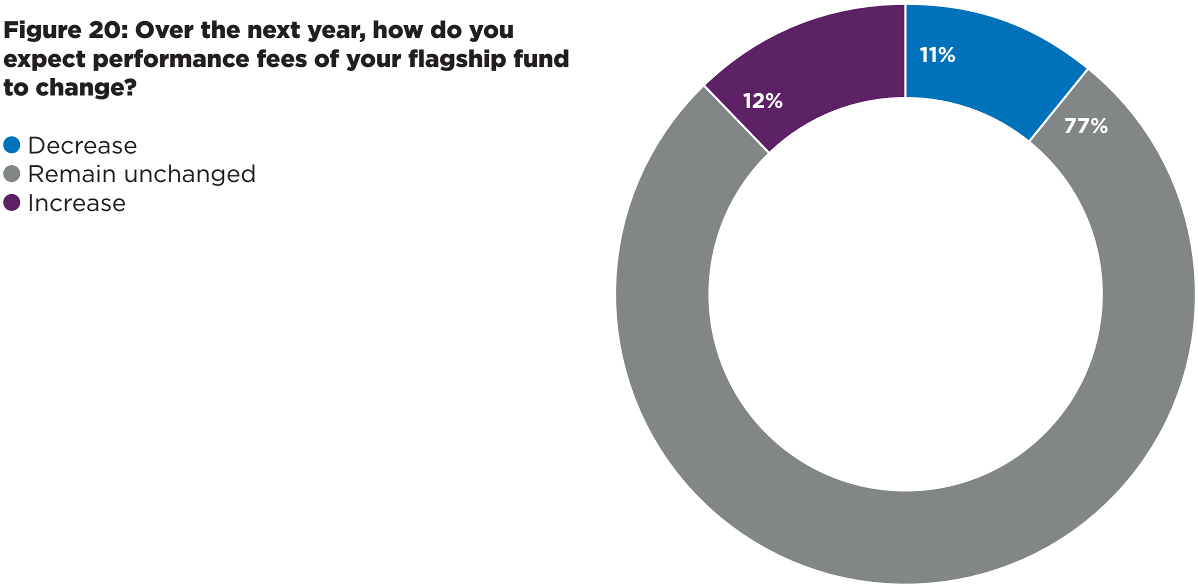
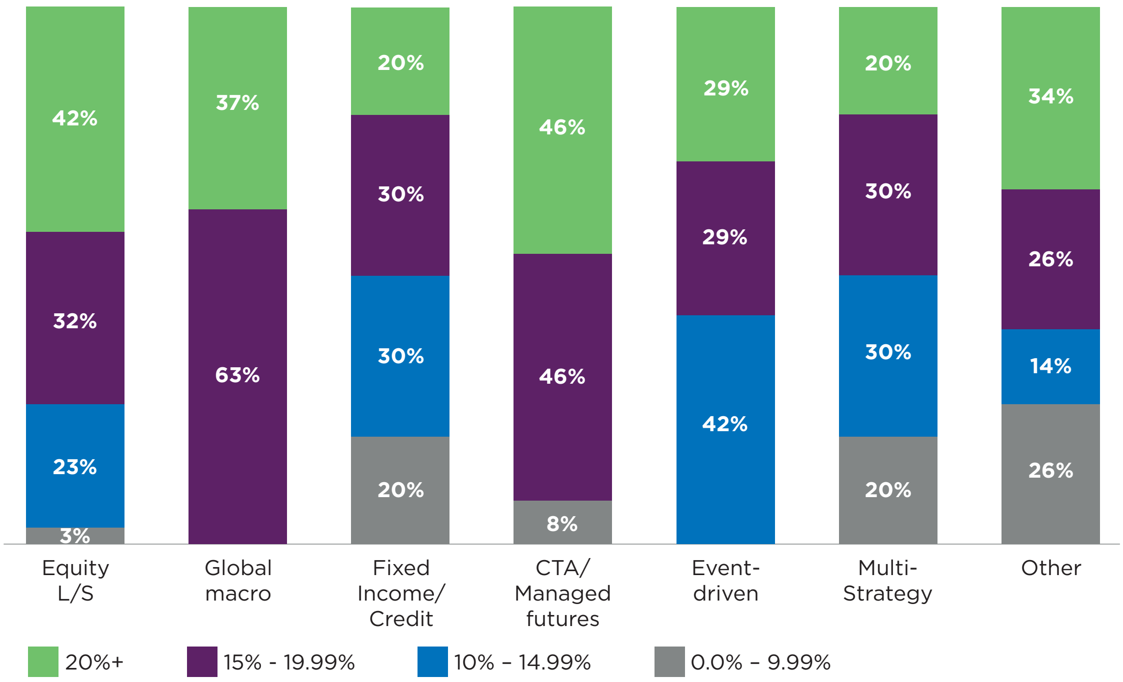


Figure 21: Performance fee breakdown by strategy



As a final note on fees, a recurring finding throughout the conversations that we held with managers is that allocators are attracted by factors other than fees. If the hedge fund strategy being considered by investors is scalable, then managers tend to be more flexible on charges they ask investors to pay to them.

The ultimate alignment of interests: skin in the game

In addition to evolving fee structures and pricing mechanisms, a key finding from our survey is how allocators want alignment with their investee funds.

96% of allocators said that it is important that a principal has their own money invested in their flagship fund. The manager having 'skin in the game' is the ultimate alignment of interest with the allocator. Most emerging managers do (88% of principals own part of their flagship fund, with 43% owning more than 10%).

Before allocating to a start-up hedge fund, 64% of investors insist on the fund providing them with a founder share class. The premise of a founder's share class is to encourage investors to allocate assets early by creating a separate share class with more favourable terms. This founder share class is available for a limited time period (the fund's first year) or until the fund reaches a certain level of AUM. Over half (54%) of the emerging managers in our survey responded that they do not or no longer have a founder's share class.

Figure 22: Before allocating to a start-up hedge fund, would you insist on the fund providing you with a founder share class?

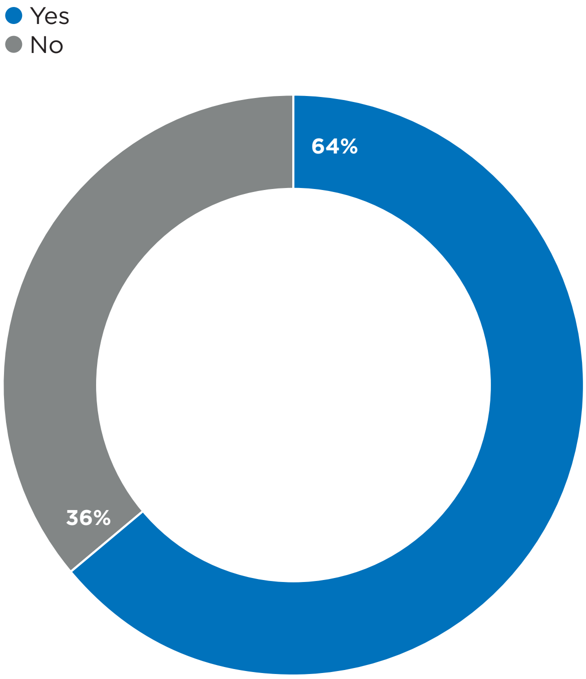
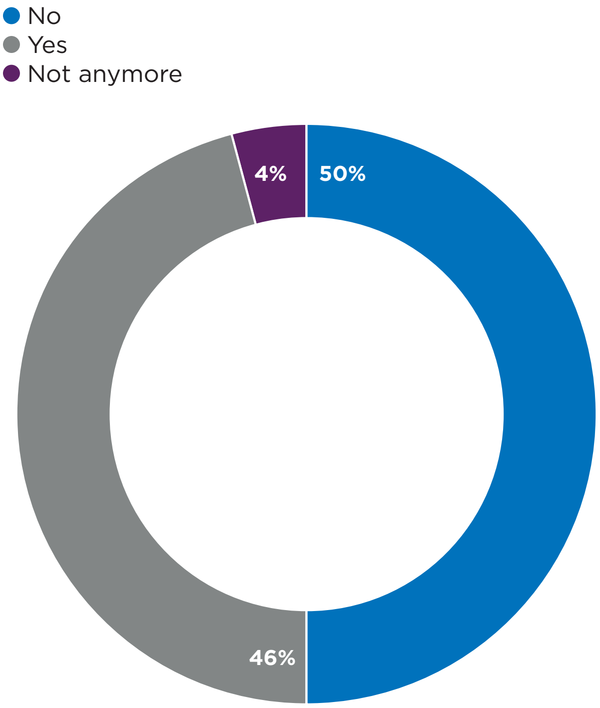


Figure 23: Does your flagship fund include a founder share class?



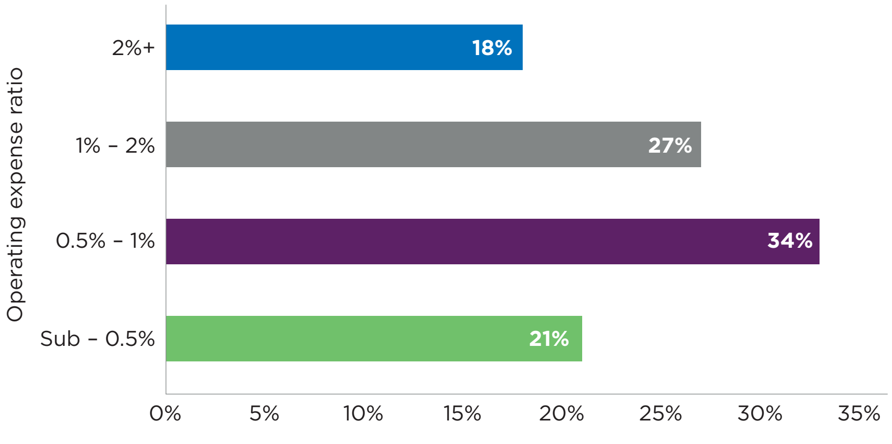
Costs: emerging managers are just as vulnerable to costs than their more established peers

Across the sample of respondents that we spoke to, start-up managers are more sensitive to costs than the more established larger managers. We found that average operating expenses are significantly higher in this segment of the market at 1.1%. Larger managers are widely documented to be in to the 0.5% region, whereas 79% of our managers are higher than this. The challenge is that many emerging managers have similar obligations to their more established peers.

Operating costs

81% of our respondents have an operating expense ratio (defined as what it costs[8] to operate the fund divided by the average value of its AUM) under 2%, and 55% of respondents estimate that they will achieve break even with less than $100m of AUM (with the overall average break even for the group at approximately $86m), with 47% of all respondents currently reaching this mark.

Figure 24: What does your flagship fund cost to run (as a measure of the fund's operating expenses)?



8 Typical costs are administrative fees and operating fees

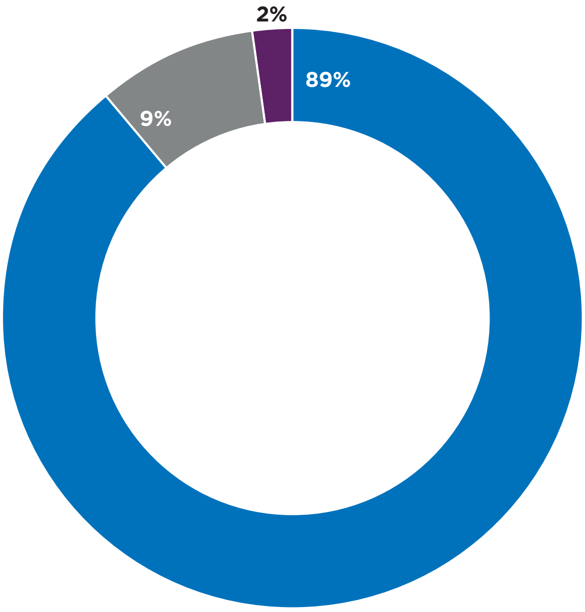
Regulatory costs

An overwhelming majority (89%) of respondents are paying up to 20% of total management company expenses on regulatory and compliance expenses. Against the backdrop of ever-increasing regulation and operational due-diligence standards[9], these figures are encouraging.

When speaking to some of the UK-based respondents directly, they have confirmed that their current expense on regulatory costs is around 10% (including staff costs), but they suggested this is likely to increase when the costs of adhering to MiFID II arise.

Figure 25: What percentage of your total management company expenses in 2016 were for the payment of regulatory and compliance expenses?

- 0-20%
- 20-50%
- 50%+

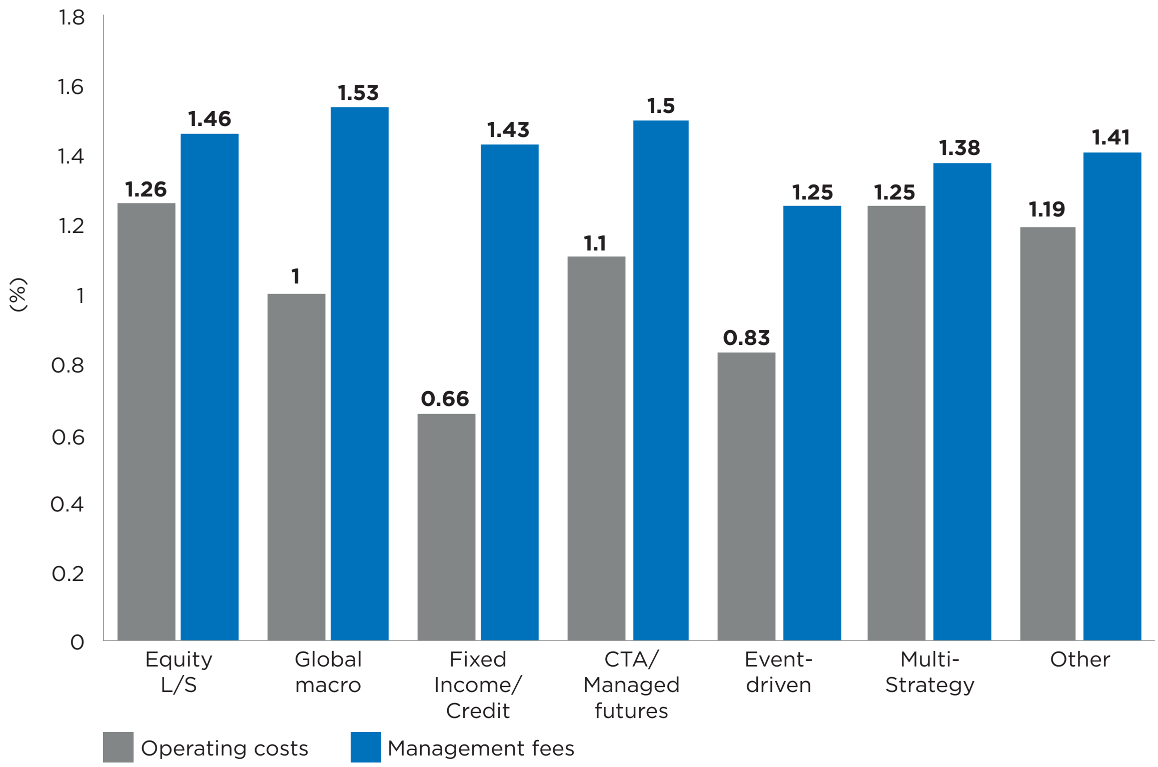


Alive and kicking

Taking all of the above analysis on fees and costs, we can observe that it is possible for start-up and emerging managers to operate a business. That is, they are able to cover their costs and remain viable with a relatively modest AUM, even before considering what performance fee revenue they might generate.

9 AIMA provides a suite of due diligence products for its members catering for managers, investors and fund service providers. For more information on this, please refer to https://www.aima.org/sound-practices/guides-to-sound-practices.html

Figure 26: Average management fees vs average operating costs per strategy



Operating model

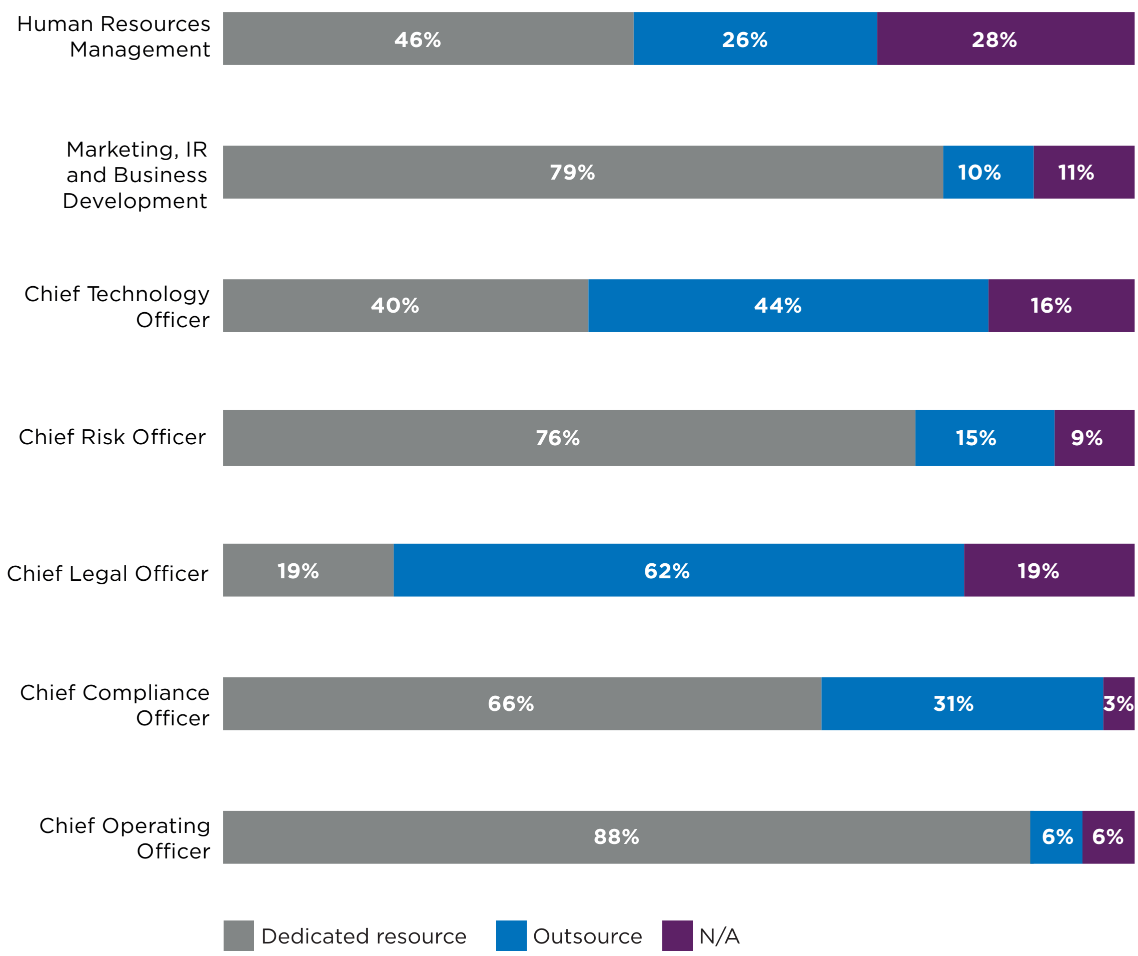
This section looks at how emerging managers are operating their businesses, and how they are using the outsourcing model to their benefit in some areas but opting for in-house, specialist resources for certain key functions.

Outsourcing versus-in house

Our survey shows that managers and allocators alike have fully embraced the concept of outsourcing, which can lead to efficiency gains for the manager.

The role of Chief Operating Officer (COO) and marketing, investor relations, risk and compliance functions are the most favoured to be conducted in-house. Legal services is the most popular function considered for outsourcing

Figure 27: Do you have a dedicated internal resource or outsource the following functions?



Across our sample of managers, the core pillars of the firm's operations are managed in-house. Arguably, after the Chief Executive Officer (CEO) and the Chief Investment Officer (CIO), the Chief Operating Officer (COO) is the next most important role in the hedge fund business. Not surprisingly 88% of the manager respondents confirmed that this position was managed in-house. Indicative of the increasing regulatory challenges, and the variety of hedge fund strategies pursued by respondents to this paper, we observe that another prominent in-house role is that of the Chief Risk Officer (CRO) with over 80% of our respondents having this as an in-house role.

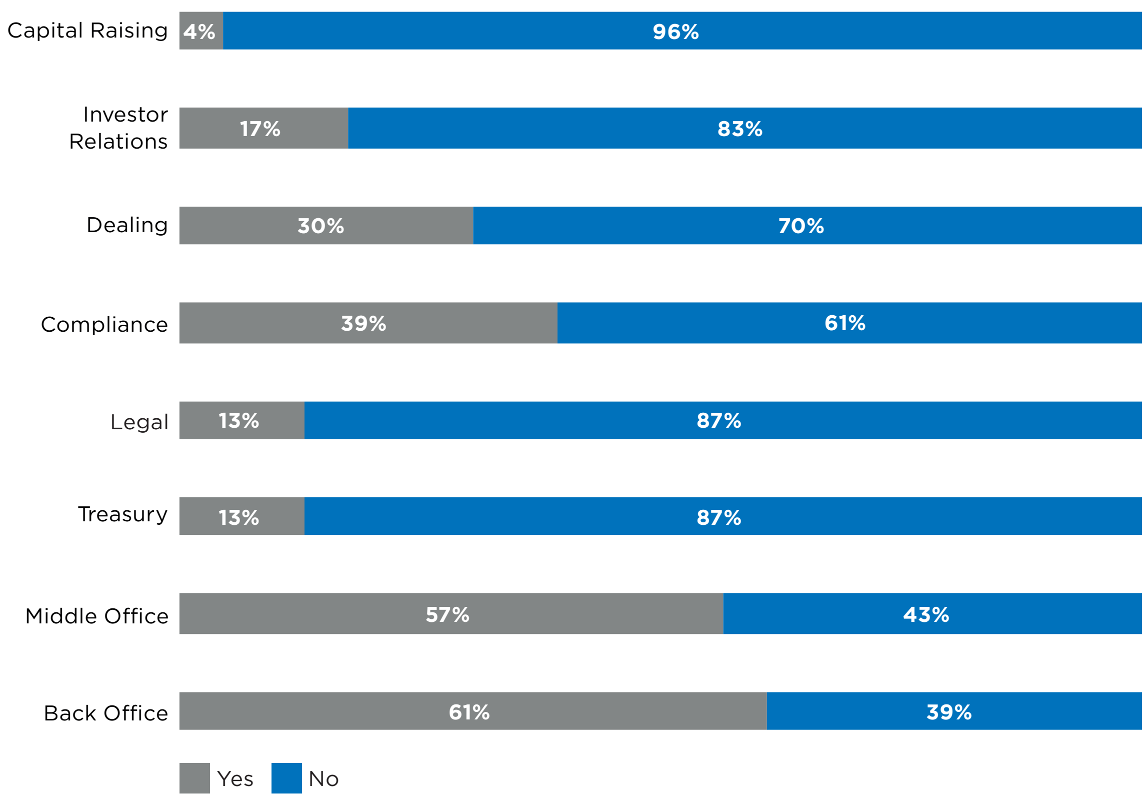
Related to this, both the roles of Chief Compliance Officer (CCO) and Chief Technology Officer (CTO) are also carried out in-house with over two-thirds of all respondents declaring that they have a dedicated in-house chief-compliance resource and nearly half of all respondents declaring that they have a dedicated resource working as a CTO. Capital raising and business development are integral to any start-up and growing business. Indicative of the increasing importance of this role in the small and emerging manager universe that we surveyed, nearly 90% of all respondents have a dedicated in-house resource to this area.

Perhaps unsurprisingly, the resources most often obtained from outside of the funds are legal, Human Resources (HR) and technology. This is especially true of funds with a smaller AUM.

According to allocators that were surveyed, 61% require emerging fund managers to have dedicated back office personnel (reports and reconciliation): 57% favour dedicated middle office staff (trade support predominantly). Dedicated personnel in capital raising (4%), legal (13%) and treasury (13%) were the least required.

Anecdotally, we recognise that in smaller firms, one person often carries out multiple roles. For example, the COO could perform the risk management responsibilities in addition to managing operations, and Legal Counsel can sometimes cover the compliance role in addition to their legal oversight role.

Figure 28: Before allocating to an emerging manager, do you require them to have dedicated personnel for the following?



Operating model

Only 39% of allocators say that excessive outsourcing weighs on their investment decisions. Hedge fund firms could outsource more. The pedigree of the hedge fund's service providers does weigh on 78% of allocators' investment decisions, as allocators recognise the benefit of working with best-in-class providers.

Figure 29: Before allocating to an emerging manager, does excessive outsourcing weigh on your investment decision?

- Yes
- No
- Indifferent

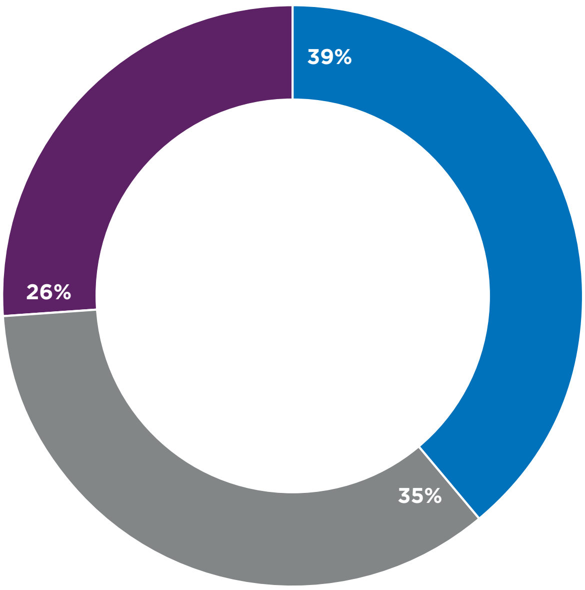


Figure 30: Before allocating to an emerging manager, does the pedigree of service providers weigh on your investment decision?

- Yes, managers should only deal with recognised providers
- No, as long as the service required is good quality

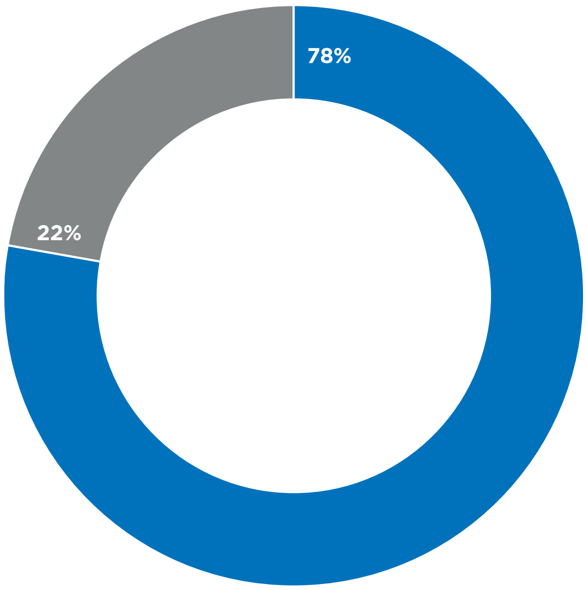
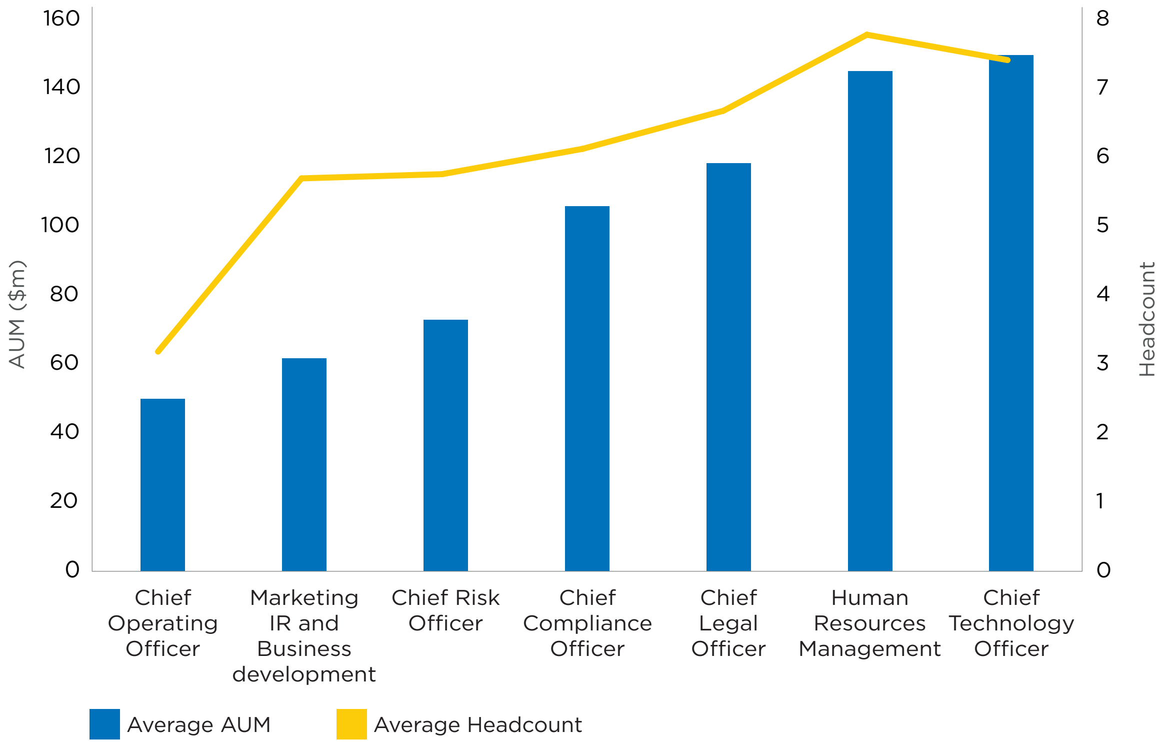


Figure 31: Outsourced roles by Average $ AUM (left y-axis) and headcount (right y-axis)

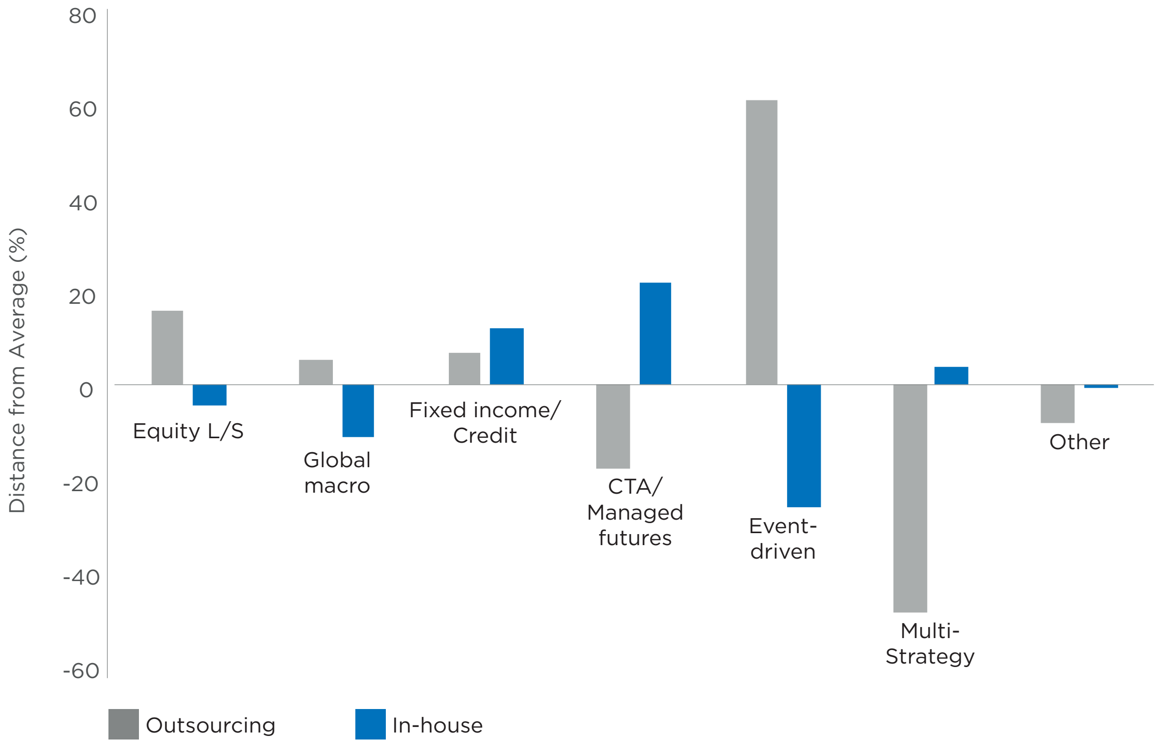


What are the most popular hedge fund strategies that outsource?

When we analyse the data across the various hedge fund strategies that reported, we find that event driven managers outsourced the most on a proportional basis versus their peers. Conversely, multi-strategy did the least outsourcing.

Operating model

Figure 32: Total outsourcing vs in-house



There were also some clear trends when drilling down into the individual roles and the various hedge fund strategies that they supported. As we saw in Figure 27, a Chief Legal Officer was one of the least likely roles within the hedge fund firm to have a dedicated in-house position. Within that result we see that none of our global macro and event-driven respondents have made internal appointments in this role whereas multi-strategy hedge funds bucked the trend somewhat with higher than average hires here.

The most insourced role was the COO. Reassuringly, all the manager respondents followed this trend; there were no significantly underrepresented strategies here.

As mentioned previously, event driven was generally the most prominent at outsourcing. When investigating further, we found that this was consistent across all the roles surveyed, apart from the COO, which they did not outsource at all. Conversely, multi-strategy consistently outsourced less than average in every role surveyed, which could go some way to explaining their higher-than-average breakeven, as found in Figure 9.

Growing the business

Hiring key people: 84% of all firm respondents intend to increase headcount, with half of these intending to increase their headcount by an extra 10-50%

Most manager respondents intend to add to their staff headcount in the next three years. 84% plan to increase their headcount over the coming year while only 16% of respondents have no current plans to make any additional hires for their firm.

As per our conversations with managers throughout this study, we appreciate that there is a fine line to balance regarding over-extending the business too soon. Typically, additional hires will be made to backfill any resourcing gaps as the firms increase in size. We see this in Figure 31 when looking at the average AUM and headcount of those firms who are looking to make significant additional hires versus those looking to make more moderate adjustments to their total headcount.

Figure 33: Are you likely to make additional hires in your firm over the next 3 years?

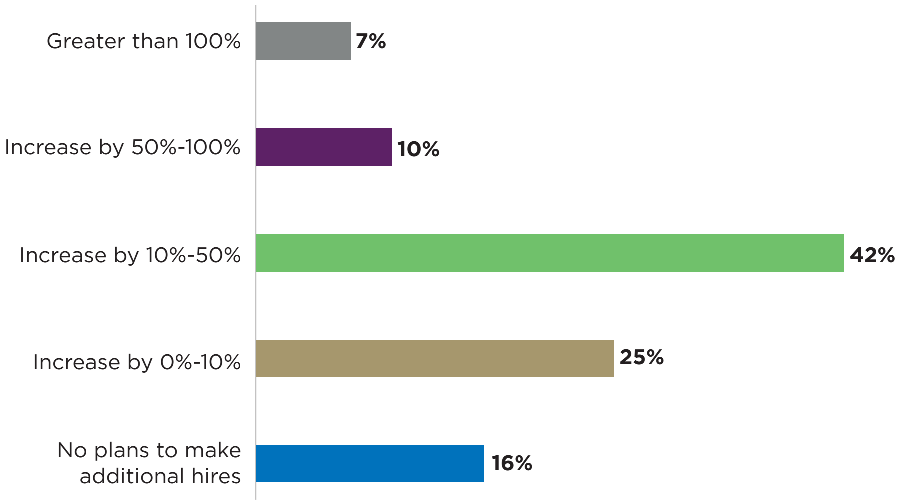
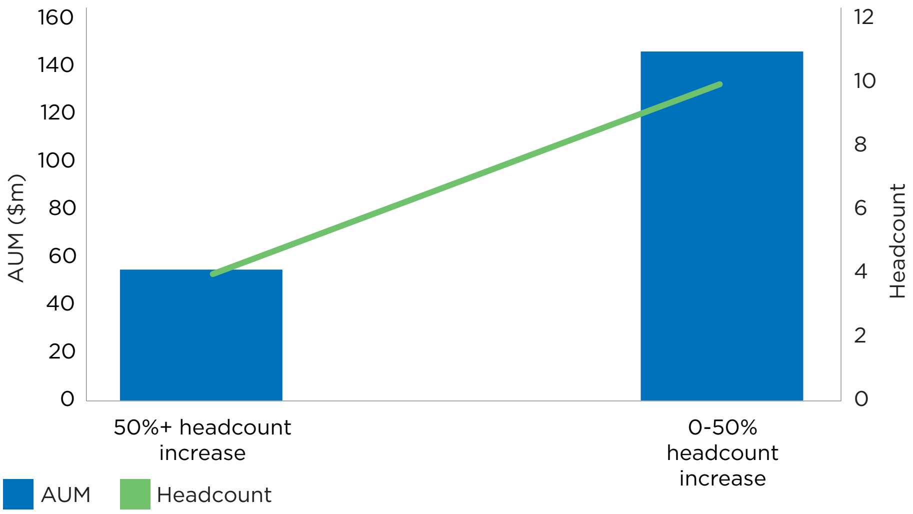


Figure 34: Additional hires comparison by AUM



Standing out from the crowd

To help us understand better how small and emerging firms are trying to be noticed, we asked our universe of managers how they try to stand out from the crowd. The managers ranked how important each of the seven factors we highlighted were to them when trying to differentiate their business offerings, where 7 is the highest ranking and 1 is the lowest. The factors were:

1. Promoting the investment strategy of the fund
2. Trying to establish and future-proof process for the regulatory environment
3. Increased use of cutting-edge technology
4. Hiring highly qualified people
5. Dedicated personnel for key functions
6. Improving the quality and diversity of the fund board composition
7. Making the fee/term structure more attractive

Most important differentiators are fund strategy and people. Board composition is the least

We see two key differentiators, namely fund strategy and human capital. 91% viewed their fund as the most or next most important aspect in providing a differentiated product offering to their clients. Just over half of the managers consider having a highly skilled team as being the most or next most important factor.

Ranked in joint third place were two factors: making the fee/term structure more attractive and future-proofing the fund for the regulatory challenges that lie ahead. The former ties in well with the findings in the section on Fees and Expenses, and the latter could be expected given the amount of regulatory change that the industry is experiencing and expecting.

Somewhat surprisingly, our findings reveal that managers view the composition of the fund's Board to be the least important among the choices that we provided. This does not negate the importance of the Board; it's just not a promotional tool[10].

10 For more information see AIMA's sound practices for Due Diligence Questionnaires and AIMA's guide to sound practices for selecting a fund director

Figure 35: Breakdown of how important respondents ranked fund strategy as a differentiator

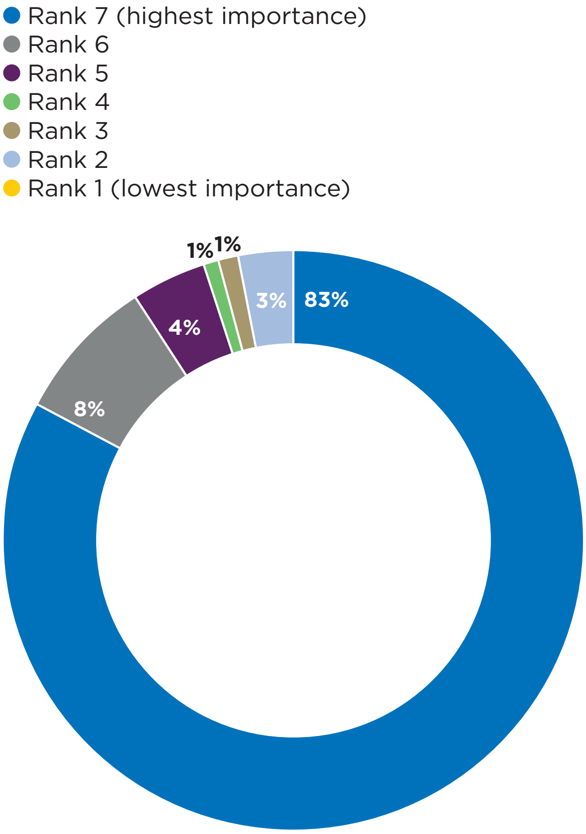


Figure 36: Breakdown of how important respondents ranked human capital as a differentiator

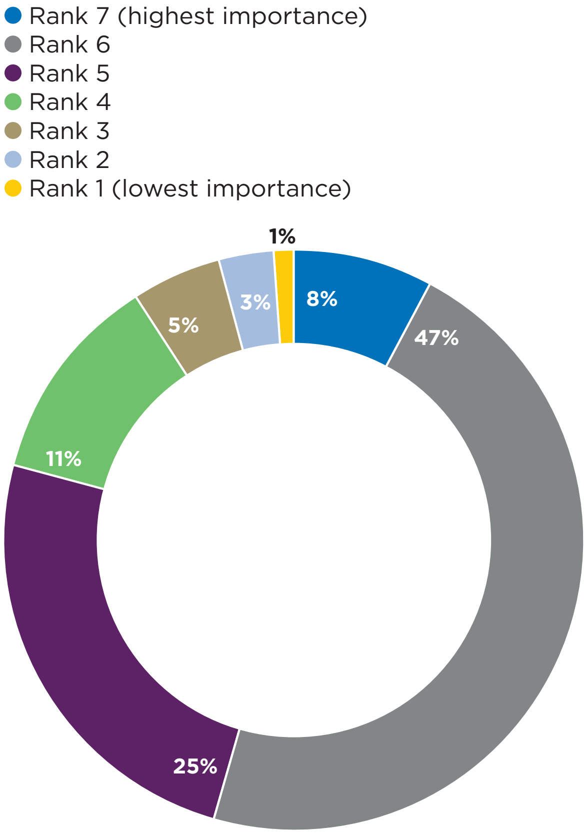
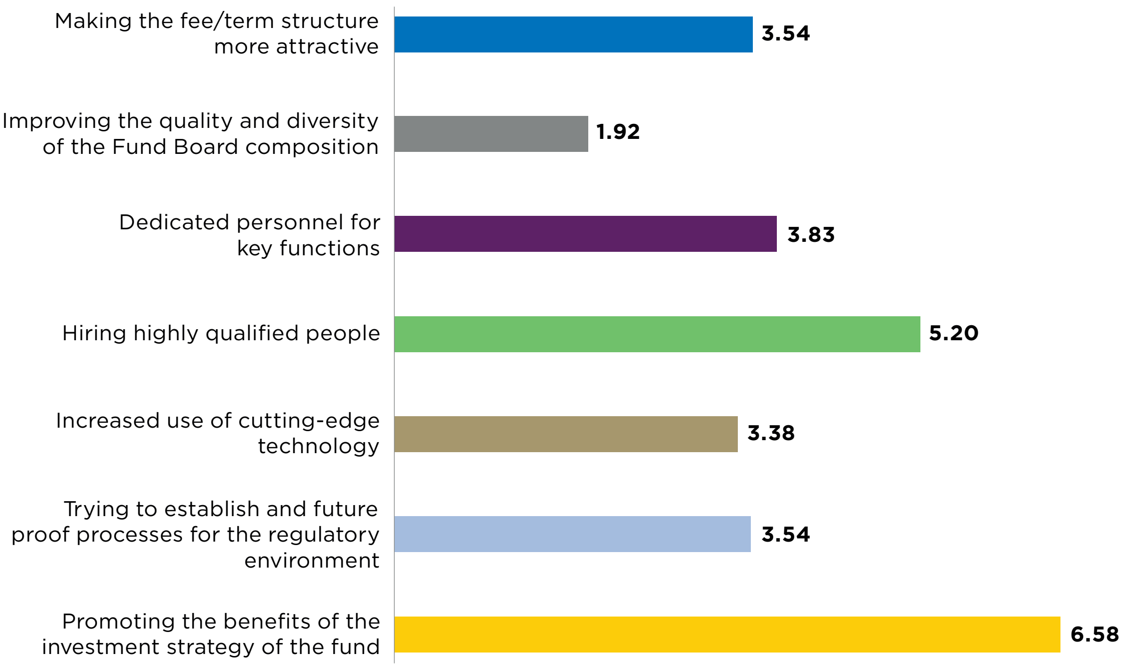


Figure 37: Please rank in order of importance, how do you differentiate your firm's product offering (Where 7 is the most important and 1 is least important)



Fund distribution through various structures

(i) Fund distribution across all respondents. Currently, 59% of emerging manager respondents have offshore fund structures, with a full half of these domiciled in the Cayman Islands. Only 9% are UCITS and none are 40 Act funds[11], even though 18% of respondents are US-based.

Figure 38: What is the structure of your flagship fund?

- Onshore (ex-UCITS)
- UCITS
- Offshore

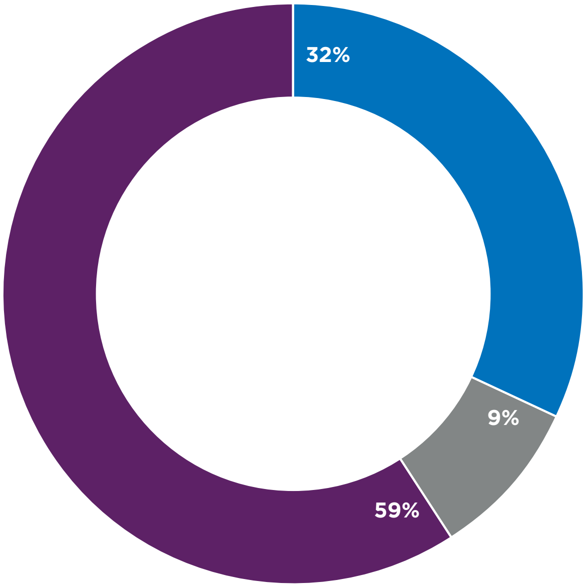
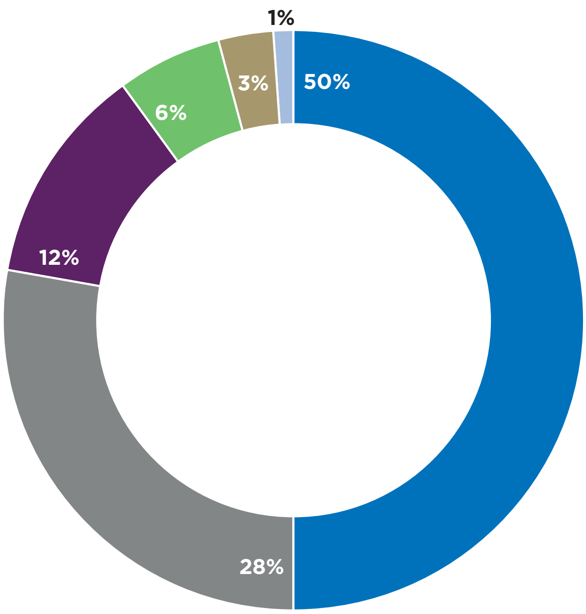


Figure 39: Where is your flagship fund domiciled?

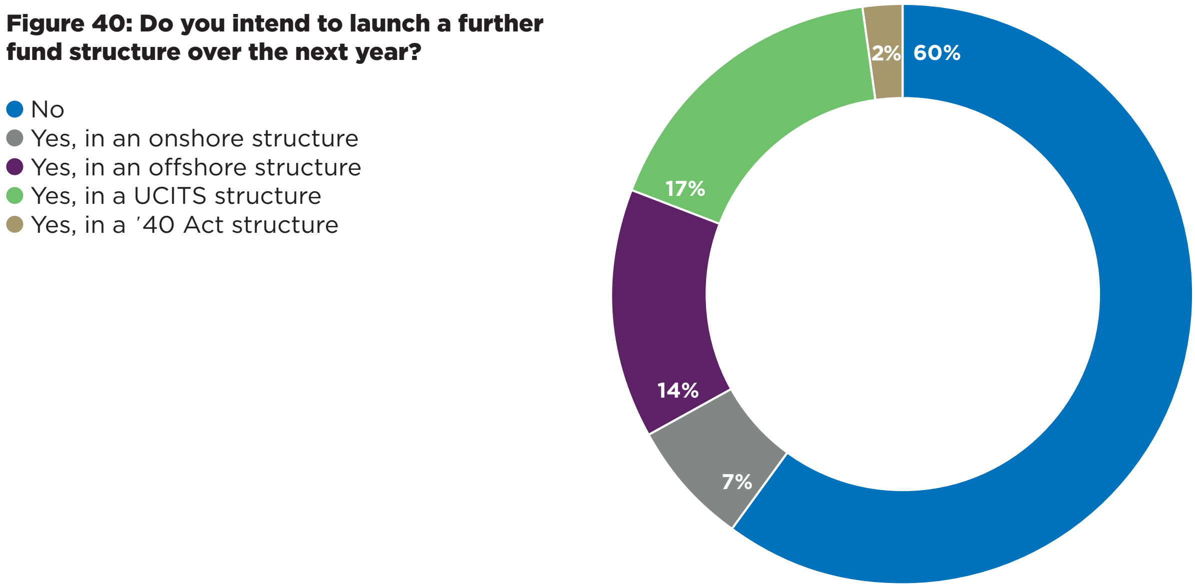
- Cayman Islands
- Other onshore
- Other offshore
- Luxembourg
- Ireland
- USA



11 A '40 act fund is a pooled investment vehicle offered by a registered investment company as defined in the 1940 Investment Companies Act (commonly referred to in the United States as the '40 Act or in some instances, the Investment Company Act (ICA)).

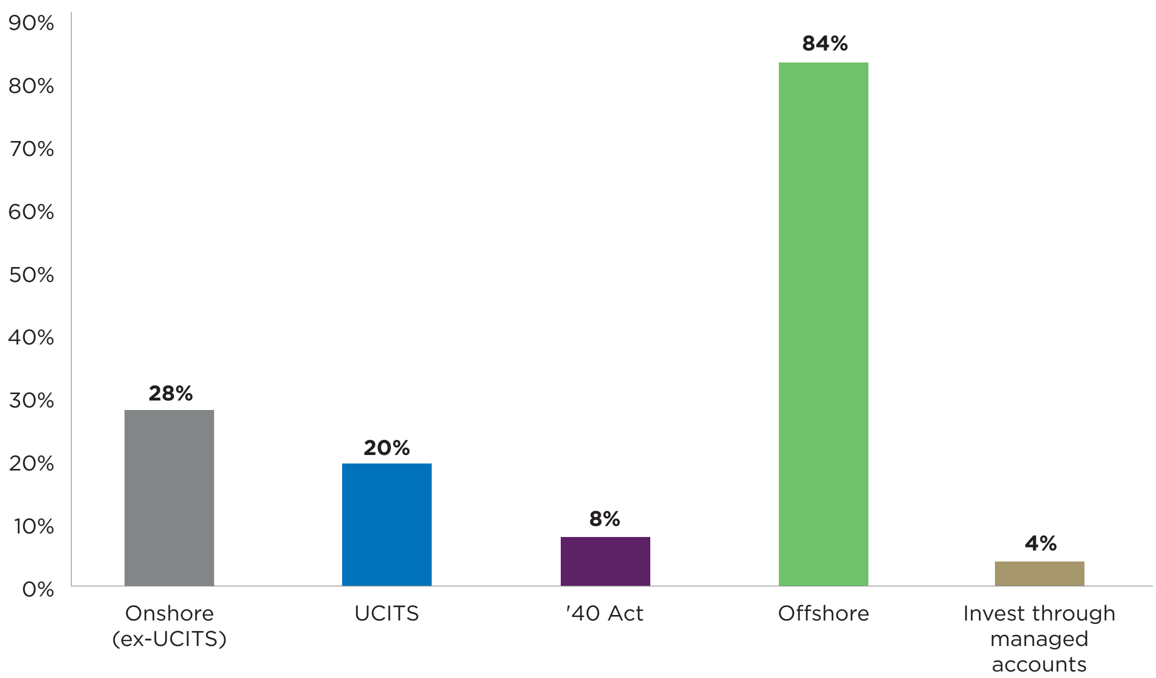
(ii) Distribution across new fund launches. Although the majority of respondents (60%) are not launching a new fund, those that intend to are split between having a UCITS (17%) or offshore (14%) structure. Only two respondents intend to launch a '40 Act fund. In practice, emerging and start-up funds tend to start with an offshore fund then add a feeder fund. If firms want to market in Europe, UCITS are the preferred structure. In practice, emerging managers tend to start with an offshore fund then add a feeder fund. If firms want to market in Europe, UCITS funds are the preferred structure.

Figure 40: Do you intend to launch a further fund structure over the next year?



Fund structures from the allocator's viewpoint: Looking at which structures investors predominantly allocate to, the clear majority (84%) invest in offshore funds, with 28% allocating to onshore structure and 20% to UCITS. Only 8% allocate to '40 Act funds. One respondent would only invest through managed accounts.

Figure 41: Which hedge fund structure do you predominately allocate to?



Growing the business

92% of allocators would invest in a manager on a regulatory hosted platform. For the manager, this facilitates speed to market as they lean on a platform's infrastructure. For an allocator, it is a known regulatory host. Two-thirds of allocators are open to investing in funds that have a less traditional domicile, i.e. Malta, Cyprus. 80% of allocators said that it is preferable for the hedge fund manager to have his/her own local regulator licence for them to consider an investment.

Figure 42: Would allocators invest in a manager on a regulatory hosted platform?

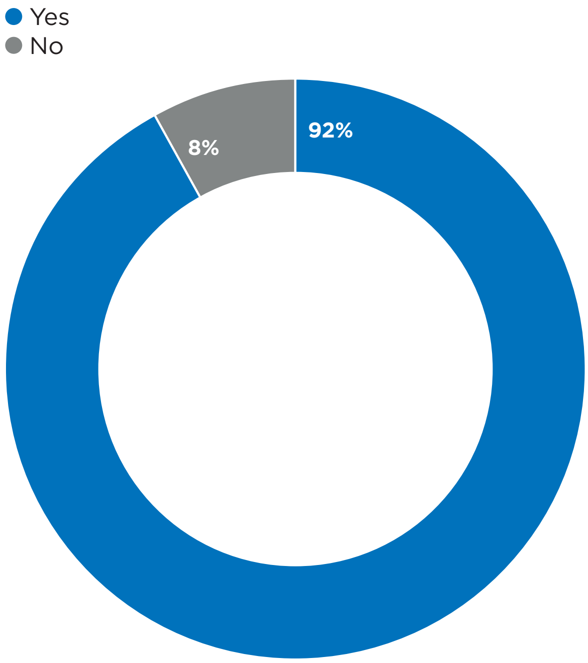


Figure 43: Are allocators open to investing in Funds which have a less traditional domicile, i.e. Malta, Cyprus?

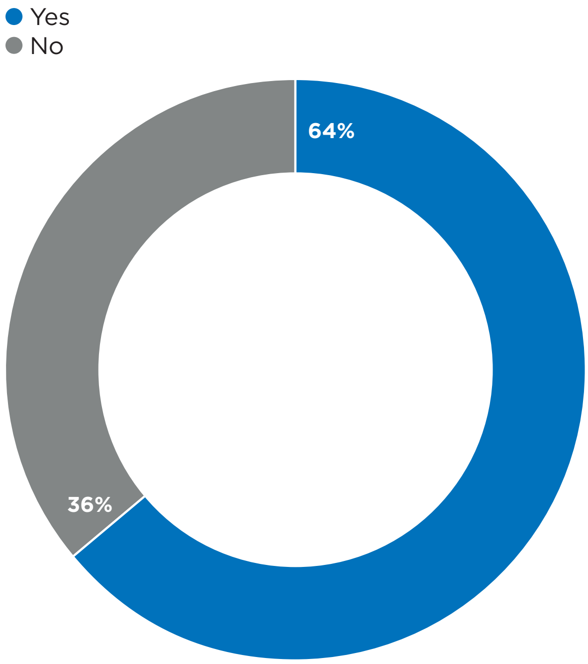
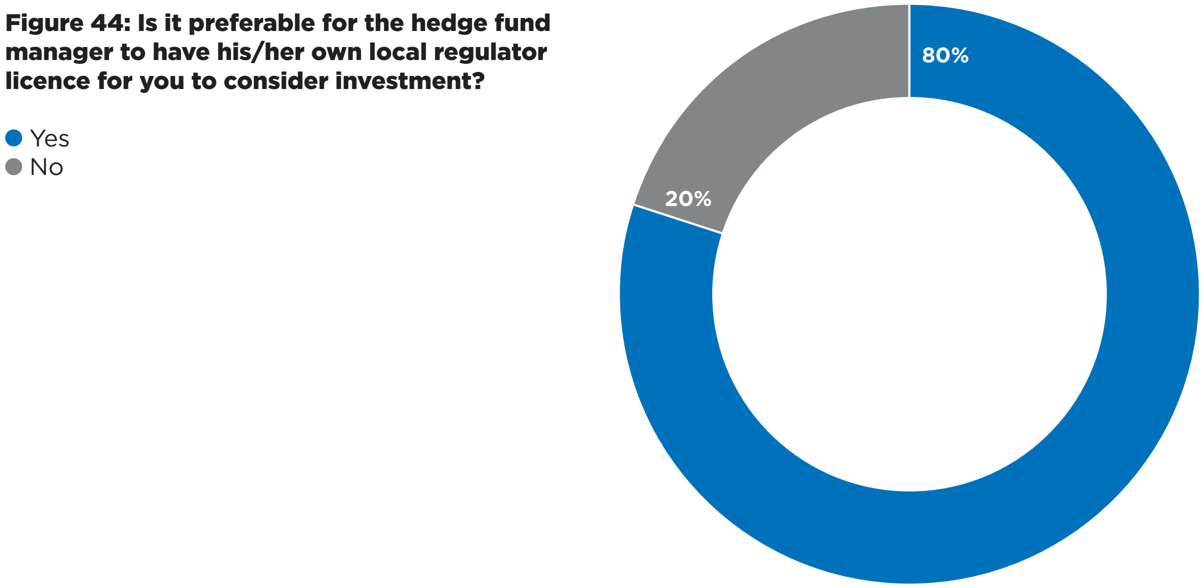
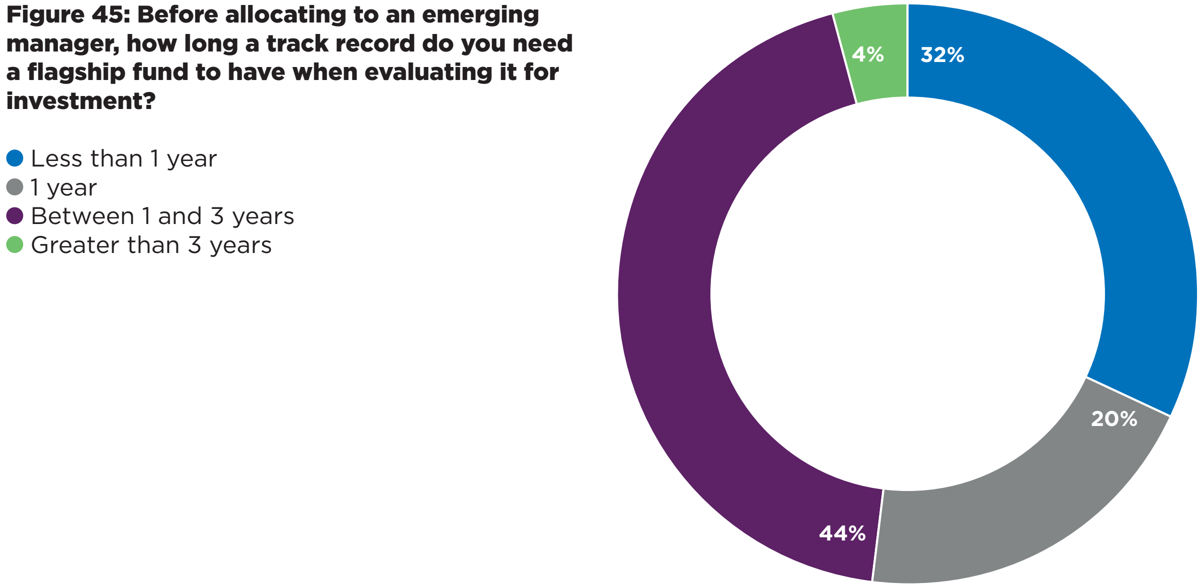


Figure 44: Is it preferable for the hedge fund manager to have his/her own local regulator licence for you to consider investment?



Track record: Looking at the responses from the allocators, two-thirds require that the hedge fund manager provides a track record of 1 - 3 years or more for its fund before considering an investment. For the manager, building it up with proprietary money is a cheaper option that most managers will pursue given the increasing costs of managing client money. Additionally, as we have seen, having such skin in the game is hugely important for investors.

Figure 45: Before allocating to an emerging manager, how long a track record do you need a flagship fund to have when evaluating it for investment?



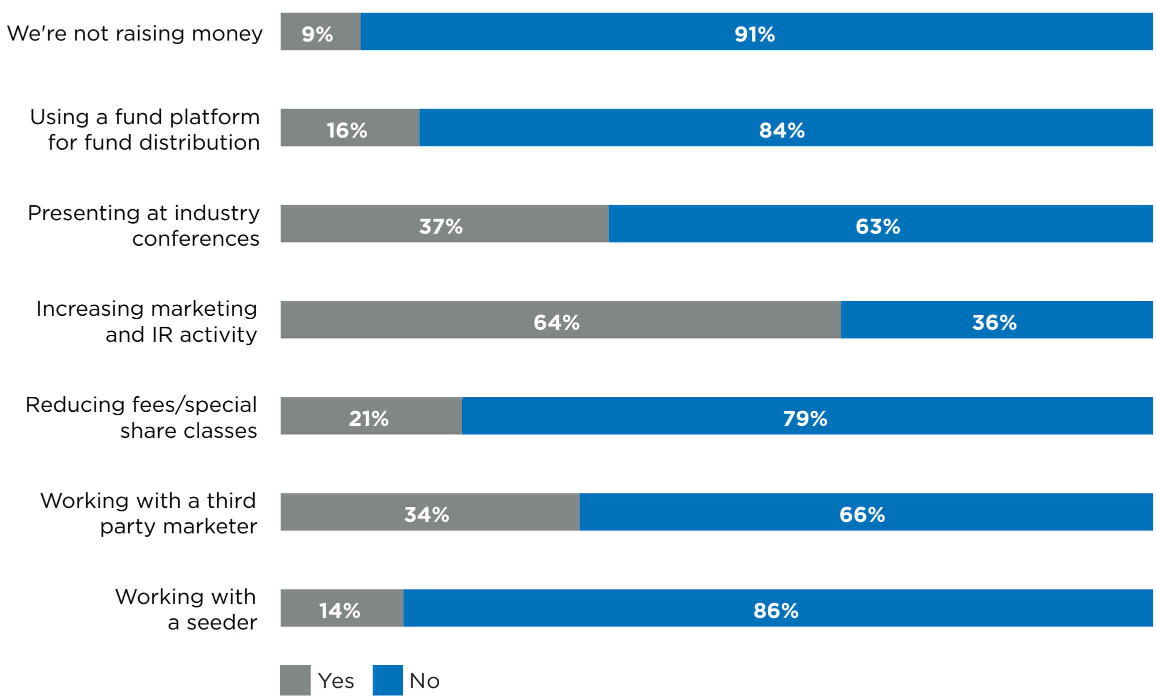
Raising capital

As we recall from earlier in this report, approximately 80% of our respondents have an in-house investor relations and marketing function. Related to this, 91% of all our manager respondents are actively raising money and are doing so through increased IR activity.

As per Figure 46, two-thirds of our respondents are currently raising money for their flagship fund through increased marketing and IR activity (64%), followed by presenting at conferences (37%) and working with a third-party marketer (34%).

A minority, only 14%, would look at seeding as an option – perhaps telling us that once hedge fund businesses have launched they would prefer not to give away incremental economics in their business.

Figure 46: How are you currently raising money for your flagship fund?



Barriers to investing

To give the other side of the picture, we asked allocators if there were any barriers to them allocating to hedge funds. Clearly, the lack of scale of many of the emerging managers makes it difficult for some allocators to even consider an investment to some of this group. As we see in Figure 47, nearly 40% of allocators are limited by the size of the potential fund they are looking at. If an allocator's ticket size is disproportionate to the AUM of the manager this may effectively rule them out.

Figure 47: Allocator checklist: reasons that would stop allocators investing in a fund

Response	Response %
Targeted or minimum investment represents more than a certain % of the fund AUM	39.1%
The business is cash flow negative	17.4%
Operational Due Diligence concerns, poor admin and lack of transparency	17.4%
Unrealistic targets, poor business plan or viability	8.7%
Investment style drift, too much illiquidity	8.7%
Only invest in start-ups or segregated accounts	8.7%
No top tier providers	4.3%
Unreasonable fees	4.3%

By contrast, the lowest cited reason for not making an allocation is unreasonable fees being charged by the manager. Clearly the fund's strategy, story and pedigree of the team are most important.

Conclusion

We believe the findings of this survey paint a bright picture for the small and emerging manager hedge fund group. This is exciting as this group is so important by number of funds, but also could make up the constituents of tomorrow's 'billion dollar club'.

Our survey showed the average break-even point for sub-$500m firms at about $86m, and it showed a third of these firms run profitable businesses with less than $50m in assets. Much of this is to do with the managers taking a forward-thinking approach to cost control and outsourcing. Equally, we observe a positive attitude towards the group from the allocators with whom we spoke to.

If they are happy to endorse these managers, then that is the ultimate validation that there is a strong and continued interest in the emerging hedge fund group and should be for a good time to come.

We would like to thank all the respondents to this survey. We hope you have found the feedback useful and informative.

About GPP

GPP is a multi-award winning financial services firm that provides prime brokerage, execution, structured products, custody and clearing services to hedge funds, asset managers, broker-dealers, wealth managers, family offices, and proprietary trading firms.

Clients are able to access the global financial markets via GPP's multi-asset class trading platform, which provides trade execution, margin financing, securities lending, clearing and custody services.

GPP prides itself on providing state-of-the-art technology and an institutional strength operational infrastructure, with a focus on tailored client service.

This is not a solicitation of any offer of service to US Persons, any services described are not intended for US Persons. GPP is not permitted to face a US Person nor a foreign person controlled by a US Person as defined under Regulation X issued by the Board of Governors of the Federal Reserve System under the Securities Exchange Act of 1934.

About AIMA

AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,800 corporate members in over 50 countries. AIMA's fund manager members collectively manage more than $1.8 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 80 members that manage $300 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

Acknowledgements

We would like to express our sincere gratitude to members of the AIMA Next Generation of Managers' Group[12] for providing their input to the development of this survey and participating in various roundtable discussions throughout this project.

We would also like to extend our thanks to the group of allocators who contributed to this survey and provided valuable insight regarding their views and expectations as to what is best required from small and emerging hedge fund managers to secure investment.

12 AIMA's Next Generation of Managers' Group provides a platform for the exchange of ideas and development of a peer networking group, for senior individuals at firms managing less than $500 million in assets under management. The group meets on a regular basis to discuss issues of common concern including capital raising, operational matters and managing the business. Membership is open to all, including AIMA members and non-AIMA members, in the case of the latter for a minimum period of time.

GPP
101 Wigmore Street, London W1U 1QU
T +44 207 399 9450
E gpp@gpp.group
W www.gpp.group