Prime Services
Capital Solutions
Hedge Fund Pulse

Coming to Terms

Recent developments in Hedge Fund fees, liquidity, and transparency

February 2016

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I. Study overview

As is well known, Hedge Fund (HF) terms, in particular their fees, liquidity, and transparency, are key elements of the framework that governs the relationship between HF managers and their investors. In recent years, HF terms have been in greater focus than was the case before the 2008 / 2009 financial crisis. Recognizing that HF terms considered acceptable to investors were dramatically different in the aftermath of the financial crisis, in 2010 the Barclays Strategic Consulting team published a content piece titled "28 Months Later" which was our attempt to document and analyze these changes. Five years later, we believe that HF terms continue to evolve as HFs remain under pressure from their investors to make these even more investor friendly. In this study, we assess recent developments in HF terms and what impact, if any, they are having on the industry.

The four main topics addressed in this study are:

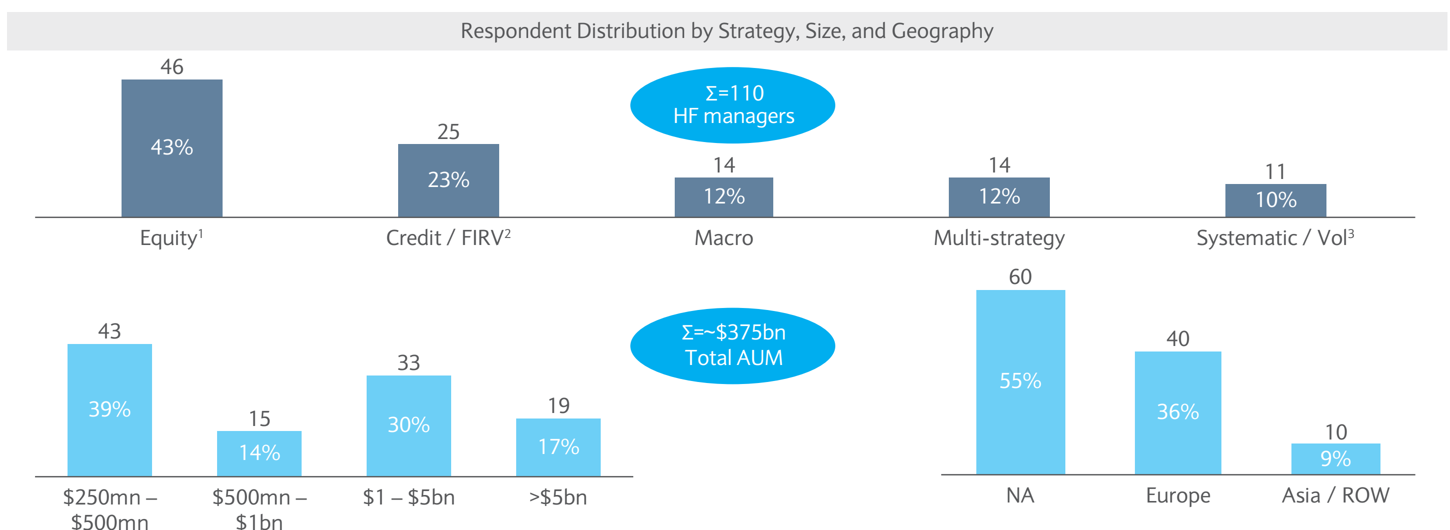
1. **Distribution of assets**
   a. How has the importance of commingled fund vehicles evolved over time at HF firms, relative to other vehicles / products?
   b. How does the importance of the flagship product and strategy (asset class) change as HFs grow bigger?
   c. How does HFs' investor base composition vary by HF strategy and size?
2. **Liquidity and transparency**
   a. How has the total time it takes investors on average to redeem their investment into HFs changed over time? How does it vary by strategy?
   b. Which strategies have the longest initial lock? Which are most likely to feature an investor level gate?
   c. How frequently do HFs communicate with investors? What are the common channels used?
3. **Fees**
   a. How common is the 2 / 20 fee structure? What percentage of assets at HFs firms are paying headline fee rates?
   b. What types of fee discounts are most commonly offered by managers? How do these vary by strategy and what are the key factors driving these discounts?
   c. What are the average headline and average maximum discounted fees by HF size and strategy? How should investors think about fee structures higher than 2 / 20?
4. **Growth and positioning**
   a. What strategies have seen the highest AUM growth over the past two years? How do flows into the industry break down by HF size and strategy?
   b. Which investor types have been the biggest contributors to asset growth recently? What are the key trends surrounding Managed Accounts (MAs) and Co-investments?
   c. What do HFs think are the main factors influencing recent asset raising success? What are HFs' key priorities going forward?

Methodology

With these questions in mind, the Strategic Consulting team tapped three main sources for data for our analyses:

1. Survey input from 110 HF managers with $375bn in total AUM in Q3 2015

FIGURE 1: Study Participants' Profile



1. Equity category includes firms that categorize themselves as Equity L / S, Sector L / S, Equity Market /Neutral, Event Driven; 2. Credit / FIRV includes Credit L / S, Distressed and Structured Credit, and Fixed Income Relative Value; 3. Systematic / Vol includes CTA, Managed Futures, Vol, Eq Quant

Note: The results presented in this chart, and all subsequent charts (unless indicated otherwise), are from a relatively small number of respondents and therefore are indicative only and not meant to reflect conclusive industry trends. Data and other information presented are derived directly from respondents and we cannot confirm the accuracy of such information. All figures refer to Strategic Consulting study results only

2. In-depth, one-on-one interviews with ~30 of these HF managers to better understand their thinking and related actions
3. External data and research, including:
   a. 50 different publications, academic research papers, and regulatory filings
   b. ~10,000 data points on HF returns (HFR Database – Hedge Fund Research, Inc.)

Figure 1 shows the breakdown of our surveyed managers by strategy, firm AUM and geography. Select highlights:

- We think the sample is quite representative of the HF industry, though there is a slight skew toward systematic / volatility (Vol) strategies at the expense of Multi-strategies.
- In terms of firm size, our sample is skewed toward larger funds (greater than $1bn), though we do have good representation across the size spectrum.
- Finally, from a regional / geographic perspective, our sample is skewed toward North America (NA) and Europe-based HF managers.

II. Executive summary

The following are high level takeaways from the study:

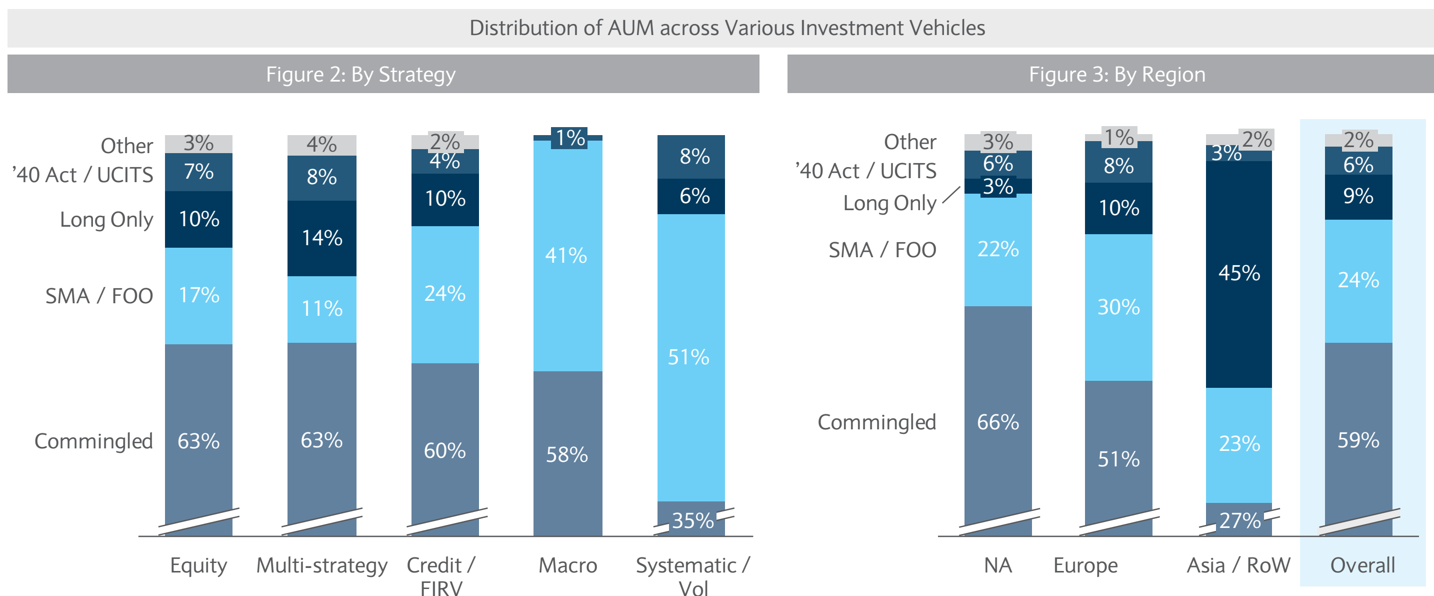
Distribution of assets

- The size of commingled vehicles (~60% of the overall AUM in our sample) seems light, relative to vehicles such as Separately Managed Accounts (SMAs) / Funds-of-One (FOOs) (~25% of the AUM in our sample overall), which we know reflects recent investor interest in bespoke products.
- Along the same lines, in our sample as HF firms grow, less and less of their AUM is attributable to their flagship product, though firms tend not to stray far from the dominant asset class of the flagship product.
- Across our HF sample, investor representation in HFs' asset base varies significantly by strategy and AUM – largely reflecting investors' known biases (e.g., institutional investors account for a larger portion of the AUM of larger managers – >$1bn – and multi-strategy HFs compared to other HFs).

Liquidity and transparency

- Our analysis suggests that the average length of time it takes an investor to fully redeem their investment in an HF is continuing to decline (e.g., from ~19 months in 2008 when we first looked into this to just over 11 months in 3Q15), although there is considerable disparity across HF strategies.
- A key driver of liquidity is HFs' use of initial locks and investor level gates – initial locks are used by ~55% of HF firms in our sample, while only ~20% have investor level gates (Credit / Fixed Income Relative Value (FIRV) HFs are the most likely and Macro the least likely to use investor gates as part of their liquidity terms).
- A surprisingly high percentage of HFs provide either current (usually through risk aggregators only) or lagged position level data to investors, although practices vary by strategy (Macro HFs appear most likely to share position level data, while Multi-strategy are the least likely).
- In choosing between different communication channels to provide transparency to their investors, HF managers in our sample appear to make rational choices – leveraging low-touch channels to disseminate generic information and using high-touch channels more sparingly.

FIGURE 2 and 3: Investment Vehicles



Note: All figures refer to Strategic Consulting study results only

Fees

- The conventional wisdom that '2 and 20' headline fees are a relic of the past seems to be true for HFs in our sample, but primarily only on the management fee side – only a third of the HFs in our sample charge a headline management fee rate greater than 1.75%, although a much higher percentage are holding the line on performance fees (~55% have headline performance fees of 17.5% – 20% and another ~30% charge performance fees greater than 20%).
- Two-thirds of the HFs in our sample offer discounts – primarily for larger tickets (~55% of the sample) and early investment / longer lock (~40%).
- Across HFs, management fee discounts appear to be commonly offered in exchange for larger tickets and / or longer locks, while performance fees are typically discounted by HFs without capacity issues / netting risk.
- Our analysis of the HF databases shows that there is correlation between higher headline fees and higher net returns, suggesting that there may be some signaling value to higher HF fees.

Growth and positioning

- AUM growth varied significantly across the HF strategies in our sample (Equity and Credit / FIRV led the way over the last two years).
- Managers in our sample credited a multitude of factors for recent asset raising success, with returns relative to competitors, investor sentiment around their strategy, and consultant endorsement being the top three.
- Offering MAs is another widely adopted practice, though the minimum AUM to set up such an account seems to vary widely across strategies – Multi-strategy HFs have the highest average ticket requirement of $75mn and Sys / Vol the lowest average at just under $30mn.
- Across our sample, the focus for the near-term future is on the flagship product (including customized mandates) as improving returns is clearly the main concern of managers and investors alike.

III. Distribution of assets

In order to set the stage for some of the following discussions about terms, we figured it made sense to first establish some patterns of distribution of assets in the industry. With that in mind, in this section we examine how the AUM of HFs is distributed across various investment vehicles, flagship product or asset class versus other products or asset classes, as well as individual investor channels' share of HFs' asset base across our sample.

Investment vehicles

One common theme across this study is that the HF industry, while quite mature in some ways, is still evolving in many other ways. One example of ongoing change is apparent when we look at the distribution of AUM across various investment vehicles. Figures 2 and 3 show that the HFs in our sample have ~60% of their AUM in commingled vehicles, ~25% in MAs, and the balance in other vehicles (e.g., long only, '40 Act and UCITS products), with some variations by strategy and geography of domicile. With only ~60% of assets concentrated in commingled vehicles, we believe this reflects the decline in importance of commingled vehicles over time and expect this trend to continue in the near future (not shown) as investors and managers get creative with the setup of vehicles to ensure that product characteristics, especially terms, meet both sides' expectations.

Across the various HF strategies chart on the left in (Figure 2), Equity, Credit / FIRV, and Multi-strategy have a similar breakdown of their AUM across investment vehicles, while Macro and Systematic / Vol appear to have very different mixes – Systematic / Vol and Macro rely more than the other strategies on SMAs / FOOs (i.e., ~50% and ~40% of their AUM, respectively). In our sample, the proportion of AUM in commingled vehicles goes down markedly along the geographic dimension as you move away from North America (NA), which has about two-thirds of its aggregate AUM in commingled vehicles, compared to ~50% for Europe and only ~25% for Asia / Rest of the World (RoW). While both Europe and Asia / RoW have a similar proportion of their assets allocated to managed accounts as NA, they appear to have a much larger proportion of their assets in 'long only' and more liquid vehicles[1] (particularly Asia / RoW, where almost 50% of overall assets are in 'long only' and more liquid vehicles).

Distribution of AUM across flagship vs. other products / asset classes

The next question we looked into was how AUM is distributed across flagship products versus other products, and the flagship asset class versus other asset classes, within our sample. Figure 4 shows that the proportion of AUM in the flagship product decreases as the size of HFs increases, which is consistent with our understanding that HFs can no longer rely on their flagships to sustain asset growth once they reach a certain size. Additionally, the reduction in the proportion of assets accounted for by the flagship accelerates as HF firms cross major size milestones (e.g., from a fall of ~15 percentage points in share of assets in the flagship as firms go from $1 – $5bn to $5 – $10bn, to a ~25 percentage point decline in share of assets in the flagship in the next size bucket of $10bn+ firms). Finally, it appears that many flagship funds hit a virtual size ceiling at around $4bn based on the proportion of our overall sample firms' AUM that resides in flagship funds across the various AUM size ranges.

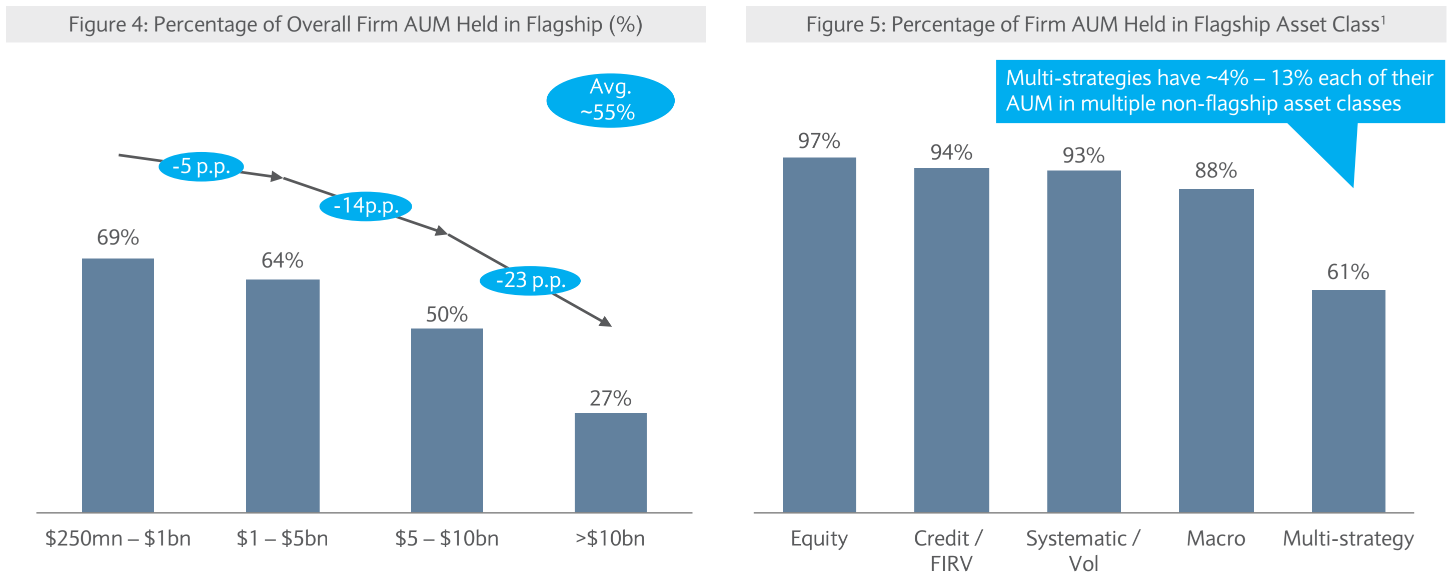
Although the average flagship fund is only ~55% of the overall AUM of the HFs in our sample, the remainder of the AUM is very likely to be invested in the same asset class as the flagship. Figure 5 shows how only Multi-strategy firms indicated that they have significant sleeves across other products / asset classes (e.g., Macro, Equity, Credit / FIRV), whereas other strategies have ~90% or more of their AUM in their flagship asset class.

1. Includes '40 Act, UCITS, CLOs, Index Plus, etc.

Investment breakdown

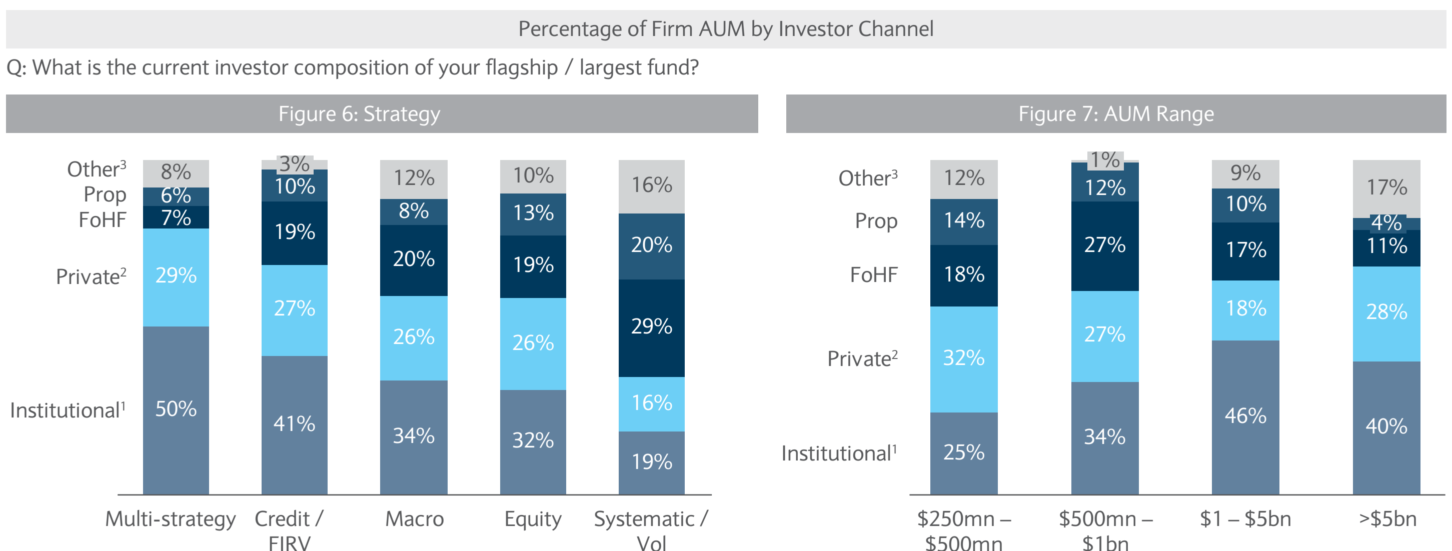
When looking at the breakdown of the asset base of HFs in our sample by investor type, we found that investors' biases are fairly obvious, when looking at the asset distribution by strategy (Figure 6) as well as by size (Figure 7). Multi-strategy HFs are popular with Institutional investors, with 50% of their assets sourced from these investors, while Systematic / Vol HFs are at the other end of the spectrum, with only ~20% of their assets from institutions. When looking at the asset distribution by HF size also, as expected, we found that larger HFs source more of their assets (40%) from institutions than smaller HFs are able to (25%). Fund of Hedge Funds (FoHFs), on the other hand, account for a larger share of AUM of strategies less preferred by institutions (primarily Systematic / Vol, but also Equity and Macro to a lesser extent). Finally, private investors are the biggest source of capital for HFs with $250 – $500mn in assets in our sample, and they are neck-and-neck with FoHFs in the next size category ($500mn – $1bn), thus indicating perhaps their respective investment 'sweet spots'.

FIGURE 4 and 5: Breadth of AUM across Flagship / Asset Classes



1. Not asset weighted across the HF respondents, refers to respondents' indications of their AUM split across multiple HF strategies
Note: All figures refer to Strategic Consulting study results only

FIGURE 6 and 7: AUM Breakdown by Investor Type



1. Institutional includes: Pensions, Endowments & Foundations (E&Fs), Insurance Companies, and Sovereign Wealth Funds; 2. Private includes: Family Offices, High Net Worth (HNW), and Private Banks; 3. Other includes investors from other financial institutions such as bank platforms, etc.
Note: All figures refer to Strategic Consulting study results only

IV. Liquidity and transparency

In this next section, we take a close look at liquidity and transparency terms being offered to investors by HFs today. We also try to establish, where possible, whether these terms have evolved over time.

Total redemption time

To analyze liquidity terms, we analyzed the total time it takes for an investor to be able to fully redeem their allocation to an HF. In order to do this, we calculated the Redemption Duration, which we define as the combined effect of the notice period, the redemption frequency, and the maximum redemption per period (i.e., investor gates, if any). The Total Redemption Time, then, is a combination of the Redemption Duration and the initial lock. In other words, we calculated the time it takes an investor to get all their money back if they were to change their mind about their allocation to an HF the same day their allocation check clears. As can be seen in the chart on the left in Figure 8, the average Total Redemption Time has fallen significantly (i.e., from ~19 months in 2008 to ~15 months in 2010, to ~11 months in 2015). From 2008 to 2010 the decrease in Total Redemption Time was completely driven by a decrease in the initial lock, whereas the improvement from 2010 to 2015 appears to be due to both a continued gradual decrease in the initial lock as well as the Redemption Duration. Although we see a 20% decline in Total Redemption Time across both periods, it is worth noting that the two time periods in question are not the same in length (i.e., 2008 – 2010 versus 2010 – 2015), suggesting that while liquidity terms are getting better generally, the rate of improvement is slowing down. The chart on the right in Figure 8 shows that while the Time to Redemption varies significantly by strategy (Credit / FIRV is almost three times Systematic / Vol), it broadly reflects the liquidity of the underlying positions.

Initial lock and investor level gates

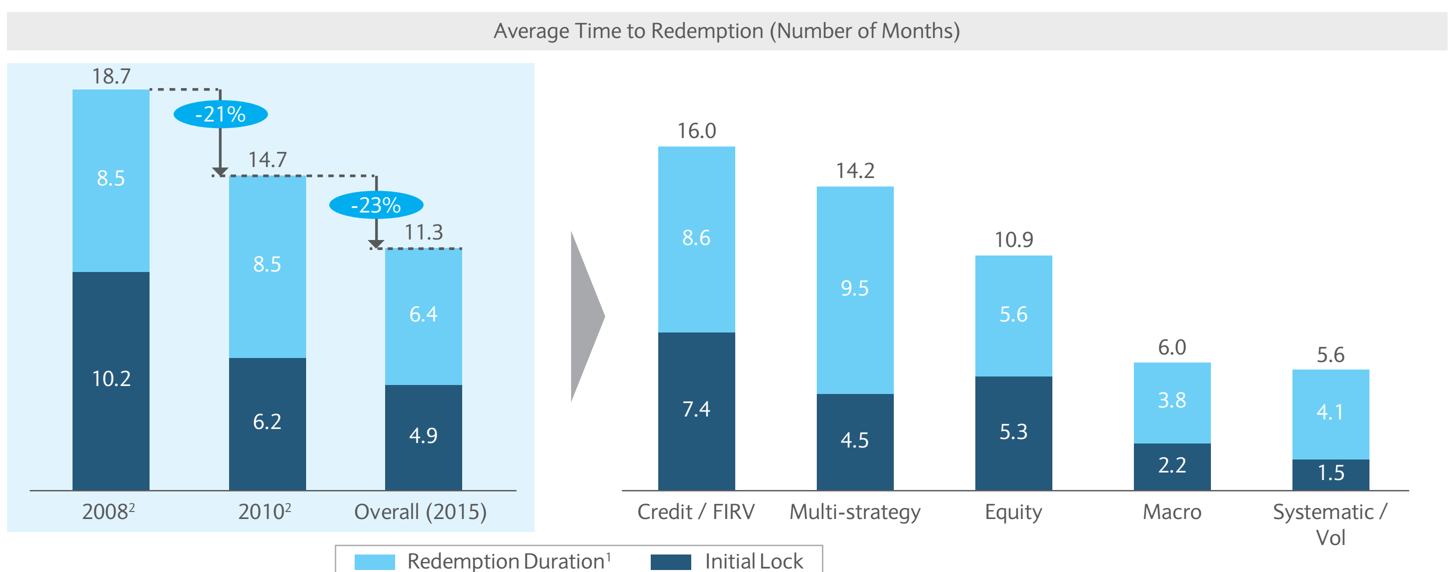
Taking another look at initial locks (Figure 9) as well as investor level gates (Figure 10) across our sample, the differences across strategies are quite evident. For instance, investors in Credit / FIRV strategies are most likely to face both the longest initial lock as well as investor level gates, whereas investors in Macro are likely to see the shortest locks and (at least in our sample) no investor level gates at all. Again, this is consistent with the liquidity of the underlying assets held / traded by these strategies, on average. Overall, the majority of firms (~55%) in our sample have an initial lock, though the average lock is well below 12 months (chart on the left in Figure 9). Again, Credit / FIRV HFs have the longest average initial lock at 11 months, while Equity, Multi-strategy, and Macro HFs are all around seven months, and Systematic / Vol HFs have the shortest average lock of only about four months.

Figure 10 shows that, in contrast to the relatively high adoption rate of initial locks, the number of firms with an investor level gate is significantly lower (55% versus 20% on average, respectively). Once again Credit / FIRV HFs are the most likely (~40%) to have one, and Macro HFs are the least likely to have investor gates (none of our Macro respondents do). Multi-strategies (25%), Equity (~20%), and Systematic / Vol (~20%) appear to be quite unlikely to have one in place and when they do, it is worth noting, they tend to be relatively short in duration as quarterly gates are the most popular by far.

Portfolio transparency

Consistent with the trend toward better liquidity, investors have grown to expect greater levels of transparency from their HF managers. For HFs, on the other hand, transparency is a trade-off between giving investors what they want and what makes sense

FIGURE 8: Total Redemption Time

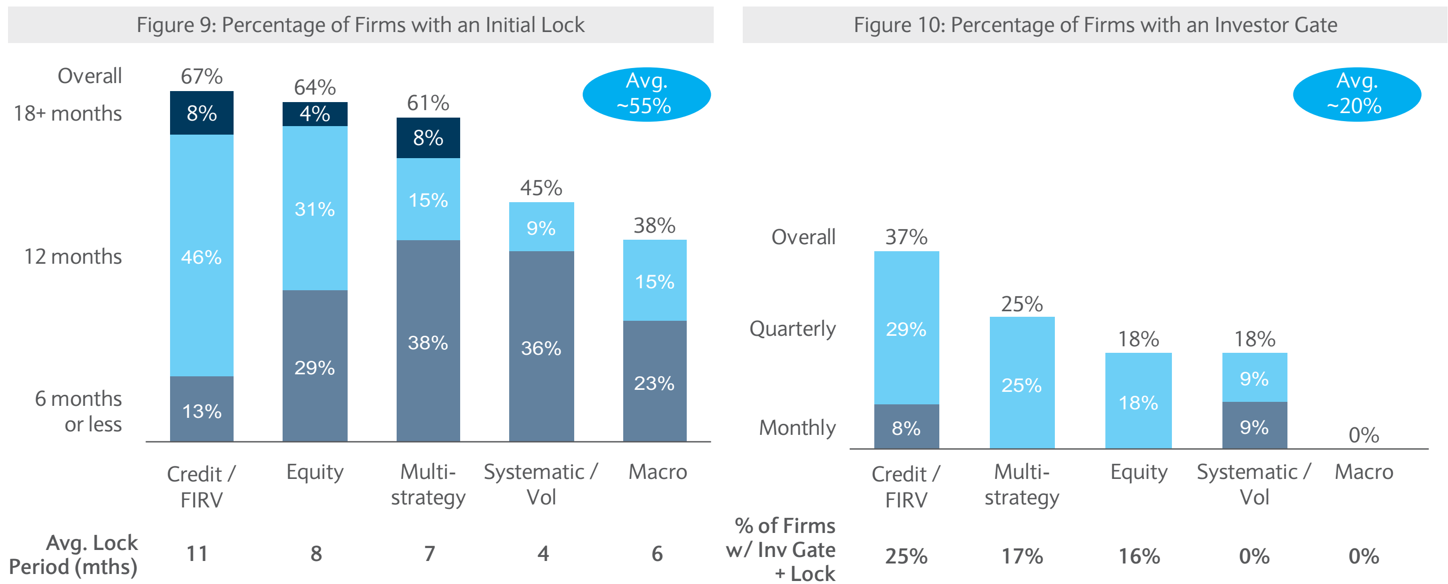


1. Redemption duration is the combination of notice period, redemption frequency, and maximum redemption per period; 2. "28 Months Later" is a Strategic Consulting piece from 2010
Note: All figures refer to Strategic Consulting study results only

for managers from the perspective of protecting their intellectual property (IP) or 'secret sauce' and preventing its misuse, although it appears that the balance is tipping toward investors. In our sample, we found that investors' expectations are generally being met, as a surprisingly high percentage of HFs provide either current (usually to aggregators only) or lagged position level data to investors, although practices vary by strategy as can be seen in Figure 11.

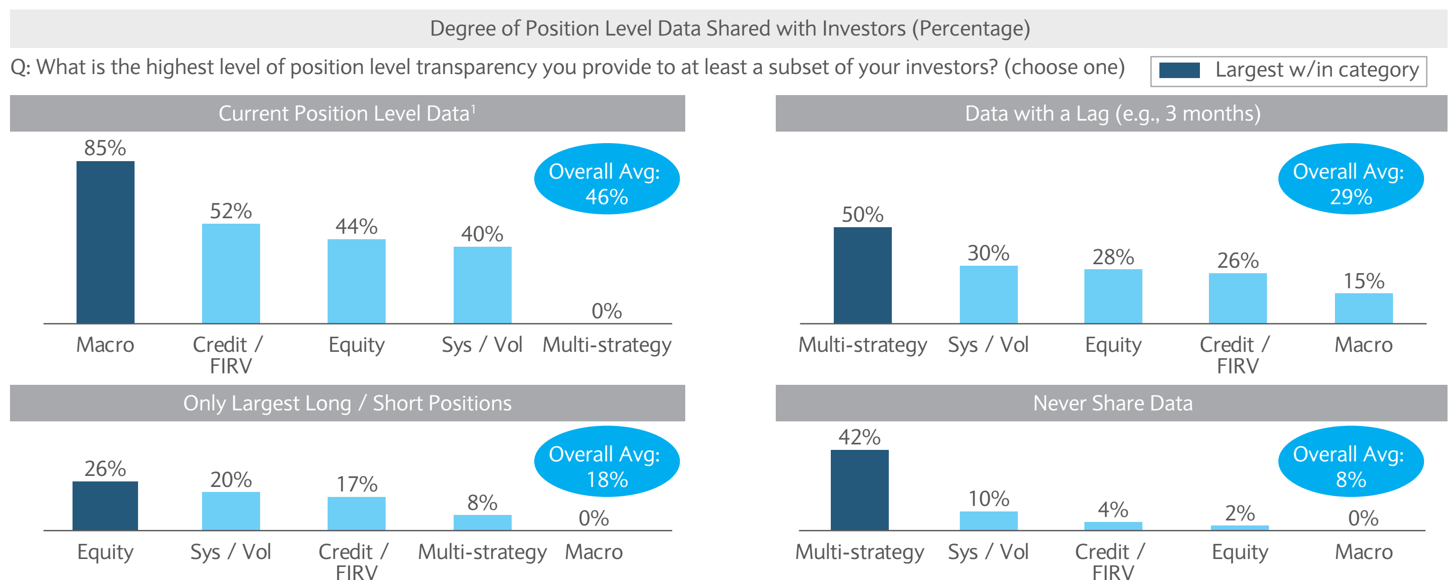
Overall, we were somewhat surprised to find that the largest proportion of respondents (46%) reported providing current position level data, even if only to risk aggregators and / or to investors in in-person meetings only. We did notice that the willingness to provide position level data is closely related to how quickly the portfolio typically turns over (i.e., the faster the turnover, the less risky it is for managers to share position level data) and how much managers feel their positions reveal their 'secret sauce'. Thus, Macro funds in our sample are the most willing to share position level data, 85% said they do this, and the rest provide this data typically with a lag. Multi-strategy HFs, on the other hand, typically have a very different approach – none of the firms in our sample indicated they share current position level data, 50% share data with a lag, 8% only share their largest positions, and 42% never share any position level data at all. Other HF strategies fell somewhere in between depending on their comfort level and ability to convince their investors of the reasonableness of the transparency given to them.

FIGURE 9 and 10: Initial Lock and Investor Level Gates



Note: All figures refer to Strategic Consulting study results only

FIGURE 11: Portfolio Transparency

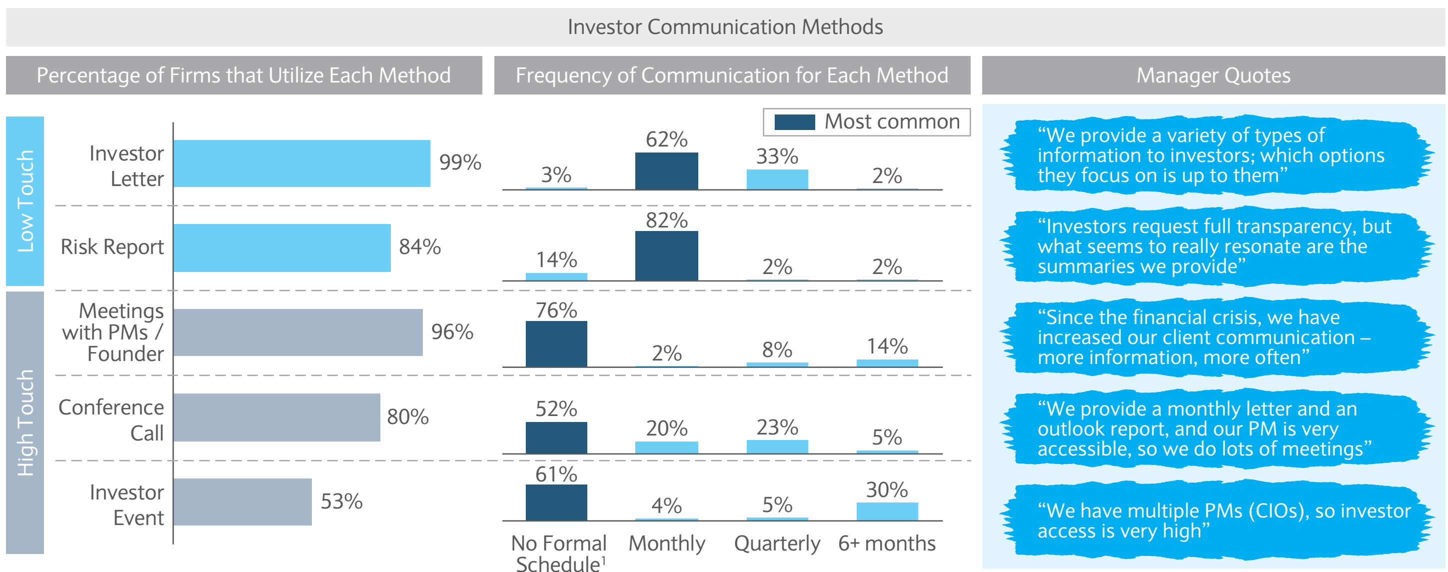


1. Current data can be shared via an in-person presentation, through managed accounts, etc.
Note: All figures refer to Strategic Consulting study results only

Typical communication channels

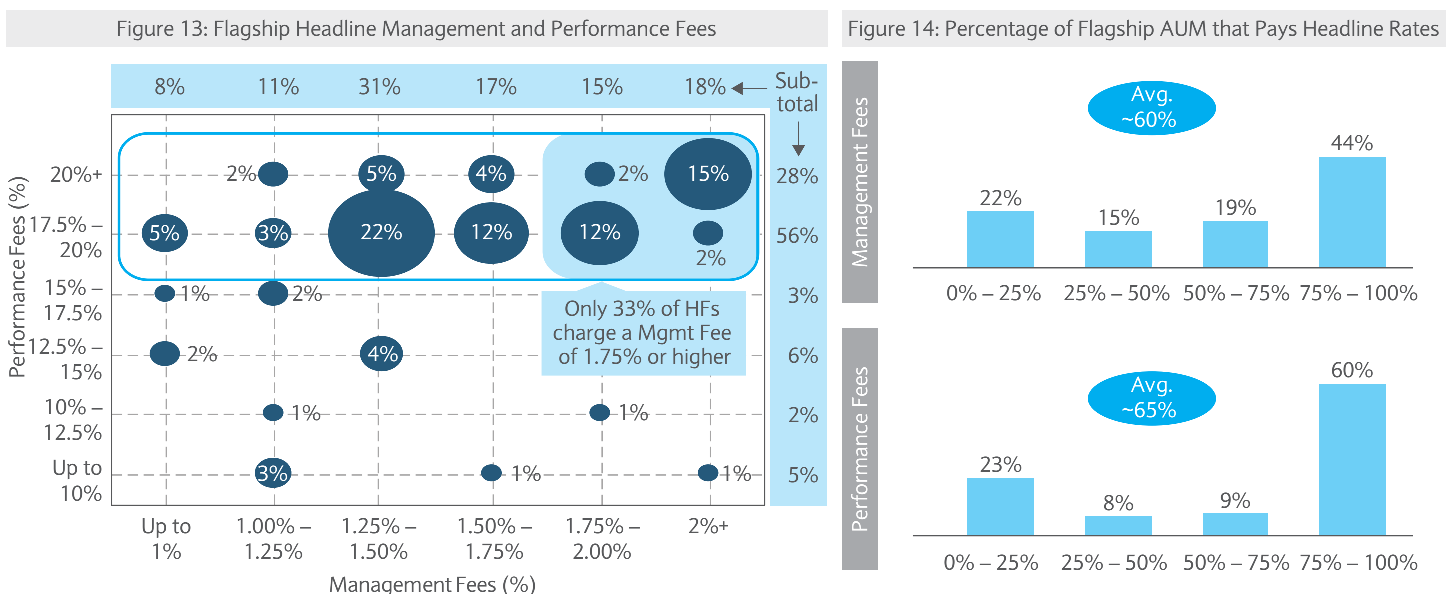
Aside from position level transparency, which appears to be the holy grail for many investors and which appears to be easier to get these days in the HF industry, we found that managers are using multiple channels to communicate more routine information to their investors. Figure 12 shows HF managers' rate of adoption of various communication channels, as well as the frequency with which each channel is utilized, on average. Managers appear to be making rational / efficient investor communication channel choices – leveraging low-touch channels more frequently (e.g., investor letters and risk reports are provided by most HFs at a monthly frequency to their investors) and using high-touch channels more sparingly (meetings with PMs / founder, conference calls and investor events are commonly utilized but not on a predetermined frequency). As expected, high-touch communication channels that are more expensive in terms of PM / founders' time (meetings and conference calls) or money (investor events) tend to be utilized on a more ad hoc and 'opt-in' basis (i.e., investors have to request these / sign up). That said, other than investor events, which require the most planning, are the most expensive, and have the most disparate audiences, even the high-touch channels were in use at 80% or more of the firms in our sample.

FIGURE 12: Typical Communication Channels Used by HF Firms



1. Generally based on investor demand and manager discretion as opposed to a more formal / regularly scheduled basis (e.g., annually, monthly, etc.)
Note: All figures refer to Strategic Consulting study results only

FIGURE 13 and 14: Headline Fees



Note: All figures refer to Strategic Consulting study results only

V. Fees

A key focus in recent years for HF investors, of course, are the fees charged by HFs. Often vilified in the press and much maligned by certain investors is HFs' ability to charge the proverbial '2 and 20' fees. We now examine HF fees and whether there is any change in HFs' ability or desire to charge the traditional '2 and 20' fees to their investors.

Headline fees

Investors like to believe that the '2 and 20' fee structure should be treated as a relic of the past and should be discarded in favor of more equitable fee arrangements. Our sample provides a good bit of proof that this may in fact be happening. Figure 13 depicts the flagship headline performance fees of HF firms in our sample (on the Y-axis) vs. the flagship headline management fees (on the X-axis), along with the aggregation and sub-totals of data points. This chart shows that the move away from '2 and 20' appears to have occurred in a material way, at least on the management fee side, where only 33% of our sample has a headline management fee rate of 1.75% or higher. However, HFs appear to be holding the line to a much greater extent on performance fees, as ~55% have a headline performance fee rate of 17.5% – 20%, and another ~30% charge 20%+. Keep in mind, though, that so far we have restricted ourselves to discussing 'headline' rates or advertised fees and many investors will tell you, "Almost no one pays the headline rates anymore." So, we decided to examine this question more closely.

Figure 14 shows the distribution of HFs in our sample by the percentage of AUM that pays headline fee rates. For example, only 44% of HFs reported that full fees are paid by more than 75% of their investors. Similarly, only 60% of HFs reported that more than 75% of their AUM is being charged headline performance fees. We dug deeper to see if there was any differentiation by strategy or fund size and found that there was considerable dispersion by HF size. More specifically, larger funds have a significantly higher percentage of their assets paying headline rates than smaller funds, likely because a larger portion of their AUM has been raised at fee structures that were historically high.

Fee discounts

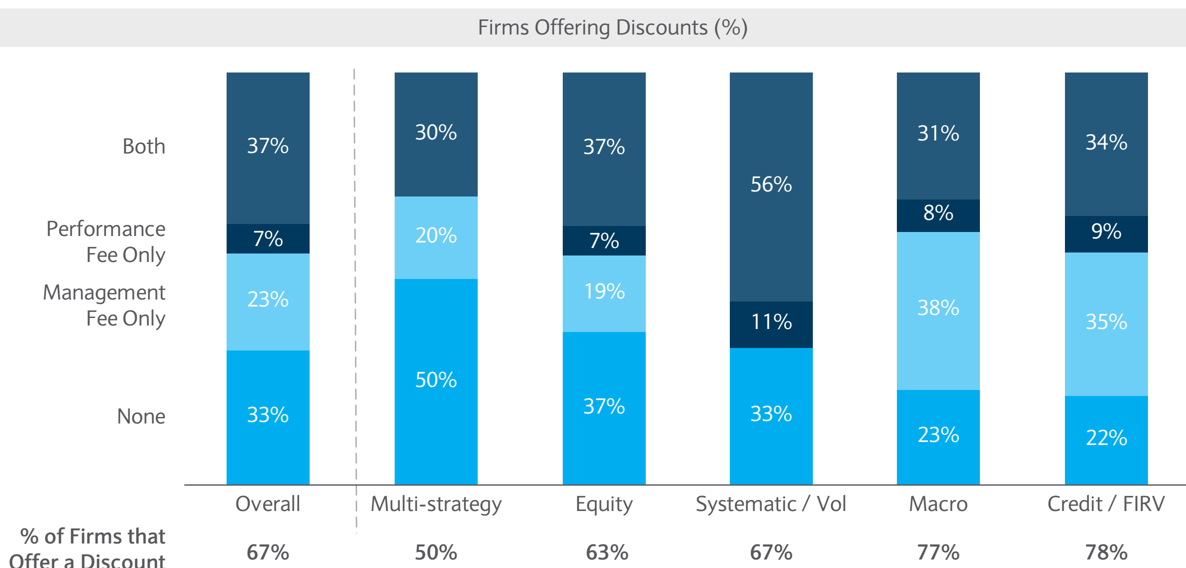
As discussed previously, fee discounting at HFs, at least in our sample, appears to be much more the norm than not. Figure 15 shows the distribution of HF firms in our sample (by strategy) according to different fee discount categories (i.e., no discounts offered, only management fees discounted, only performance fees discounted, or both discounted). It illustrates the extent to which discounts are prevalent in the industry, as ~67% of HFs in our sample overall offer fee discounts to their investors. The chart shows that a larger percentage of managers in our sample are discounting both management and performance fees (37%) rather than either management fees or performance fees alone (23% and 7%, respectively).

As we look at fee discounts across strategies in Figure 15, we see that there are significant differences between the individual strategies' approach to discounting (e.g., only 50% of Multi-strategy firms offer a discount, while ~80% of Credit / FIRV managers do so). Furthermore, very few HFs discount performance fees alone, which is consistent with our understanding that given the perceived interest alignment in paying performance fees (and netting risk for Multi-strategy firms), most investors zero in on management fees first and then on both management and performance fees to seek discounts.

Drivers and delivery of discounts

The obvious next question is: who gets fee discounts and why? We looked into the key drivers and the answers were not surprising. Figure 16 shows that larger ticket sizes (for 56% of managers) and longer lock / early investments (for 52% of managers) appear to be the main reasons why managers are

FIGURE 15: Fees Discounts



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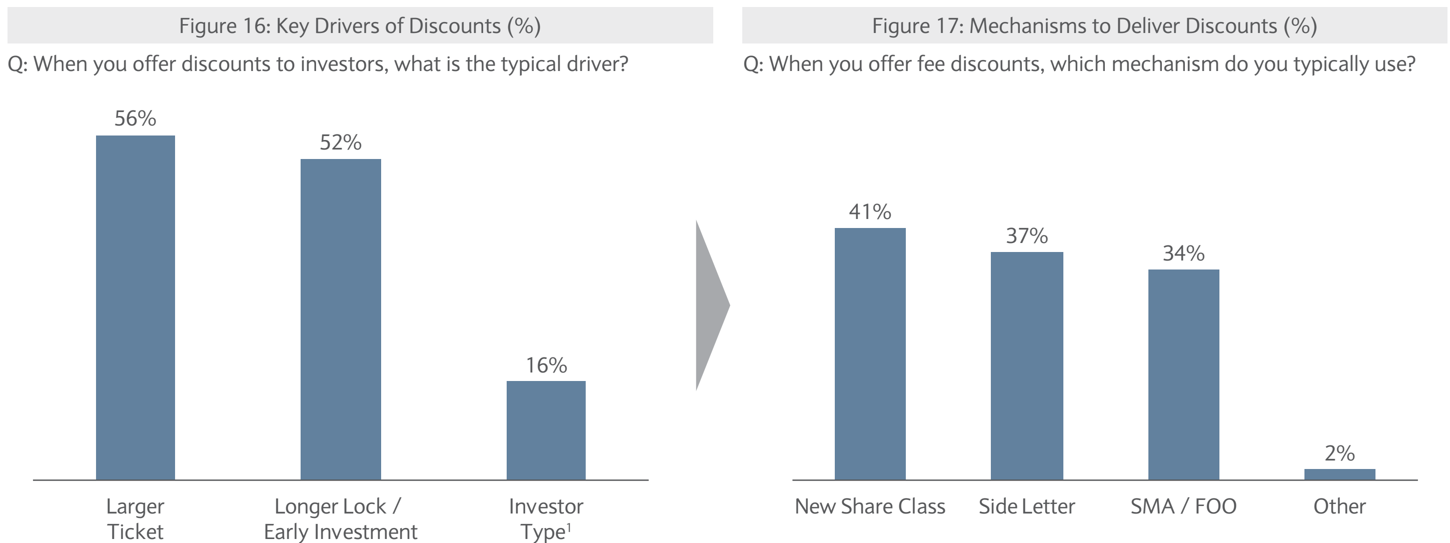
willing to agree to discount fees. With regard to longer locks, it appears that while liquidity terms offered to investors continue to improve in their favor, managers are trying to manage the overall liquidity profile of their capital by offering discounts in exchange for longer locked capital. Given the deteriorating liquidity in secondary capital markets, this seems to be a rational thing to do.

Regardless of the rationale for offering discounts, HF managers appear to have three main mechanisms to deliver discounts to their investors. Figure 17 shows that HF managers are almost equally likely to offer discounts by adding new share classes, providing side letters, or setting up managed accounts (e.g., SMA / FOO). HF managers do have a slight preference for new share classes, probably because they are a 'cleaner' way to implement discounted fees, e.g., prevent MFN (most favored nation) issues from arising, and are a less operationally intensive way of implementing a different fee structure (e.g., as opposed to managed accounts).

Fee discounts by strategy

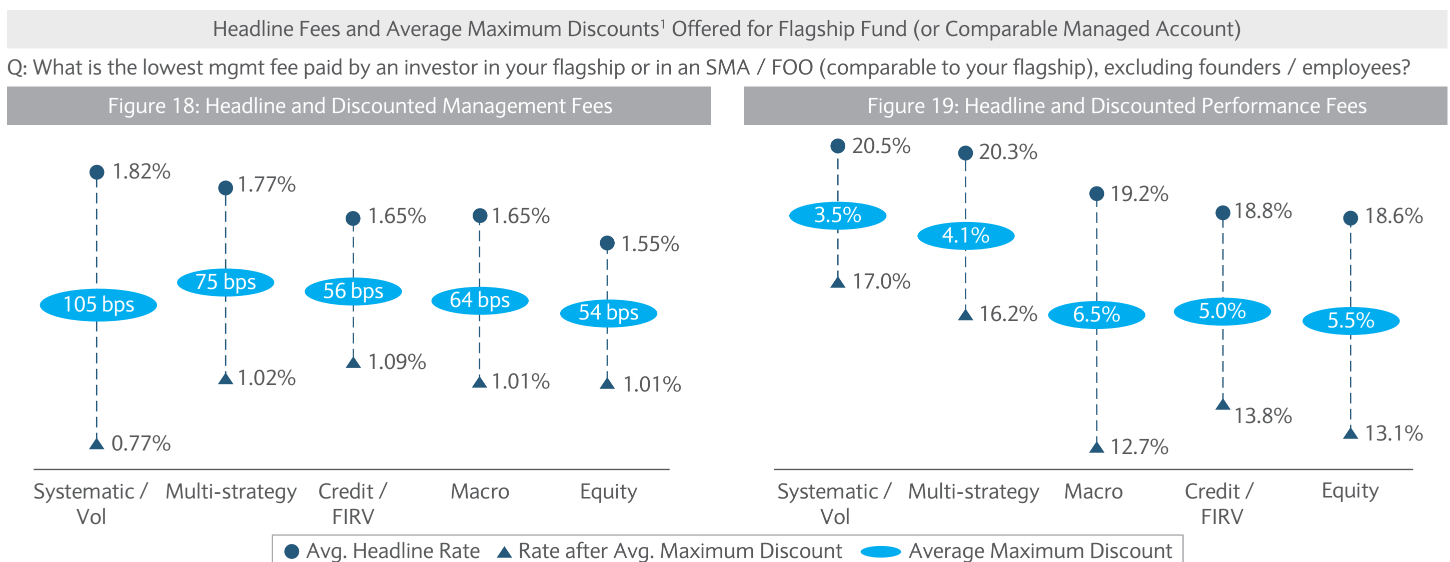
Beyond the frequency, types, and rationale for discounts, we were also curious about the depth of discounting that goes on for both management fees (Figure 18) and performance fees (Figure 19). These figures depict, in our sample, the average headline management and performance fees, the average maximum discount and the lowest average discounted fees paid by investors in HF firms' flagship fund or an associated managed

FIGURE 16 and 17: Drivers and Delivery of Discounts



1. HF managers willing to offer discounts in order to adjust their channel mix, such as a move to more institutional investors
Note: All figures refer to Strategic Consulting study results only

FIGURE 18 and 19: Fee Discounts by Strategy



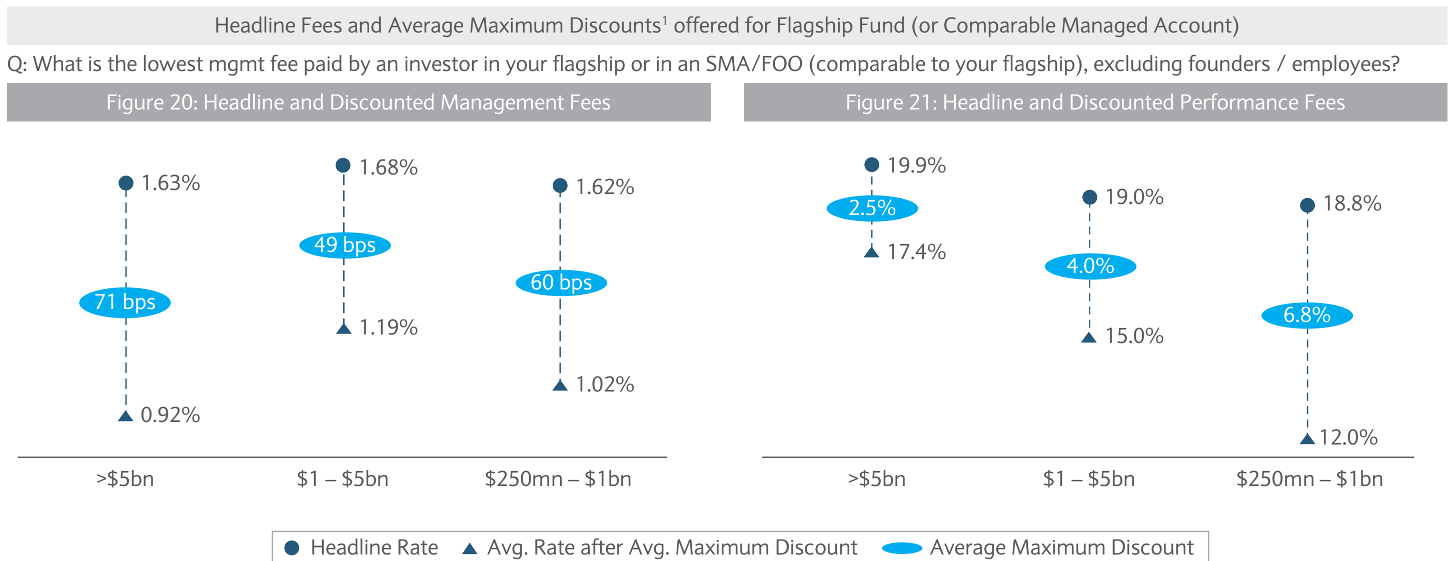
1. Maximum discount refers to the difference between the headline rate and the lowest mgmt / perf fee paid by an external investor in a flagship fund or in an SMA / FOO (comparable to a flagship fund)
Note: All figures refer to Strategic Consulting study results only

account (by strategy). It appears that promotional pricing is common across strategies when it comes to management fees (i.e., high headline fees are usually accompanied by similarly high discounts – equity strategies have the lowest headline number, on average, and consequently discount it less than other strategies). The higher cost structure of some HFs (e.g., Credit / FIRV and Multi-strategy) also gives them the ability to resist investor pressure for discounts on management fees. Performance fees, we think, tell a different story: performance fees are discounted most by strategies without capacity issues / netting risk (e.g., Macro, Equity L / S), whereas strategies that are more likely to be sought after / capacity constrained (as some systematic managers are) or have netting risk associated with them (many Multi-strategy HFs) have higher headline performance fees and lower discounts, on average.

Fee discounts by firm AUM

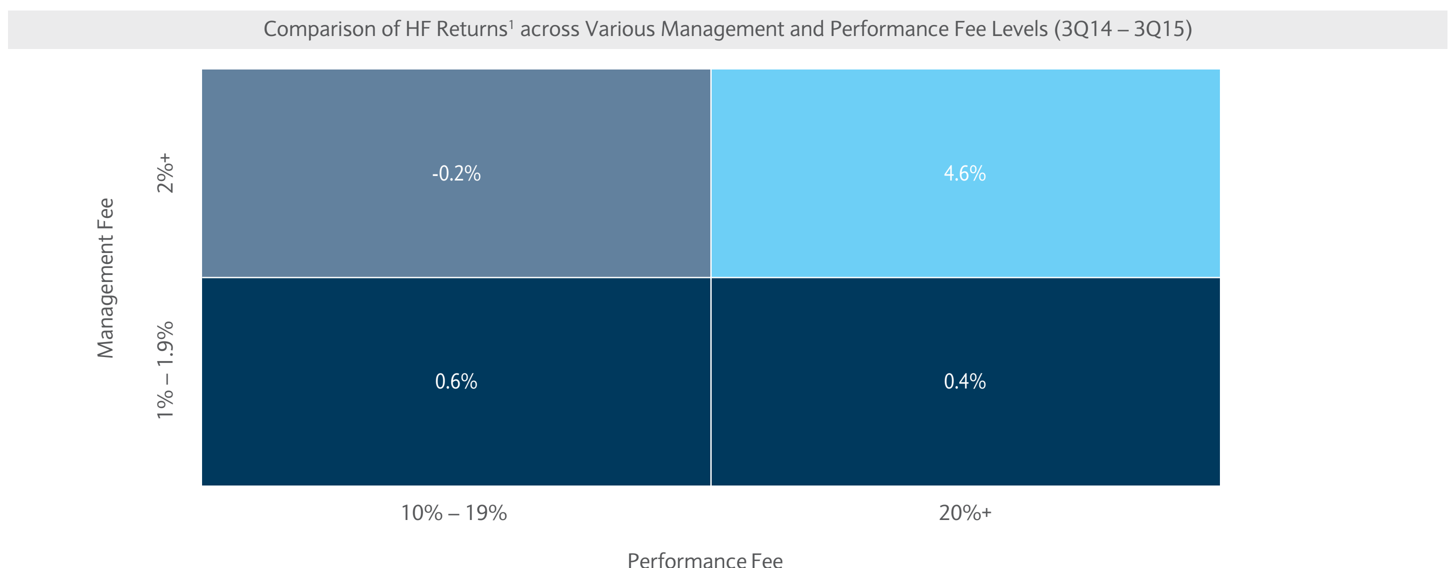
Taking the analysis on discounting a step further, we also delved into how discounting occurs at HFs with various levels of AUM. Across size categories, headline management (Figure 20) and performance (Figure 21) fees are very similar, while the level of discounting reflects either investors' negotiating leverage or managers' pricing strategy. For example, the management and performance fee rates for small and mid-sized managers reflect their respective negotiating leverage (i.e., smaller managers have lower headline fees and offer larger discounts on both management and performance fees). Larger firms, on the other

FIGURE 20 and 21: Fee Discounts by AUM



1. Maximum discount refers to the difference between the headline rate and the lowest mgmt / perf fee paid by an external investor in a flagship fund or in an SMA / FOO (comparable to a flagship fund)
Note: All figures refer to Strategic Consulting study results only

FIGURE 22: Fees vs. Returns



Source: HFR, Strategic Consulting; 1. Returns are self-reported consistent with conventional reporting methods, which specify investor capital under management, net performance fees and leverage
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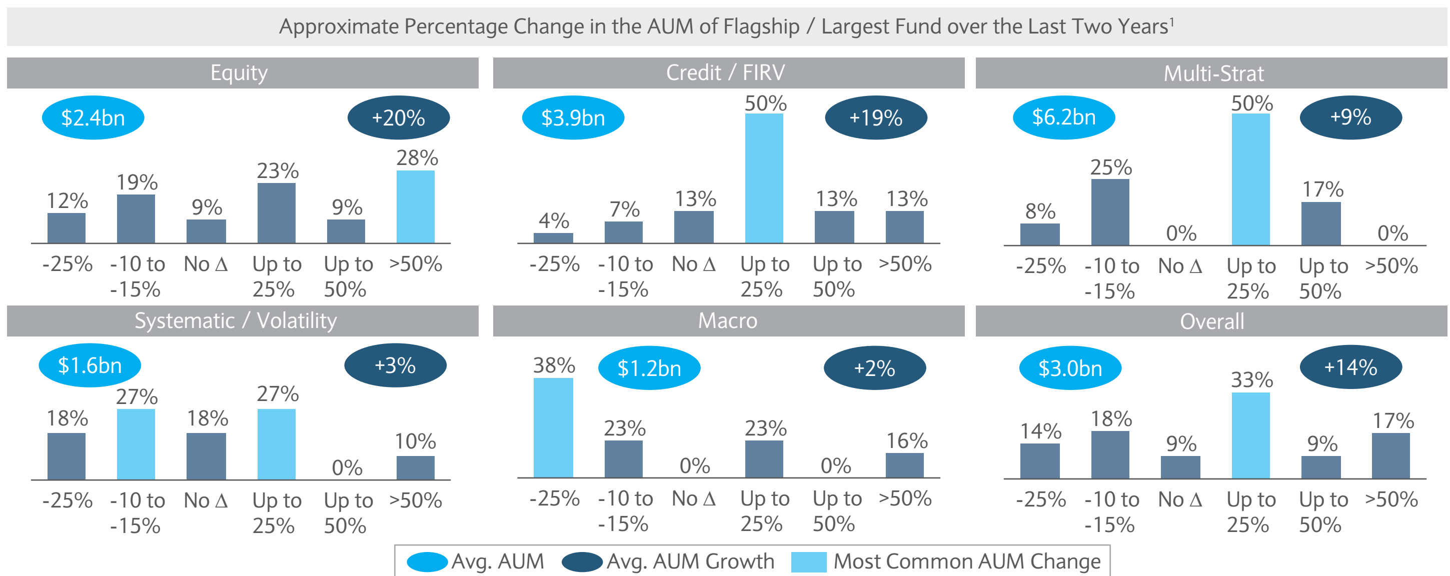
hand, are the most flexible on management fees (presumably for the right investors and the right ticket size / liquidity terms), but they are also the least likely to discount performance fees, suggesting that the management fee discount is a bit of a 'loss leader' strategy.

Fees vs. returns

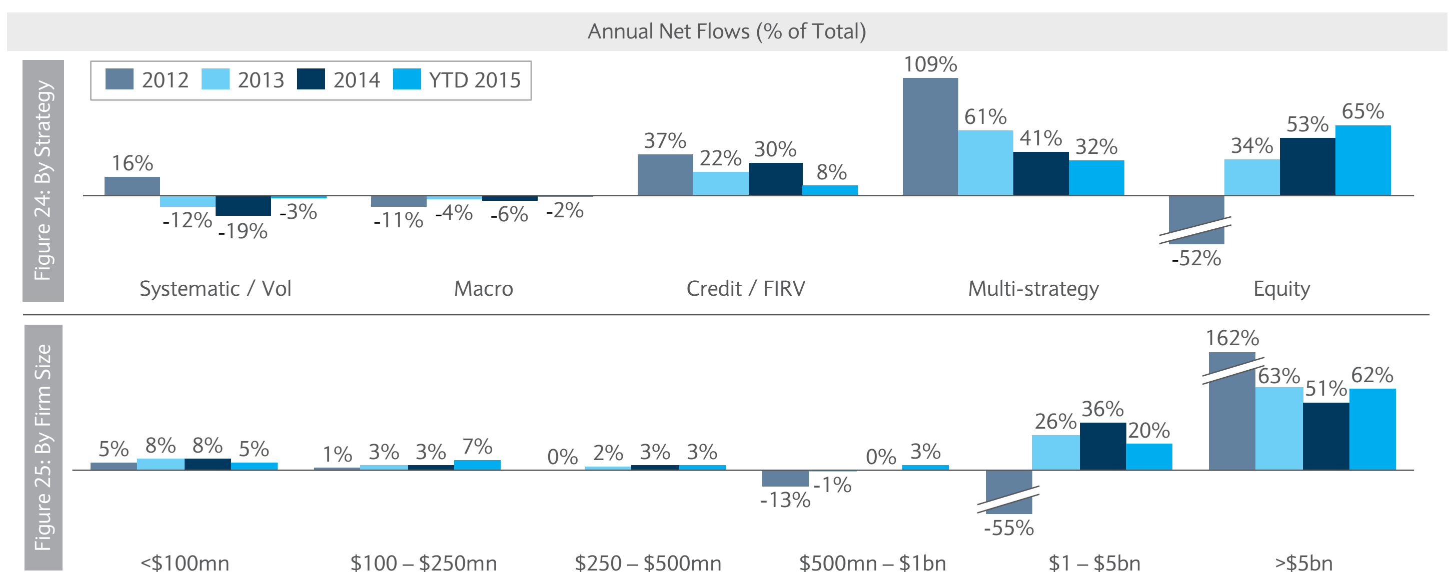
To round out the discussion on fees, we decided to take a step back and and analyze the relationship between headline fee levels and performance. We utilized fee and returns data from HFR to try to identify whether or not fee structures can be a signaling mechanism to investors (i.e., are managers that demand high fees signaling their ability to deliver high returns?). We looked at the net returns of a large number of HFs (on a strategy-agnostic basis) over a one-year period. Broken out across two sets of average management and performance fee levels, it appears, as shown in Figure 22, that the best returning quadrant is the one representing managers with the highest overall fees (2%+, 20%+). While a flaw in our analysis is that we looked at only a one-year period, the data does suggest that the best managers are confident of being able to generate strong returns and therefore demand higher fees. Although any fee discounts are not taken into consideration, we know from earlier analysis in this study that discounts are well distributed across fee structures and therefore it is unlikely that these results would be greatly impacted by their inclusion. The results in the table do suggest that focusing on 'net returns' as opposed to headline fees may make the most sense for investors looking for the best performance.

FIGURE 23: AUM Growth by Strategy



1. The period covers 2014 – 3Q15
Note: All figures refer to Strategic Consulting study results only

FIGURE 24 and 25: HF Flows by Firm Size / Strategy



Source: HFR, Strategic Consulting
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VI. Growth and positioning

In this section, we examine how various hedge fund strategies in our sample have grown over the past two years, the key drivers that promoted growth, and their plans for the next couple of years.

AUM growth by strategy

To get an understanding of the growth trajectory of the HFs in our sample over the last couple of years, we asked them how their AUM has grown since 2014. Figure 23 shows that assets in our sample grew by 14% on average, though there was a bit of variance across, as well as within, strategies. For instance, Equity and Credit / FIRV had the highest average AUM growth over the last two years (+20% and +19%, respectively) – two times the next highest strategy (Multi-strategy) in our sample. This reflects both recent performance as well as investor interest in these strategies over the past couple of years. Looking at the distribution of AUM changes, it is evident that different strategies have very differently shaped distributions, with Equity having a more even distribution compared to Credit / FIRV and Multi-strategy, both of which have a spike in the 0% – 25% category. Meanwhile, the majority of Systematic / Vol and Macro HFs, saw either no change to their AUM on average or saw a reduction.

HF flows by firm size / strategy

Looking at the annual net flows into the industry by firm strategy,[2] Figure 24 shows that since 2012, ~95% of net asset flows have gone to Multi-strategy and Equity HFs – though over this period, flows to Multi-strategy and Equity HFs have been trending in opposite directions, with Multi-strats getting the lion's share of flows in 2012 and lower flows each year since then, and Equity getting the lion's share in 2015, after flows to them grew in size in each of the prior years. Figure 25 shows a relatively counterintuitive view of asset flows by firm size. Anecdotally, most of the 'buzz' in the HF industry has been about smaller and emerging HFs, yet most flows still go to larger, more established firms. Over the last four years, at least four-fifths of net flows have gone to $1bn+ firms, and more than half have gone to the largest firms ($5bn+). The next largest HF size category, $500mn – $1bn, has seen an increase in flows on an annual basis, but still achieved a high of only 3% of overall flows over the period.

Asset growth by investor channel

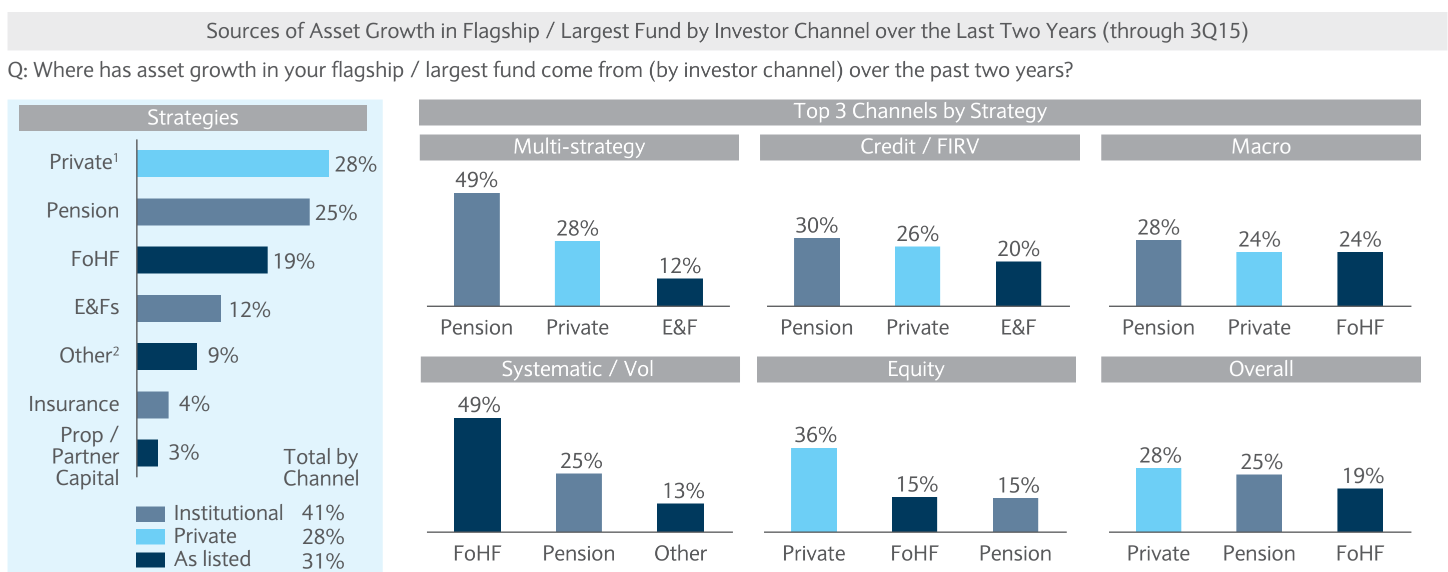
When we analyzed sources of flows for the HFs in our sample by asking managers to pick the single largest source of assets in their flagship or largest fund over the past two years, the results were much as we expected. The chart on the left in Figure 26 illustrates how institutions, collectively, were the most significant drivers of asset growth over the last two years (41% of managers picked institutional investors), though private investors and FoHFs were not that far behind (28% and 19%, respectively). The chart on the right breaks down the data by strategy and shows that, other than for Equity managers, the HFs in our sample ranked Pensions as either the #1 or #2 channel with regard to asset raising (#3 for Equities). Despite this, private investors, at almost 30%, were the largest single investor channel responsible for recent growth and FoHFs (~20%) came in at #3 (chart on the left again).

Approach to managed accounts

When we dug into the rationale for the recent asset growth among the HFs in our sample, we found that offering new products / derivatives of flagship products were material contributors. One of these developments is the proliferation of managed accounts.[3]

2. Based on data from HFR
3. Includes both SMAs and FOOs

FIGURE 26: Asset Growth by Investor Channel



1. Private includes HNW, Private Bank, and Family Offices; 2. Other includes investors from sovereign wealth funds, other financial institutions, etc.
Note: All figures refer to Strategic Consulting study results only

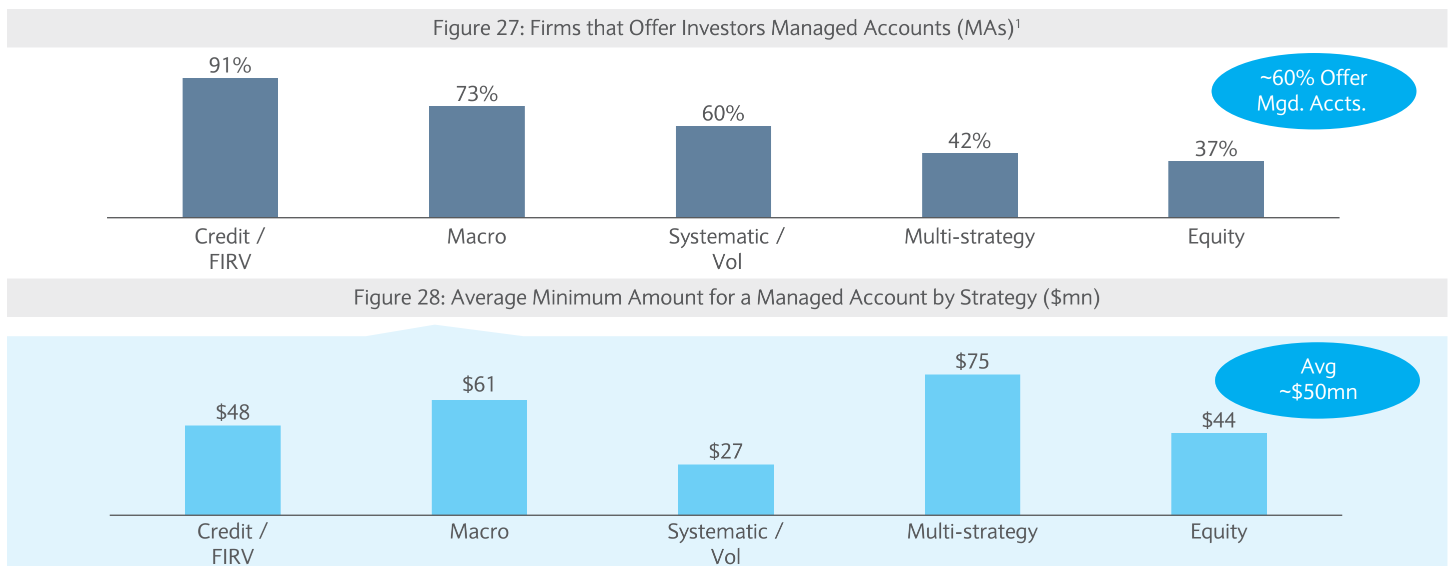
More specifically, Figure 27 shows that ~60% of HFs are using these vehicles to expand their asset base. Credit / FIRV managers (~90%) are the leaders in adoption of MAs, followed by Macro (73%) and Systematic / Vol strategies (60%). Equity and Multi-strategy HFs have the lowest levels of adoption, likely due to the added complexity associated with these strategies (e.g., tracking error can be a challenge for Multi-strategy HFs even though they are typically adequately resourced to handle the increased complexity).

In general, managers expect a minimum investment in an MA as a way to address the added cost and complexity of administering them. Figure 28 shows that the average minimum ticket size required to establish an MA across our sample was $50mn, though it is important to note that there were considerable differences across various HF strategies. The minimum ticket size acceptable to a manager is a function of both strategy and size, with larger firms tending to prefer a higher cutoff amount (not shown).

Approach to co-investments

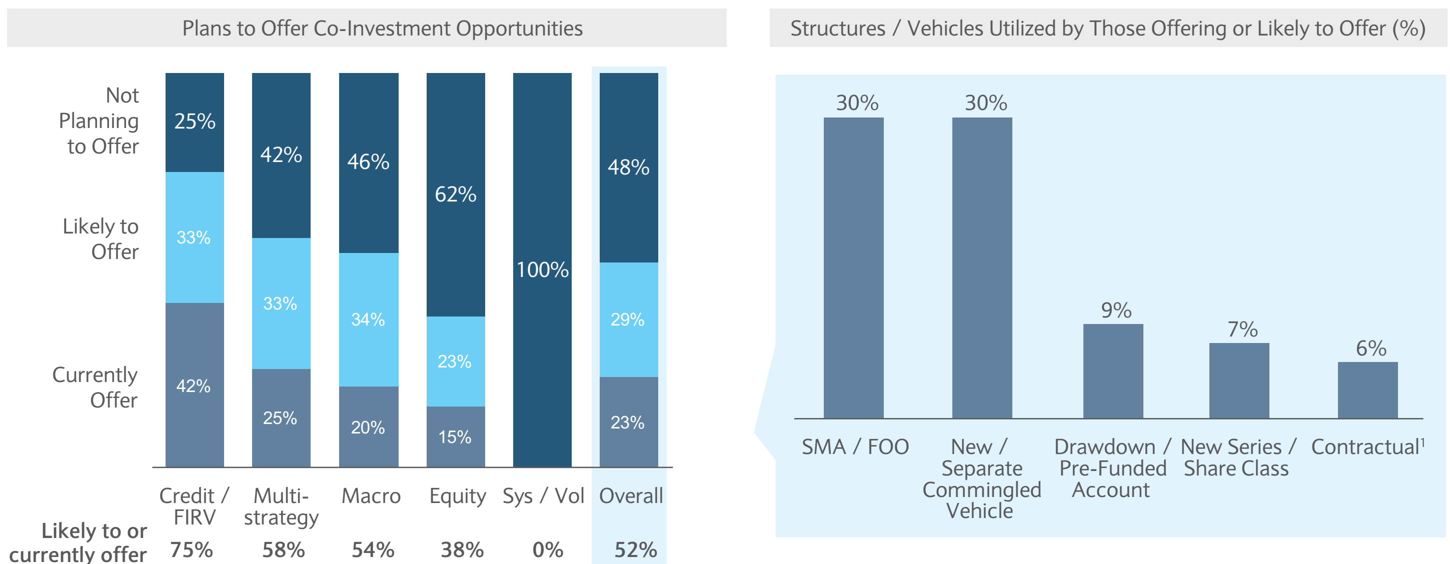
Co-investments have been very popular in recent years with investors as they feel these products often represent the best that HFs have to offer (i.e., lower fee structures, greater incentive alignment, and access to the best ideas). Managers, on the other hand, use co-investments sometimes when they run into concentration or liquidity limits in commingled vehicles as well as to build goodwill with investors / prospects. Figure 29 shows that, in our sample, across strategies (other than Sys / Vol),

FIGURE 27 and 28: Approach to Managed Accounts



1. Includes both separately managed accounts (SMAs) and fund-of-one (FOO) vehicles
Note: All figures refer to Strategic Consulting study results only

FIGURE 29: Approach to Co-Investments



1. Refers to an arrangement between an HF and an investor where an investor buys an asset separately and transfers control (e.g., voting, timing of sale) to the HF for instance
Note: All figures refer to Strategic Consulting study results only

there is a material number of managers currently offering co-investments (~25%) and even more (~30%) that are likely to do so in the future. When it comes to the structures utilized to offer co-investments, managed accounts and dedicated commingled fund vehicles are the most common vehicles as shown in the chart on the right in Figure 29.

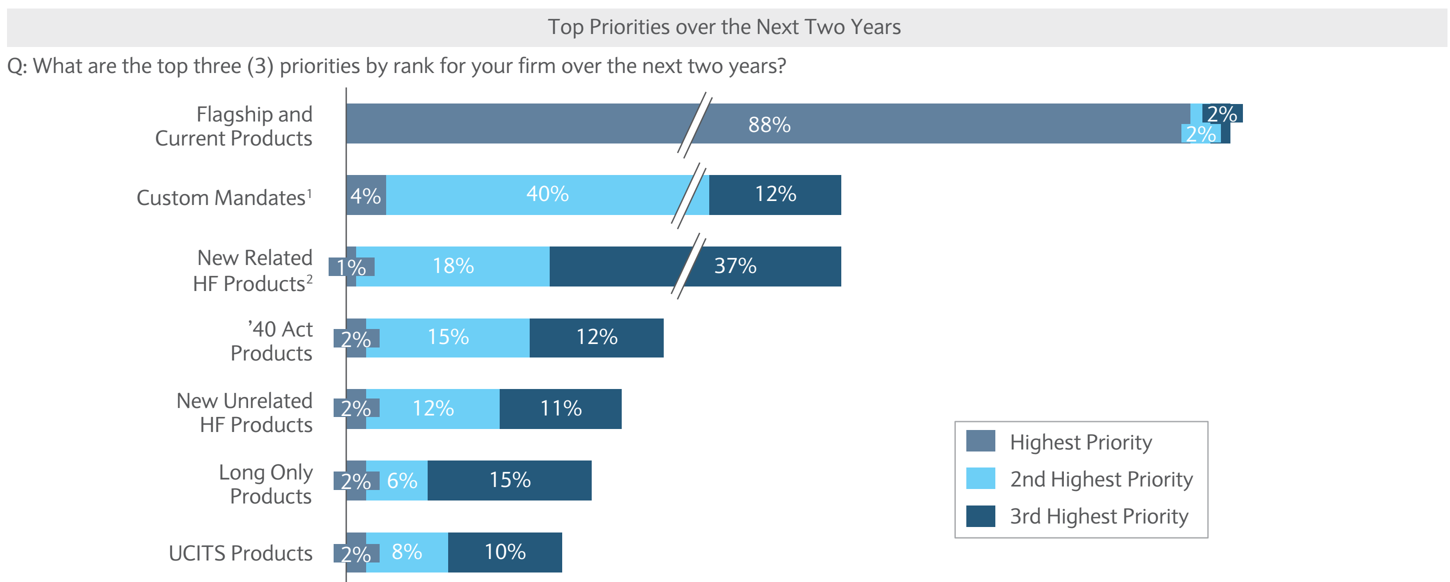
Near-term product / marketing priorities of HFs

Despite the interest in MAs and co-investments, not surprisingly, most firms are focused on marketing their flagship and current products over the next two years as shown in Figure 30. There appears to be some appetite for offering custom mandates and new products (both still predominantly related to the current flagship) as HFs attempt to turn around recent (underwhelming) performance. With regard to related HF product launches under consideration, the plan is to offer (1) significant improvement in fees and transparency (across our sample, firms are ~6 times more likely to offer lower fees and better transparency on new products than not) and (2) slightly better liquidity (firms are ~1.5 times more likely to offer better liquidity on new products than not – not shown).

Factors driving success in asset raising

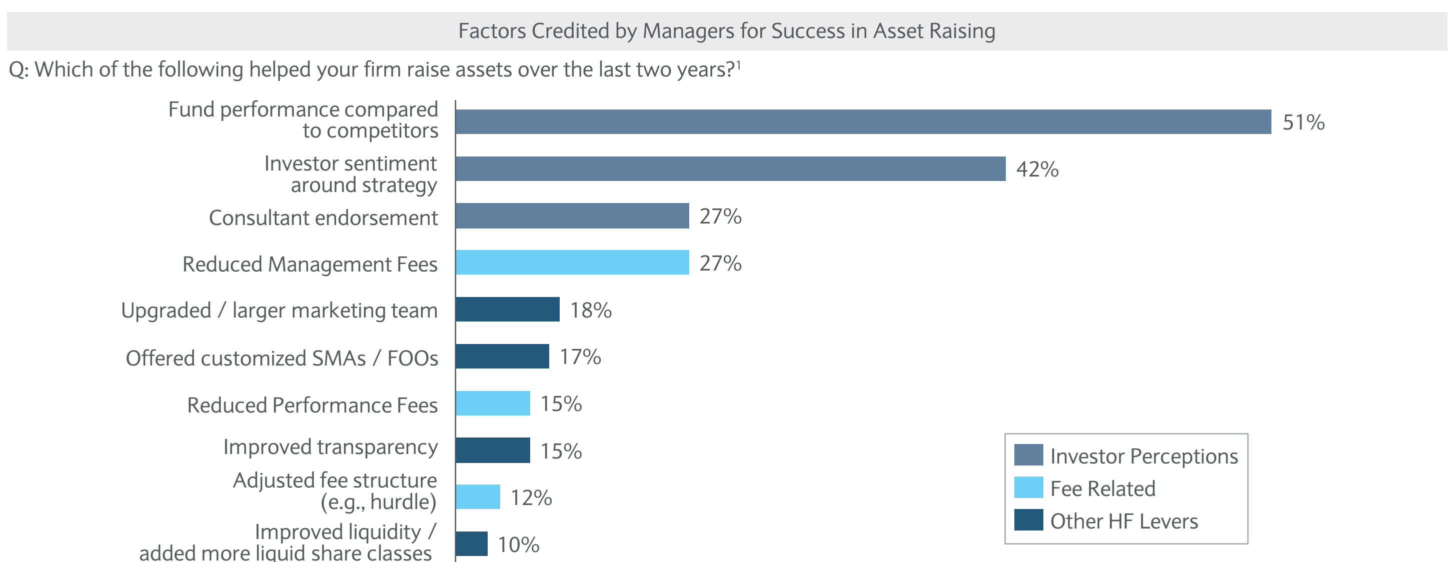
As managers look to grow their businesses in the future, they can look back at what has worked for them in the recent past. Unfortunately, in their own words, HF managers appear to have little control over some of the top factors that impact their success in asset raising. Across the list of options in Figure 31, those that are related to investors' perceptions of a manager /

FIGURE 30: Near-Term Product / Marketing Priorities of HFs



1. Custom mandates based on existing HF products (e.g., FOOs); 2. New HF products intended to be launched in the next 12 months compared to flagship product (from investors' perspectives)
Note: All figures refer to Strategic Consulting study results only

FIGURE 31: Factors Driving Success in Asset Raising



1. Three additional categories with <10 attributions are: Collecting fees over a longer time frame (7%), Offered co-investments (4%), and Added claw-back provisions (2%)
Note: All figures refer to Strategic Consulting study results only

strategy (e.g., performance relative to peers, sentiment around a strategy, and consultant endorsement) appear to have had the greatest impact on asset raising success (or lack thereof) over the last two years. Levers related to fees in general were the next biggest factor – reduced management fees in particular appear to be important (more important than reduced performance fees by a factor of two), reflecting investors' preferences. Unfortunately for managers, other factors (e.g., upgrading the quality of the marketing team, the availability of customized accounts, and improved transparency / liquidity) are increasingly becoming 'table stakes' and play a more limited role in helping asset raising efforts.

VII. Considerations

In conclusion, we leave our HF managers and investors with the following considerations:

1. Managers
    - Recent trends in fees, liquidity and transparency suggest almost a 'race to the bottom' among managers.
        - This trend represents diminishing returns to managers and is unlikely to significantly improve asset raising success.
    - On the other hand, while holding the line on fees (especially performance fees) is admirable, if performance does not justify the confidence, expect investors to act with their feet.
    - Performance (resulting in better investor perception) must be the main priority in 2016 – many of the factors that historically helped raise assets (e.g., lower management fees, offering managed accounts, improving transparency to be competitive) are all 'table stakes' in the arms race between managers now.
    - Finally, we expect a difficult asset raising environment in 2016, and launching unrelated products / strategies may be a luxury in the near future even if performance has been good in 2015 (very few managers in our sample are planning to do so).
2. Investors
    - Negotiating leverage for investors has never been better – keep in mind though that net returns matter and the lowest possible fees may just be a red herring.
    - The challenge for investors is to find the 'diamonds in the dust' because many managers with great long-term track records have also stumbled in 2015, and they may represent bargains right now.
    - If liquidity terms look like they are too good to be true, they probably are – against a drumbeat of bad news on liquidity in secondary markets, we think some of the liquidity terms being offered are pretty unrealistic already (~45% cumulative reduction in time to redemption across managers we sampled in 2008 versus now).
    - With interest rates expected to be on the rise (in the US at least), it may make sense to take another look at hurdle rates – our data suggests most investors are not focused on these at the moment.

VIII. Capital Solutions

The Capital Solutions team within Prime Services offers a unique blend of industry insights and tailored client solutions for a broad range of issues.

Capital Introductions

- Maintenance of ongoing investor dialogue to provide valuable feedback to HF managers.
- Introducing HF managers to a select number of interested investors.
- Hosting events that provide a forum for knowledge transfer and discussion / debate on industry issues that helps educate and inform both clients and investors.

Strategic Consulting

- Development of industry-leading content, driven by primary analysis, on the HF industry and its participants (e.g., HF and FoHF managers, institutional investors, investment consultants).
- Provision of management consulting services to HFs and asset managers on business topics such as the launch of a new strategy, marketing effectiveness, product development, and organizational efficiency.
- Acting as an HF competence center internally for Barclays.

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