



Traits of success

What hedge fund
managers think
it takes to succeed



Research study in collaboration with AIMA



Foreword



Alternative investment firms have evolved tremendously over the course of the last 20 years, particularly since the financial crisis. But has the magic formula for success changed in that time? This is a key question that EY and the Alternative Investment Management Association (AIMA) address in this research report.

What we have found confirms that some fundamentals are timeless – the need to invest in people and business infrastructure, for example, or the value of growing your relationships with your clients, the funds' investors. We have learned that some facets of a successful firm have clearly evolved in recent years, in particular around transparency and the construction of sustainable, long-term businesses.

For an alternative investment firm, as much as any other business, success is in large part driven by articulating a clear message in advance, delivering what you have promised and doing so reliably over time. This applies to relationships with both investors and staff, where alignment of interests (financial and philosophical) and culture emerged in our survey as critical factors.

Our interviews with successful individuals in the industry also clearly show that the industry continues to evolve rapidly. In part this reflects the growing maturity of individual firms, their desire for continuity and their need to retain as well as attract investment capital. It is also a response to changing market conditions, such as low yields and the secular reduction in financial market liquidity.

The adaptability of the industry is one of its great strengths. Our research makes it clear that successful alternative investment firms are already responding to the changing demands being placed on them. The growing focus on transparency and fee flexibility are two examples of this willingness to change. As they develop, managers' views of success will no doubt continue to evolve.

The ability to manage that process of change will be critical. The industry needs to remain at the cutting edge of investment and defend its worth. For individual firms, their ability to both remain relevant and, where possible, to stand out from their peers both now and in the future could be the ultimate benchmark for continued success.

We hope you enjoy reading this paper.



Jack Inglis

CEO, AIMA

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Executive summary



It's a time of great change for the hedge fund industry. EY's *2016 Global Hedge Fund and Investor Survey* identified lower levels of fund performance across some hedge fund strategies, rising investor expectations, pressure on fees and requirements for robust operating models as several of the key challenges currently facing the hedge fund industry. The survey also concluded that facing these challenges head on would give hedge fund managers the finest chance for success.

This paper is the report of a joint research project by EY and The Alternative Investment Management Association (AIMA). It seeks to identify common characteristics of successful hedge fund managers, not only across strategy and geography but also over time. We hope that the observations in the paper will be useful and provide interesting insights for managers to consider amidst an array of challenges, both now and in the future.

Our research focused primarily on the hedge fund business model, although the findings are also relevant to other specialist asset managers across the wider spectrum of alternative asset managers. To carry it out we turned to those who know best, interviewing more than 40 senior individuals at hedge fund firms in the US, the UK and Asia-Pacific that account for more than US\$100b in assets under management (AUM). The firms our interviewees represented ranged from emerging firms (with less than US\$500m AUM) to much larger firms (with up to US\$15b in AUM). We would like to extend our sincere gratitude to these individuals for giving us their time and for sharing their experiences with us. These provide us with invaluable insight into the factors most likely to contribute to success in hedge fund management.

We did not set out to define "success" for a hedge fund manager. As discussed in the Introduction, it soon became clear during our conversations with hedge fund managers that success means different things to many people and belies any attempt at a universal definition. This not only reflects the industry's diversity, but also its growing maturity in many markets. We

Manager descriptions – key

Emerging manager – less than US\$500m AUM

Small manager – less than US\$1b AUM

Midsize manager – between US\$1b-US\$10b AUM

Large manager – more than US\$10b AUM

deliberately looked beyond the obvious requirement of investment performance – although here, too, there were different opinions as to what constitutes good performance. Instead, we started by accepting good performance as a sine qua non for the whole industry. Besides, the rapidly evolving demands of a sophisticated investor population are making it increasingly hard for good performance to shelter any shortcomings in other areas – particularly over the long term.

We also did not set out to find a blueprint for success. Instead, we sought to identify characteristics and behaviors that may contribute to a firm's success, noted common factors and explored differences of opinion. We examine the results of this process in our key findings, which we group into three areas that hedge fund managers view as being vital to success. These are:

- ▶ Managing people and culture
- ▶ Managing the infrastructure
- ▶ Managing investor relationships

Our key findings include:

- ▶ The vital importance of succession planning to a hedge fund firm's longevity
- ▶ The need to balance a strong operational infrastructure within the firm with a vibrant culture that is not too "institutionalized"
- ▶ The importance of adapting to changing market conditions while retaining a consistent investment approach
- ▶ The need to demonstrate increased transparency toward investors while deciding on the optimal amount of portfolio-level disclosure they are willing to provide to investors
- ▶ The readiness to take a flexible approach to fee structures, lock-ins and other investment terms in the quest for strong alignment

- ▶ The willingness of hedge fund firms – even those still in the early stages of development – to turn away capital from investors that do not share their investment values
- ▶ The need for firms to not only recruit and retain the right staff but to develop a lasting and positive culture based on positive engagement with clients and empowered employees

Although the characteristics of a successful hedge fund manager are largely consistent between markets, our research also identifies some regional variations (page 19) in hedge fund managers' views of success. In Asia-Pacific, geographic fragmentation and shallower markets have clear implications for investment and operational decision-making. Meanwhile, in Europe and the US, hedge fund firms are often longer established and focused on factors that will sustain their success into the long term – such as the importance of a strong firm culture and close alignment between managers and investors.

The evident ability of hedge funds to evolve in response to changing market conditions should mean that the sector is well-placed to prosper in the future. However, the respondents to this paper also recognize a range of challenges, including disruptive innovation from emerging technology, overcapacity, the costs of compliance, and continuing fee pressure.

The hedge fund business model faces a challenge to remain relevant to investors. Remaining relevant will require the industry to demonstrate a high level of adaptability and versatility, as well as the ability of its incumbents to do so, while retaining their distinctive characteristics will be critical to its future success.

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Introduction



What are the key characteristics of a successful hedge fund firm? This is the deceptively simple question that EY and AIMA aim to answer in this paper.

Our approach

To do so, we conducted a program of qualitative research, involving in-depth interviews with senior leaders at some of the more successful hedge funds globally. The aim was to capture the views and experiences of those that have already succeeded in this highly competitive sector. We spoke to a worldwide sample of more than 40 key principals, spanning firms of different sizes and strategies across many different jurisdictions covering a total AUM in excess of US\$100b. Our sample includes some fund managers and groups that have been in existence for more than 20 years, backed up by consistent good performance for a substantial amount of assets managed over time. We analyzed their response in detail to identify the most important common elements for possible success.

Our research should be viewed in the context of a maturing industry. The hedge fund industry has evolved significantly in recent years. Although new firms continue to launch, new entrants are fewer than during the pre-crisis years, a reflection of both the higher barriers to entry that exist today and the many institutional investors who prefer to invest only with larger and more established hedge fund brands. Many of the industry's leading firms have long since reached maturity, especially in the more established markets of the UK and the US. While starter firms focus on attracting investment and growth, more mature funds increasingly concentrate on retaining existing investors for longer periods and properly supporting their business from an infrastructure and operating model perspective. As hedge fund firms aspire to achieve greater stability and longevity, many firms are also characterized by a growing emphasis on developing a solid organizational culture supported by good ethics and values.

“You need to get through the first 18 months in order to survive. To reach longevity you need investors who are willing to stand by you for the long term.”
Large manager

These developments have challenged the outdated but still popular criticism leveled at hedge fund firms that they are “speculators” taking leveraged “bets” on “risky” investments. It is a hedge fund’s business to assess and profit from risk in financial investments, and as the industry matures, successful firms are applying a highly developed and effective risk management approach in both their investment strategies and their own business models.

Evolution

The industry’s investor base has evolved, too. Before the crisis, hedge funds largely managed capital invested by or on behalf of wealthy individuals. Today, institutional investors such as pension funds, endowments and foundations account for the absolute majority of the industry’s investment capital.¹ Their requirements have helped to drive change in hedge fund firms’ operational infrastructure and risk management, as well as encourage enhanced transparency and greater flexibility around fee structures.

These changes have led to an evolution in hedge funds firms’ views as to what constitutes success for their business. Our respondents demonstrate that it is clear that many hedge fund firms take a broader view of success. While objectives such as diversification and capital preservation are essential, building an enduring business based on partnerships or closer alignment of interests with investors is also key.

Success beyond performance

In this paper, we have therefore intentionally tried to look beyond “investment performance” as a driver of success. After all, these factors are highly subjective. For example, is investor retention always a sign of success, given that fund redemptions can mean that investors want to crystallize their investment gains?

We argue that the size of the business is not necessarily a good indication of success and suggest that there should be an

appropriate balance in the pursuit of scale. Many hedge fund firms acknowledge that building out the business too aggressively can make it harder to replicate past performance – especially if the capacity of their fund does not allow for this. Indeed, some acknowledge that they had rejected further commitments from investors in order to maintain the quality of their fund’s performance. However, this is rare for new managers, who are usually keen to reach asset thresholds, which they believe will open doors to further investors. Investor selectivity is invariably a luxury for managers who have already attained success in terms of scale and sustained performance.

Only a few of the respondents were willing to define the exact level of performance that they believed best denotes success for them, although several mentioned that their track record of reporting consistently strong returns was a significant cornerstone to their development.

The vast majority of those firms that we spoke to consider the ability of the fund(s) to deliver a unique set of risk-adjusted returns as being paramount in meeting the expectations of their investor base. Specifically, this means producing a level of fund returns that is consistent with or better than the traditional investment set (as presented by equity, fixed income and credit markets) but by taking on a lower level of risk (as measured by volatility).

In summary, the goal of this paper is not to offer hedge fund firms a prescriptive blueprint for success, but to share the views of some of the more established and successful hedge fund firms as to what are the characteristics they pursue when building a hedge fund business. We hope our findings will provide practical insights to other firm participants in the market, wherever they operate and whatever their firm’s goals may be.

“Fund performance is a must, but hard to define as a differentiating factor.”

Small manager

¹2016 Global Hedge Fund and Investor Survey, EYGM Limited, 2016.

Key findings

1. Managing people and culture

Recruiting and retaining the right staff is vital to success

Hedge fund firms view the recruitment and retention of the right people as vital to providing the firm with the best chance for success. Of the participants that we interviewed, most of them go to great lengths to find team members that are “a good fit”. As one hedge fund firm put it, “Taking the time up front to make sure you hire the right people prevents negative surprises happening down the road,” said a midsize manager. Many experienced managers say that having the right skills and personality traits are more important than having a résumé that includes attending a top university or gaining experience at a leading bank – “having the right cultural fit is often more important than specific knowledge,” said a midsize manager.

“You need to have thick skin and an open mind.”
Midsize manager

As a result, recruitment is often a very time-consuming exercise. Some of our respondents admit to putting potential job candidates through 10 or more interview stages, and even then, this may not necessarily result in a hire being made. “Talent acquisition is rigorous and it takes so much time to find the right people,” said a midsize manager, and which was a typical comment. Staff retention is equally just as important, given that investors tend to be wary of hedge fund firms that have high staff turnover. “Low employee turnover speaks about the stability of the manager’s operations,” said one small manager, while another small manager explained, “A fund with high turnover among executives cannot be trusted by investors.”

In practice, investors’ attitudes to a firm’s staff turnover vary depending on a range of factors. The departure of a fund’s principal will always be a source of great concern to a fund’s investors, especially for a smaller-sized hedge fund firm. Nonetheless, the loss of a more junior investment analyst can still upset the fund’s investors if that individual has a unique expertise, which is integral to the fund’s development. Further, some managers that we spoke to consider a certain degree of staff turnover to be beneficial, with one midsize manager commenting that “frequent staff turnover is necessary to keep the team performing at a high level.”

Removing disruptive or underperforming individuals is equally crucial

Our respondents also identify another important aspect of successful people management: the ability to identify underperforming individuals (whether these are on the investment side or the operations side of the firm) and where necessary, remove them. A widespread consensus among the managers that we spoke to is that underperforming staff can quickly damage a firm's culture, reputation or performance. "In this business there is no scope for people who can't pull their weight. You need to get rid of them straight away," said one large manager. Interestingly, a smaller percentage of our respondents seemed to be less keen on making changes to their personnel if their fund started to encounter performance problems. They argue that because they have spent significant resources, both on time and money building out their team, they would be more inclined to stay faithful with them despite some period of underperformance – and in particular where the team has performed strongly in the past. That being said, where underperformance is persistent, the manager will move to replace and restructure the team.

It is striking that many managers see disruptive employee personalities in their firm as a greater threat than underperforming employees. "There is zero room for problem children," said one small manager. Another midsize manager notes that certain personalities can be "disruptive to culture and success." Even the most talented individuals should not be spared if they are deemed to cause disharmony – "If there is someone not pulling their weight and others can see it and resent it, this can be a total drag on the business. Eliminating it, then, requires discipline and is emotionally difficult," said another midsize manager.

Remuneration remains an important factor in attracting and maintaining the right talent

Remuneration has always been an important aspect of people management in the hedge fund industry. Hedge fund employees are highly skilled and in significant demand, and thus expect to be rewarded for good performance.

A hedge fund firm's internal compensation mechanisms are an important tool for achieving alignment between the firm and its investor, as well as between the firm's principals, other investment staff and operations teams. That being said, and based on our survey, there is no consensus as to what an optimal reward strategy looks like. Managers take account of investor views, with some saying that investors prefer to see managers compensated via a high fixed-payment structure, while others prefer the emphasis for compensation to be determined on a more discretionary basis. Similarly, we see shifts in compensation structures influenced by regulatory change, the preferences of investment consultants and other factors.

Whatever approach they may favor, hedge fund firms need to make sure that all their staff are incentivized appropriately. Poor alignment between the remuneration of investment and non-investment staff at their firm is likely to be harmful to team cohesion. While many respondents see collective incentives as conducive to team spirit, some also want to make sure that their operational staff do not suffer excessively during periods of poor investment performance.

Successful hedge funds show a growing interest in nonfinancial incentives

Remuneration is only part of the story. Many of the respondents that we spoke to are recognizing that nonfinancial sources can also be very important to employees in their firm. As one small hedge fund firm put it "firms that focus too much on compensation rarely last." Increasingly, hedge fund firms acknowledge a stable, motivated team as a crucial element of any potential success. Furthermore, our sample of hedge fund firms is placing more focus on factors such as the personal development of their staff. Although most of them tend to hire experienced staff wherever possible, there is a growing belief in the value of coaching and developing junior staff. "Nurture your people," said one small manager respondent, while another small manager explained that "underperformers are given a chance to learn from peers and prove their capabilities."

Career progression is another very important factor, albeit one that in some cases can be challenging for smaller hedge fund firms to deliver to their staff. There can be particular tension among investment analysts hoping to become portfolio managers. Some firms actively encourage their analysts to move into management positions over time, but others prefer to recruit older analysts with no desire to run money. A compromise approach adapted by some of the managers that we spoke to allows for their firm's employees to benefit from a more gradual increase in responsibility, with senior principals or CIOs likely to continue to veto their investment decisions."

"The firm's environment must be an extension of one's personality, and employees should therefore feel comfortable, enjoy coming to work, be in sync with one another, aligned to their clients' needs."
Small manager



A strong, distinctive culture is increasingly important to success

Changing attitudes to staff management coincide with an increasing effort to create or preserve a distinctive organizational culture within the hedge fund firm. Our respondents suggest that having a strong culture tends to contribute to the pursuit of other key business traits within their hedge fund business such as their investment philosophy, increased emphasis on being transparent, better investor alignment and the management of their personnel. Some respondents have even gone so far as enshrining all of these in a formal document – the equivalent of their code of culture, which helps them guide behaviors and address difficulties as they arise.

Hedge fund firms are also increasingly enabling their staff to achieve a healthier work-life balance. All respondents to this paper emphasize their desire to foster a strong collegiate atmosphere across their business, where their staff both work and play together.

Some respondents encourage flexible working practices and many provide complimentary recreational facilities at their firm. Most of our respondents allow their employees to dress down during office hours. Acknowledging the importance of a more balanced work/life style, some of the more established firm respondents provide an in-house gym facility.

Most of the firms that we spoke to define their firm's culture in intellectual terms. Many encourage all their staff to participate in open discussion regarding all aspects that affect the development of the business. Many also encourage and promote greater creativity, in particular a willingness to think outside the box as being critical to the development of their business. "Our values are best described as openness, sharing information, transparency and encouraging good ideas," said one emerging hedge fund firm. Collective discussion is especially esteemed – "We strive for an honest open environment that promotes healthy debate, leading to a maximum scrutiny of investments," said one midsize manager.

Several managers that we spoke to emphasize the importance of having an ethos that prioritizes the investor and safeguards the industry's reputation. Some managers that we spoke to have implemented formal organization frameworks to evaluate an employee's trustworthiness, reliability and general attitude toward their fellow colleagues. Indeed, some of the more important hallmarks that best describe a successful hedge fund business model include the importance of having an industry-standard professional reputation, a best-in-class ethical culture and a satisfied and happy workforce.

Motivating staff and creating a strong culture may seem a surprising objective for a sector popularly regarded as having a hard-nosed and ruthless reputation. On the contrary, the firms that count these characteristics as the bedrock for their success demonstrate the industry's desire to be innovative and provide a unique working atmosphere that gets the best out of their staff. Such characteristics can also bring other benefits, such as increasing the resilience of the firm: "When there are challenges, a close and supportive team is valuable," said a midsize manager.

Adaptable leadership is emerging as a key driver of sustained success

Most of the respondents see strong leadership as a crucial factor in building a successful business model. The majority of the industry's most successful hedge fund firms have been built by strong-minded individuals with a clear sense of "how we do things." This entrepreneurial spirit shapes each firm's unique approach to investment and operational decision-making – core factors contributing to the success of a firm.

For a hedge fund firm, one important aspect of good leadership is the ability to strike the right balance between encouraging debate and maintaining a clear chain of command. Successful leaders promote discussion: "The tone from the top encourages everyone to voice their opinions, even if they differ from the lead portfolio managers," said a midsize manager. But they also need to retain the authority to break deadlocks and resolve interpersonal tensions: "Avoid having too many chiefs," said one large manager.

Industry leaders cannot afford to sit still and watch as the industry evolves. As one hedge fund firm put it, "Growing anything to scale has its challenges." For a firm to stay sharp and successful, hedge fund firms need to be adaptable and seek out staff who have different capabilities and may offer a different opinion to that of other senior personnel in the hedge fund.

"Culture needs to be living and breathing. It must come from the top, needs to grow as you grow the firm and augment over time."

Small manager

Looking forward to succession is vital to longevity

For hedge fund firms that view success as growing a platform or building a legacy, succession planning poses a significant test to their firm's longevity and ongoing relevance to investors. One-third of all assets in the hedge fund industry are managed by firms where the founder is more than 60 years old, and another third of assets are managed by founders in their 50s.² Planning, specifically succession planning and business continuity, is key to a firm's continued development. Succession planning is less of an issue for single manager hedge funds, which may opt to return capital or convert to a family office on the principal's retirement. However, for multi-manager funds, the question of succession typically becomes more challenging as the fund becomes more successful. Among firms where one or two principals have a particularly prominent role, the issue can become too sensitive to confront. As one large manager put it, "Most hedge funds have not really grasped succession planning yet."

Nonetheless, many hedge fund principals are keenly aware of the need for a smooth and successful handover to the next generation of industry leaders. Some have already been through the process and may even be approaching a second phase of succession. Others are exploring ways to adjust their senior management hierarchy and create a more stable partnership-style culture. Overall, firms who participated in this study are increasingly conscious that failing to address succession planning can be a concern for their investors. As one large manager put it, "Succession planning is something every hedge fund should be working on when thinking about the long-term future of the business."



²Katrina Stefanova, "The Looming Talent Crisis: Are Hedge Funds Due For a Wake-Up Call?," *Forbes website*, <http://www.forbes.com/sites/katinastefanova/2015/04/25/the-looming-talent-crisis-are-hedge-funds-due-for-a-wake-up-call/#66bcc7f62d22>, accessed 14 November 2016.

2. Managing the infrastructure



A strong – but flexible – operational infrastructure is a key enabler of success

The need to satisfy due diligence checklists and the increasing demands from investors and industry regulators mean that a robust operational infrastructure is imperative for a modern hedge fund firm.³ The days when investment shrewdness alone was enough are long over – “It is no longer possible to set up a hedge fund with a couple of guys running a spreadsheet,” said a large manager. One respondent argued that a firm’s operational credibility could even be viewed as more important than its investment performance in today’s regulatory climate. Several firms that we spoke to stressed the need for having strong operational talent at a senior level established within the firm at the outset of launching a hedge fund business.

Further, hedge fund firms stress the importance of having strong infrastructure being put in place from day one. “We built a structure that was fit for purpose,” explained one midsize manager. Early stage hedge fund investors like endowments and multi-family office investors increasingly expect hedge fund firms to have made the appropriate investment in their operational infrastructure and there is little to no tolerance for hedge fund firms that try to operate without a robust operational framework in place.

Several hedge fund firms mentioned that their operational capabilities are designed to support a far larger level of fund assets than they currently manage. The ability to scale their operating infrastructure allows them to grow as fast as market conditions dictate, without the risk of being overwhelmed by resulting operational bottlenecks or tripped up by failures in client or regulatory reporting.

The successful management of the firm’s infrastructure is not just about being expansionary. Some of the respondents also highlight the value of their business being flexible enough to scale down costs during more challenging years without creating operational disruption – “You need to ensure that infrastructure is very flexible,” said a midsize manager. This need for ongoing flexibility underlines the critical importance of having good in-house operational talent, as well as the need to attract and retain talent across all aspects of the business, including the firm’s support functions.

As firms grow, successful infrastructure management can become more complex

As the hedge fund industry becomes more institutionalized, many firms are considering whether they should outsource some of the more operational elements of their business (popular areas of the hedge fund business that are being considered for outsourcing include the firm’s IT, compliance and reconciliation

³AIMA Investor Steering Committee, “A guide to institutional investors’ views and preferences regarding hedge fund operational infrastructure,” May 2011.

reporting). Approximately one-third of the hedge fund firms that we interviewed focus on outsourcing. Amidst increasing constraints coupled with rising operational costs across the hedge fund business model, hedge fund firms are having to prioritize the services they can execute inhouse and which services they might be better off outsourcing to a third party.

Some hedge fund firms we spoke to see clear value to outsourcing some parts of the business, despite the expense – “Complete outsourcing is very costly, but we have been rewarded with significant value add benefits from the start, including more of our time being freed up to allow us to focus more on improving the performance of the fund,” said a midsize manager. Importantly, not getting it right could make outsourcing problematic. A clear understanding of current and future requirements for the hedge fund business is vital to getting outsourcing for the firm right the first time – “If you decide to outsource middle and back office then you can’t change this so easily,” said an emerging manager.

Investors want to see evidence of a firm having strong processes and controls in place at both the fund level and firm level. Many of the interviewees for this study emphasize the need for a segregation of duties – both within the firm and its fund(s). Clear distinctions between a firm’s front and back office staff are vital, even for the smallest firms. Most portfolio managers recognize the importance of having strong leadership and processes on the “business” side – “You need the right people doing the right things,” said one large manager. Some respondents warned that an under appreciation of non-investment functions can be an Achilles’ heel for even the most successful hedge fund firms either because these functions can then distract other senior hedge fund principals from their core responsibility, or because they can undermine investor confidence.

Does becoming more institutional carry a risk?

As hedge fund firms grow larger, cross-functional responsibilities reduce and it becomes easier for firms to maintain the divisions of responsibility that larger investors typically prefer. Some managers see the benefits of having a more institutional mindset, such as a focus on continued improvement for the firm or an interest in operational benchmarking against their peers. Some of the hedge fund managers that we spoke to were concerned that the industry may be hampered by an “excessive institutionalization,” pointing to the emergence of a silo mentality as a threat to the continued development of their business. One midsize US manager had particularly strong views on this subject remarking, “Institutionalization is chiseling the industry down to mediocrity.” While many would disagree, several hedge fund firms that we spoke to see a need for a greater degree of balance in this area – “The plan is to try and not get too institutional,” said one midsize manager.

While hedge funds are focused (and correctly so) on delivering the institutional quality infrastructure that the increasingly sophisticated and institutional investor base is demanding, they clearly are also mindful of retaining the “alternative” spirit that made them attractive to those investors in the first place. We expect that the firms that walk the line between an institutional organization and a dynamic independent will prosper, and while an infrastructure failure can be immediately calamitous, loss of identity and innovation can be as damaging over the long term.



3. Managing investor relationships



Setting realistic expectations from the start is essential to sustained success

The most successful relationships evolve over time and, like any relationship, they require continuous effort. Every investor has their own needs and preferences, while equally, every hedge fund also has its own unique features.

Integral to fostering a successful investor relationship is a realistic assessment of expectations by the manager in terms of what they can deliver to their investor. This needs to start from the first contact managers have with their investors – “It is hugely important to articulate the right message and be honest in expectations up front,” said a small manager. Indeed, such views are crucial at every stage of the firm’s development. Hedge fund firms need to be clear with investors about the kind of performance that is possible for their fund(s) under a particular set of market conditions. All too often, mismanaged expectations can result in frustration from investors.

“Be brutal about your core competencies; be articulate and crystal clear.”

Midsize manager

Respondents to this paper agree that hedge fund firms should avoid overambitious predictions with regard to performance: “Communicate exactly what you can and cannot do ... never overpromise as this will impact your credibility,” said one midsize manager. Some of the managers also cautioned against setting out an aggressive pitch to investors – “A big mistake that some funds make is to anticipate what investors want,” said a midsize manager.

While some firms may launch products simply to meet the latest apparent investor trend, the most successful hedge fund firms prefer to focus on creating solutions that best meet the expectations of their clients within their existing capabilities.

Managers feel it is important to strike up a rapport with investors but some caution against over-reliance on the investment principal's personality. Managers should guard against the use of hyperbole in all forms of communication with their investors, whether this is just in a simple casual exchange with an investor or in a more formal correspondence. An investor's hard-won confidence can be easily undermined by undeliverable promises on the part of the manager, intentional or otherwise.

Communicating complex investment strategies to investors can be challenging. Many interviewees stress the need for having a clear story to present to their investors rather than disseminating a complex or cryptic narrative. Borrowing from a frequently used US phrase, "Keep it simple, stupid," is a common remark mentioned by the managers. The onus is on managers to find a way to explain the substance of their investment views to investors, however complex they may be.

Of course, investors also need reassurance, especially during periods of underperformance. This is where clear, realistic expectations set by the manager from the start can prove their worth – "because the fund was clear from the start about our strategy and operating style, investors don't question our decisions," said one midsize manager.

Successful funds choose their investors carefully

The hedge fund participants for this paper see increasing value in performing their own due diligence on potential investors. In some cases, managers are prepared to turn away new investment capital, unless they are convinced that the investment makes sense for them in the long run, and that both they and their prospective investors share common goals for a strong alignment of interests – "The management will not take capital injections from investors who do not understand or care about the context of where their money is being invested," said one midsize manager.

There are compelling reasons for hedge funds to reject additional capital. These go beyond practical considerations, such as the difficulty of replicating past returns as the scale of a fund grows or the ability to liquidate positions in adverse markets.

For firms that are not currently managing at their fund's full capacity, this is a brave decision. The fact that some hedge fund firms view this as a driver of success highlights the value of having a strong alignment between managers and investors.

Consistency is crucial, but this needs to be tempered with flexibility

Setting expectations is just one step to ensuring better investor relations. According to the respondents to this paper, the need for greater consistency in adhering to a fund's investment philosophy and how to communicate this to investors is also a critical factor in building a better relationship with the firm's clients.

"Don't hide away from tough messages, even in difficult times." Large manager

"You have to do what you believe in and not get caught up in the hype – of which there is a lot of in the industry," said one midsize manager. "know what you are and what value you can bring; have a plan and ensure that you stick to it!," said another midsize manager.

Similarly, inconsistency – especially if a hedge fund is moving away from its investment philosophy, or stated objectives – is extremely damaging and possibly fatal to the confidence of an investor. "It is fatal to be inconsistent, especially when you have switched on investors. Investors are very suspicious of a change to an investment story or the firm's investment process," explains one midsize hedge fund leader. A second said, "Straying from your path is disorientating and unlikely to yield long-term success." While another cautioned, "Do not deviate from the investment style that first attracted investors."

However, consistency does not mean that hedge fund firms can ignore changes in the investment landscape and opportunities available. It is just as important for firms to evolve in response to a change in market conditions within parameters dictated by the fund documents and articulated by the fund's principals. Many hedge fund firms we spoke to identified their ability to alter their firm's course in response to macro events as a critical factor to their firm's success. "There has been some adaptation driven by market fluctuations, but no style drift," said one emerging manager.



Maintaining ongoing communication with investors is essential

Consistency is not the only aspect of successful investor communication. Increasingly, hedge funds are advocating proactive communication with investors.

A closer examination of the manager respondents to this paper reveal that all of them now provide regular investor updates, although the frequency of this reporting varies from the near continuous to the more typical monthly or quarterly briefings. Increasingly the format of these reports are more tailored to their investor base, evolving from the typical standard level of communication – an approach that their investors endorse.

This is particularly important in difficult times, even if such conversations can be challenging – “Be bold when communicating to investors that in reality, things are not going well, instead of window dressing,” said a small manager.

Investors receive increasingly high levels of transparency – but firms offer varying levels of disclosure

Transparency is indispensable to investor trust. The majority of the midsize managers we spoke with put forward this view, with some commenting, “Transparency can never be detrimental to business” and “investors can see virtually anything they ask for.” Today’s managers clearly go to significant lengths to provide investors with the levels of transparency that they demand, whether this is due to a better understanding of the investment side of the business or addressing queries about the firm’s operational infrastructure.

“Very few people get into trouble for overcommunicating, but many get in trouble for undercommunicating.”
Midsize manager

What does transparency mean in practice? Being clear about what are the expected standards by both the fund and the firm when accepting a new investor can help avoid later misunderstandings. It also helps investors to understand that transparency does not come without a cost. Investor communication takes time and consumes resources, whether conducted by fund principals or dedicated relationship managers.

A commitment to transparency means that most hedge funds are providing regular data in their ongoing communications and responding to ad hoc investor queries. These can range from typical questions pertaining to the fund's performance to queries about the rationale for putting on a particular position or even a demanding request for a better understanding about an aspect of fund operations or governance. "It really depends who your investor is – there is no hard or fast rule," said one midsize manager. Different funds also respond in different ways. Even if many view ad hoc requests as a time-consuming distraction for portfolio managers, it is clear that hedge funds will respond to investor requests as best they can – "Transparency ... means giving thoughtful answers backed by reasoning, even if the news is not necessarily what investors expect," said one midsize manager.

"There is way more demand for transparency. Five or six years ago we would decline to give out information, but today there is a need to be more flexible."
Midsize manager

For some of the respondents, transparency is not just about providing performance and risk reports and responding to queries, but also about giving investors regular access to key individuals in its firm, "to show there is nothing to hide," said one midsize manager.

Successful hedge fund firms tend to offer full portfolio disclosure only on a face-to-face basis (if at all). Most managers are skeptical about why investors might need this level of information, and some feel that sharing it can even be counterproductive to building a better relationship with their client. As one midsize hedge fund manager put it, "We do not believe in disclosing excessive information that may in fact be irrelevant and unhelpful to investors."

Dedicated, expert investor relations teams are becoming the norm for many hedge funds

Given the importance that hedge fund firms attach to expectations management, transparency and communication, it is not surprising that many hedge fund firms count investor relations⁴ (IR) as integral to a firm's successful development. Smaller start-up firms are less likely to employ full-time IR personnel, placing a greater burden on portfolio managers. As firms grow their business, it is becoming increasingly common for them to develop expert, dedicated IR teams.

"It is fundamentally important to get the right type of clients in your strategy. They must understand your strategy, your style and how you manage. The IR function should not be incentivized to sell."
Small manager

A successful IR function gives investors access to knowledgeable staff with a deep understanding of the fund's investment processes and operational framework. This not only allows the firm's front office to concentrate on generating performance returns, it also reduces the risk of disappointment from challenging investor performance being exacerbated by poor relationship management. As one midsize respondent commented – "You absolutely need to have these people." In contrast, others stressed that a poor IR function can be detrimental to investor relationships – "You can definitely screw up through bad client service," said one midsize manager.

Reassuring the fund's existing investors is just as important as attracting them in the first place, and good IR teams are particularly valuable in challenging times. "There is a lot of value in the IR function, especially in bad times to ensure that money is not pulled out by investors," said one large hedge fund firm, with another midsize firm commenting, "Retention in tough periods is definitely improved by good client service."

⁴"AIMA publishes guide for investor relations professionals," *AIMA website*, <https://www.aima.org/article/aima-publishes-guide-for-investor-relations-professionals.html>, 16 June 2016.



Many of the successful managers we spoke to are making IR a more prominent and specialized feature of their business models, and this trend seems likely to continue. Several stressed the importance of considering the range of skills within the IR teams. For example, having staff within the firm who are better able to communicate the characteristics of their product helps the investors understand what the manager can offer and also ensures that managers understand what the investors are expecting from them. Similarly, investors seem to increasingly value the chance to speak to the firm's product specialists, with some of the firms that we spoke to, in the course of this work, mentioning that they employ former analysts in an IR capacity. We also note that the more successful firms are more rigorous in their training of IR teams, to ensure that they understand their fund structures comprehensively and appreciate implications for investors based on their nature and jurisdiction. Ensuring that their IR teams have sufficient experience and stature to independently manage communications and investor queries can remove the burden from the firm's portfolio managers.

Importantly, larger successful managers have identified that having senior specialists responsible for the IR function as one factor for success. Indeed, some of the managers view long-serving IR specialists as so integral to success that they have now offered them a stake in the business. This deviates significantly from the original hedge fund model where IR team members were relatively junior and their remuneration was mostly subscription driven.

Managers are increasing flexibility to achieve better alignment with investors

Many respondents see achieving an alignment between the interests of managers and investors as the ultimate goal of successful relationship management. One of the key attractions of hedge funds and other alternatives products has always been the close alignment that managers seek to offer to investors. Concepts like “skin in the game,” the almost universal practice where managers invest a significant portion of their own money alongside external investors and the high watermark, a peak value above which performance fees are paid, are almost unique to alternatives and have underpinned the industry’s growth for decades. In contrast, mutual funds and other forms of traditional investments are not designed in the same way.

A commitment to alignment is not altruistic. Close relationships between hedge fund firms and investors require considerable effort on both sides, but deliver mutual benefits. A recent AIMA survey⁵ shows that managers are working increasingly closely with investors to foster this relationship. Conversely, a perception of poor alignment and inflexibility can be very damaging to the hedge fund business model. As one large manager put it, “Investors will lose confidence without clear alignment, which could be terminal for the business.”

In recent years, hedge funds have become increasingly flexible with the fund fee structures they offer to investors. Several managers we spoke to say that they have granted fee concessions to their investor base. However, a growing number of firms are going further. AIMA’s survey shows that more than three-quarters of managers either offer or are considering to offer a sliding fee scale for larger investments. Longer lockups, which many managers see as important to success, are being linked with reduced fees more frequently. As stated by one midsize manager, “The long-term view is that the locks protect investors from each other.” Well-established practices such as principals investing personally in their funds are also being formalized more often.



⁵“In Concert – Exploring the alignment of interests between hedge fund managers and investors,” AIMA, September 2016.

Regional variations



Overall, managers' views in North America, Europe and Asia-Pacific have a lot in common. Some themes, such as the importance of a consistent investment philosophy, the need for greater transparency and the value of having a strong operational firm infrastructure strongly resonate from the universe of managers that contributed to this piece. Nonetheless, there also seem to be some variations in emphasis between the regions, as to what traits a firm would likely adapt when establishing their business.

Asia-Pacific

The fragmentation of Asian markets presents some obvious operational challenges. Given the smaller sized industry of Asian managers, a number of managers worry about the lack of market liquidity (needed to execute their investment strategy) and stress the need to educate investors about the role that hedge funds play in providing liquidity and a greater sense of order to markets.

Several managers cite internal capacity as a limitation on growth, although others take the view that "small is beautiful." Asian hedge funds also see their brand and investment culture as an important differentiation attribute. Due to their relatively smaller size, each team member is a vital cog in the machine and must exude those attributes, or face being changed up. In comparison to their larger US and UK counterparts, Asian fund managers are not thinking as much about succession planning given their operations tend to be smaller in size.

Among our manager respondents, Asian hedge funds aspire to be more entrepreneurial than their larger peers operating out of the US and the UK. There is good potential for first mover advantage when entering a new market or asset class. In contrast to their US and European counterparts, founding principals and senior portfolio managers play a greater role in the IR function of Asia-Pacific-based firms. There is also generally less fee pressure as successful managers are able to differentiate themselves.

Europe

The European managers that we spoke to (mainly in the UK) presented the widest range of views as to what constitutes success. This reflects the diversity of the European market, which includes many well-established firms for whom brand, legacy and succession may be important but also includes emerging managers, many of whom seem determined to do things differently and embrace the changing environment as an opportunity.

Nonetheless, the managers we spoke to identified similar characteristics as contributing to their success. Almost all European managers we spoke to focused on the value of working with their investors in an open and collaborative way built on transparency, aligned interests and long-term mutual benefit. There is an increased appreciation of an IR function that does not “sell,” but represents the firm to its investors in a professional manner, based on a detailed understanding of the investor and the firm.

UK managers were particularly thoughtful in their approach to fostering a unique culture, mainly with regard to attracting and retaining key personnel in what is a very competitive talent market. Managers at all stages of their life cycle were focused on culture as the basis for something that will last, showing the faith of both established and emerging managers in the future of the European industry.

On the operational side, UK managers are more inclined to consider outsourcing parts of their operations and administration, given the more cost-competitive environment. Still, the primary focus on quality and execution preserves a general reluctance to give up control of anything that could damage reputation to achieve operational excellence.

We expect the drive toward institutionalization at the larger end of the UK market to continue, with established firms able to expand the range of strategies they cover, having invested significantly in infrastructure that will allow them to do so. We also expect smaller firms specializing in specific strategies and delivering excellence to benefit from investors’ appetite for a differentiated approach, from an increasingly tailored IR presence to manage the demands of those investors and an increasingly institutional infrastructure to deliver it.

North America

The US market features some of the world’s largest and longest running hedge funds. Our population of US managers identified many of the same success factors as their European peers, including the need to develop and retain staff, the value of good alignment, the merits of an innovative culture and the value of adaptable leadership.

For many US managers the importance of investment in the relationship with their investors and the associated transparency and other requirements seemed to be more widely embedded in the industry. This may reflect the more significant presence of institutional investors in North America hedge funds over a longer period and managers’ acceptance of the demands of such investors.

The North American market is also characterized by intense competition for investor capital. The resulting pressure to retain capital is a leading consideration among managers in the region, contributing to the general recognition of the need for strong relationships with investors, actively monitored and managed by dedicated professionals.

For many US managers, the culture of a firm was very closely linked with its founder and the founder's personality. Managers felt that strong leadership from founders and their insistence on running the business exactly how they wanted was important to a firm’s success, both in terms of brand and attracting talent. This emphasis, together with the maturity of the market and the many long-standing firms within it, explains why appropriate succession planning was considered critical, at least to those for whom success means a business that will outlast its founders.

Growing costs of compliance are a concern for some US managers, and the ability to manage costs appropriately was cited by many managers as critical to their success, in particular during the early years of business.

Many managers acknowledged the need for the North American hedge fund industry to stay on its toes and ensure that it retains its unique attractions for investors as innovation and the increasingly global talent market in hedge fund centers in Europe and Asia-Pacific catch up in terms of infrastructure and attracting institutional investment.

Conclusion

Success means different things to different firms, depending on their life cycle stage, business model, investment strategies and chosen markets. While some hedge fund firms view size as a marker of their success, others specifically warn about the potential risks of excessive growth. As one large hedge fund manager put it, "Success is an objective against oneself, depending on the type of business you are trying to build."

It is clear that many hedge fund managers see a similar range of factors as crucial to their success.

We summarize our key findings as follows:

- ▶ Managing people and culture
 - ▶ The relatively small size of hedge fund firms and their need to be creative and distinctive makes the management of people and culture a vital aspect of success.
 - ▶ Firms need to recruit, retain and motivate the right staff. Effective, aligned remuneration is vital, but nonfinancial factors and a positive culture are increasingly seen as equally important.
 - ▶ Hedge fund firms need to confront "weak links" head on, if necessary by removing disruptive or underperforming staff members.
 - ▶ Effective leadership is critical, and this highlights the importance of succession planning.
- ▶ Managing the infrastructure
 - ▶ A strong operational infrastructure within the firm has long since become a vital contributor to success in the hedge fund arena.
 - ▶ Hedge fund managers also emphasize the vital importance of having strong in-house operational talent and their operations team having appropriate status, influence and discretion within the firm.
 - ▶ Our research suggests that hedge fund firms need to walk a fine line between greater robustness of the firm's operations and excessive institutionalization.
- ▶ Managing investor relationships
 - ▶ The need for clarity and transparency is crucial to many aspects of successful investor relationships, including expectation setting and communication.
 - ▶ Investor expectations are constantly shifting, and managing these requires a perpetual process of rebalancing.
 - ▶ The ability to adapt changing market conditions while maintaining a consistent investment approach is a crucial example of this balance.
 - ▶ Another key decision for firms to take is the extent of portfolio data disclosure they are willing to provide to investors.

- ▶ Most hedge fund firms are strengthening their investor relations capabilities. Many are also working more closely with investors to improve alignment – including via greater flexibility over fee structures, lockups and other investment terms.
- ▶ Some firms are even prepared to turn down new investment if the investor is not a good long-term fit for the development of their business.

Many of these factors are interlinked. For example, firms that have the right culture makes it easier to recruit the right people, helping them to give their investors the right experience.

The subtlety of hedge fund firms' responses show that it is wrong to generalize about the industry. These are organizations that place a high value around creativity, investor satisfaction and protection, long-term planning, employee welfare and ethical behavior.

The fact that hedge fund firms have evolved so much in recent years suggests that they remain well placed to grasp any future opportunities. Investor demands are changing, and firms are responding in kind. As one midsize manager noted, "Investors are no longer looking for high-risk, high-return funds, instead they want to diversify and dampen the volatility of their portfolios."

Of course, change does not only bring opportunities. Our research confirms that hedge fund firms face some significant hurdles in the years ahead. To begin with, they are not immune to the technological, political and regulatory threats that are reshaping the financial world. They also face a number of sector-specific challenges. One is increasing competition for capital investment, including from mainstream asset managers entering the alternatives space. Several managers see overcapacity in the industry as a problem – "It has become really crowded and quite a tough space to operate in," said one midsize manager.

A second challenge comes from the growing costs of compliance. "The regulatory and legal environment have significantly impacted the costs of launching," said one large manager while another midsize manager described growing compliance burdens as "a tax on the business that did not previously exist." These factors mean that newcomers are seen as facing greater hurdles than in the past – "Starting a hedge fund today is not as easy as 10 years ago," said another midsize manager.

Looking ahead, hedge fund managers are well aware of other emerging threats. There is widespread recognition that continuing fee pressure will be a major challenge. "Many firms have already amended their fee structures in response to poor performance or the threat from more cost-competitive products," said one midsize manager.

Some see a need for the sector to regain its distinctive edge, one midsize manager complaining, “The push to become more institutionalized has killed the business as we know it – the production of real alpha is diminished. It is less entrepreneurial, less iconoclastic.”

“It is always good to keep thinking of what might come around the corner, and how to address that.”
Large manager

The adaptability of the hedge fund industry is one of its great strengths. Our research makes it clear that successful hedge fund firms are already responding to a slew of changing demands. Their receptiveness to an increased focus on transparency and acknowledgement for greater fee flexibility are two examples of their willingness to change.

In an environment of persistent low yields and the likelihood for increasing market volatility (supported by a tighter monetary policy as well as a more expansionary fiscal policy), the importance of delivering a unique set of risk-adjusted returns is only increasing. Arguably, more than ever before, hedge funds need to emphasise why they are different to their peers and how they stand out from the crowd. As one midsize manager put it, “Doing something different does not automatically make you successful. ... Difference needs to provide an advantage to the investor.”

As they develop, hedge fund managers’ views of success will no doubt continue to evolve. The ability to manage that process of change will be critical if hedge funds are to remain at the cutting edge of investment, defend their worth, stand out from their peers and enjoy continued success. The hedge fund industry needs to sustain its track record of innovation if it is to continue to evolve as a solutions provider for investors.

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