



Hedge Fund Manager Survey 2018.

Charting the evolution of the
billion-dollar hedge fund.

A large, detailed image of a wood cross-section, showing concentric growth rings and a rough, natural edge. It is framed by a thin grey border.

Making it Big

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Introduction

A start-up's journey in any industry is not easy: it involves facing a series of challenges and hurdles. Those hurdles must be recognised, understood and then overcome.

As a measure of the industry, just under five hundred hedge funds manage approximately \$2.8tn in assets¹. They contain only a little more than 10% of the industry in terms of number of firms but manage close to 90% of its assets. Much attention focuses on this club and firms close to attaining this status.

But what about the rest of the industry? Those estimated 3,000 firms, that run no more than \$1billion in AUM², account for approximately \$400bn AUM. In our paper, *Alive & Kicking*, published last year, we examined the universe of emerging managers (which we define as having AUM of up to \$500m). Expanding on this work, this year's paper looks at those firms that run no more than \$1bn AUM and those that have made it into the billion-dollar club.

Through six key takeaways, this paper provides a road-map for all emerging and start-up managers seeking to build their firm to a billion-dollar business. In drawing on these takeaways, we sought feedback from both investors and managers alike.

Ultimately, what's good for emerging managers also benefits the entire hedge fund industry. Investors value having the best choice possible; incumbent firms benefit from having their preconceptions challenged.

We hope that this paper is of use to both emerging managers who are in the process of growing their firms, but also of use to those who are considering launching a hedge fund.

Tom Kehoe CAIA, Global Head of Research, AIMA
Sean Capstick, Head of Prime Brokerage, GPP.



¹ Source: Global Billion Dollar Club, Spring 2018, HFM.
² Source: HFM data.

Methodology

In conducting this survey, we reached out to all sizes of hedge fund managers to chart the evolution of a billion-dollar hedge fund manager – from just starting up to having 'made it big'.

We also surveyed various allocators to help us understand their expectations of a growing fund. We wanted to find out what influences an allocators decision when they are deciding whether or not to invest.

01

Hedge fund manager survey³ with input from 155 hedge fund managers globally accounting for approximately \$400bn AUM.

02

Input from global allocators, who in aggregate amount to \$1 trillion, and allocate roughly \$90bn to hedge funds.

03

Input from a series of manager roundtables. We spoke to a representative group of emerging managers (managers below \$500m AUM) and larger more established managers (managers in excess of \$1bn AUM).

³ Percentages in charts may not add up to 100% due to rounding.

Executive summary

‘Making it Big’ provides insights from larger managers who have blazed a trail in building a billion-dollar hedge fund business. The research examines their path to growth, providing a road map for all emerging and start-up managers as they make their way to \$1bn AUM.

The work is informed by asset managers and industry allocators representing an estimated \$500bn in total hedge fund AUM. Over 70% of manager respondents surveyed fall into the big six categories of investment strategies: equity long/short, global macro, fixed income credit, CTA/managed futures, event driven and multi-strategy.

We discovered that if managers aspire to be a billion-dollar business, they need to start life acting like a billion-dollar business: managers need to implement marketing and communications strategies that actually work and constantly keep the investor in mind. Being transparent, investing their own money in the fund and maintaining working capital levels are essential.

Deploy effective marketing

For emerging funds, investing in an effective marketing strategy can be seen as unnecessary until the fund is larger. Indeed, funds smaller than \$100m AUM deviated most from the 11% average marketing spend of management fees. Funds managing between \$100-\$500m and those managing over \$1bn all hire an in-house marketing specialist. Although this chicken and egg scenario can be problematic for managers, it was clear that investing in marketing is very important and this was further reiterated by the manager roundtable sessions, with firm advice to concentrate on marketing or hire a marketer early in the fund’s lifecycle.

Established funds appear to rely heavily on personal marketing and networks fundraising. Allocator responses confirmed the effectiveness of their personal networks for sourcing investments, and the importance of maintaining access to the manager during and after the investment process.

Allocators were shown to receive marketing content positively. By offering allocators transparency around the hedge fund strategy, approach to risk and correlation to the market, smaller funds could mitigate the effects of a short track record.

Shoot for critical mass

Funds that successfully surpass \$100m AUM open themselves up to a greater field of opportunities to receive capital investment, and the array of allocators who can invest in them increases. Seed funding was shown to provide an effective way of accelerating the growth of a smaller fund and allows the team to grow.

Have skin in the game

All allocator respondents demanded that the manager invest their own money in their funds. This was to offer certainty that they were investing alongside the manager, and that gains and losses would be felt by both parties.

Management fees are important, but align with your investors

The research analysed fee structures across five global regions and seven fund strategies. We found that some strategies are starting to feel the pressure, perhaps due to the emergence of an increasing variety of smart beta, risk premia style strategies with similar characteristics.

Managers and investors alike understand the importance of management fees to the day-to-day running of a fund and to cover costs. As such, they have remained relatively stable or have slightly increased for the majority of strategies.

The research suggests hedge fund managers are increasingly working to ensure that their fee arrangements are aligned to clients’ needs. Performance fees can be maintained at healthy levels by virtue of their alignment with potential investor benefits: responses revealed 80% of managers charge over 15% in performance fees.

Make every effort to underwrite your business for the immediate future

The possibility for a fund to breakeven with \$86m AUM was a unique finding of last year’s *Alive and Kicking* research, and this overall average figure remains relatively static at \$85m in the current results. New insight from funds with over \$1bn AUM revealed that this number clearly grows as AUM grows: a requirement of \$180m AUM to breakeven, offering useful intelligence for the future \$1bn manager.

However, achieving breakeven does not happen after a defined period of time or after a critical event, as it is a moving target. Feedback from the larger, \$1bn+ AUM managers who gave insights into the idiosyncrasies of their fund made salient the importance of having enough working capital to support two to three years of sub-scale AUM.

Know when to build a permanent team

Results revealed the importance of possessing particular senior in-house staff. The COO function appeared to be an inherently important role, being the least outsourced by all sizes of fund. Importantly, funds managing between \$100-\$500m and those managing over \$1bn all hire an in-house marketing specialist.

Demographics

A detailed look at the respondents to the survey

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Manager demographics

Half of our 155 respondent managers were established more than five years ago, with only 11% of respondents defining their hedge funds as ‘start-ups.’ Among those that consider themselves to be start-ups, none of them are greater than \$70m in size.

65% of respondents to the survey manage less than \$500m in assets, thus falling into our definition of ‘emerging manager’. Among those firms defining themselves as established for more than three years (66%), a majority already manage more than \$500m of assets. 10% of all respondents to the survey manage between \$500m and \$1bn in assets, in line with industry totals, with the remaining 25% managing over \$1bn in assets.

Almost all of those that did not already manage over \$1bn, emphasised their desire to break through the ‘magical’ AUM barrier and become part of the “billion-dollar club”.

“What does it take to make it big and break into the billion-dollar club? Should you try? What should you be prepared for along the way?”

\$402bn

total AUM from 155 respondents

\$235m

median AUM

65%

are emerging managers
(those with less than \$500m AUM)

50%

were established more than
five years ago

Billion-dollar club

Throughout this report you will see comments from the Billion-dollar hedge fund managers that joined our roundtables providing insights and inspiration from the very top.

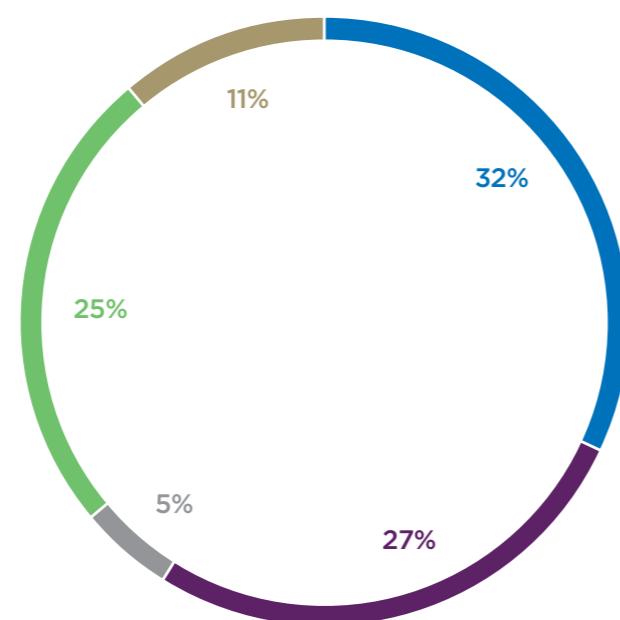
The geographic dispersion of respondents is broadly representative of hedge funds globally with a strong representation of responses coming from the US, UK and Asia-Pacific regions, historically, the most important locations for alternative managers.



Fig 1. Regional breakdown of managers

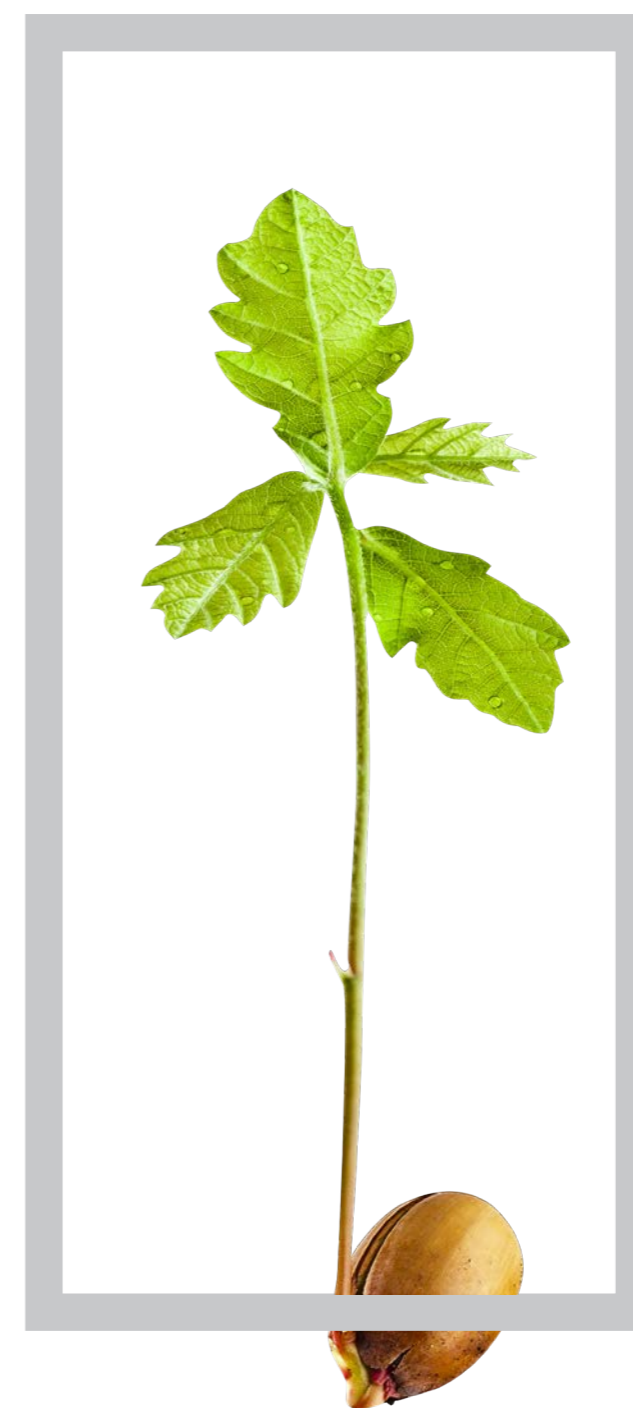
Asia-Pacific	23%
Europe ex-UK	14%
North America	22%
Rest of the world	6%
UK	36%

Fig 2. How managers describe their firms



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

Allocator demographics



59
respondents

\$1 trillion
estimated total AUM

\$89bn
estimated AUM allocated to hedge funds⁴

34%
allocate over \$1bn to hedge funds

⁴ Calculated from mid point responses.

In addition to the manager survey, we also surveyed a wide variety of hedge fund industry allocators to obtain their views regarding small and emerging managers and their larger peers.

We have recently seen the advent of dedicated ‘Emerging Manager’ programmes, such as that run by Mass Prim⁵, Albourne Partners⁶ and PAAMCO Prisma⁷ to name just three recent industry initiatives; all of which points to a continued appetite among the institutional investor community for allocating to start-up and emerging hedge fund managers.

Fig 3. Respondents by allocator type

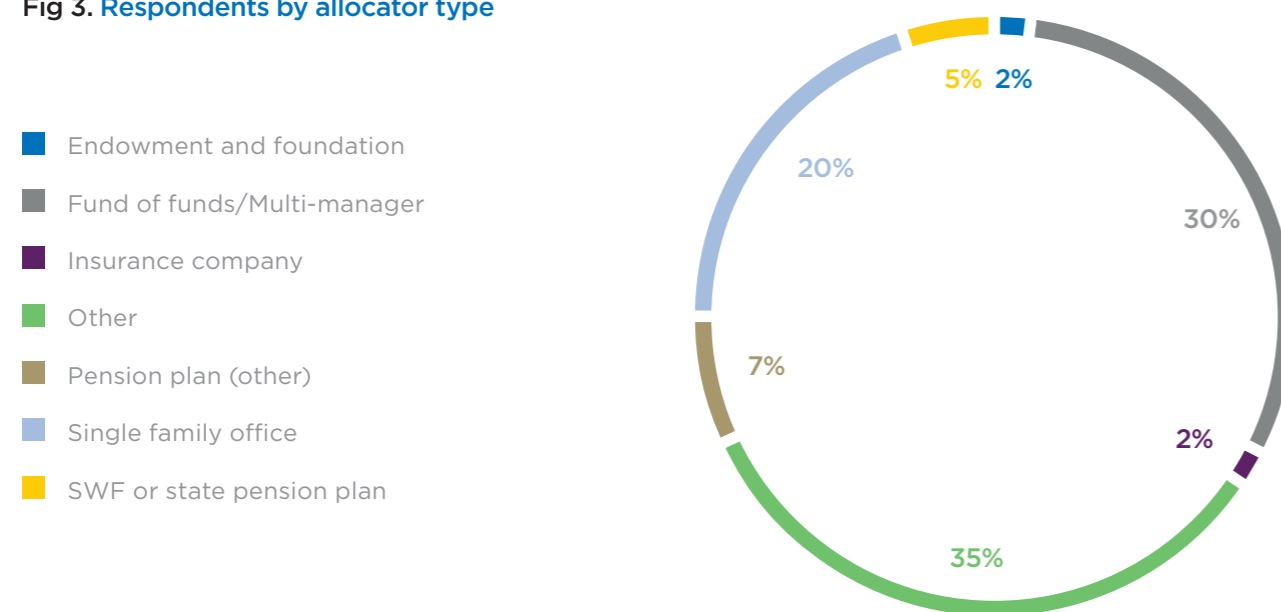


Fig 4. Regional breakdown of allocators

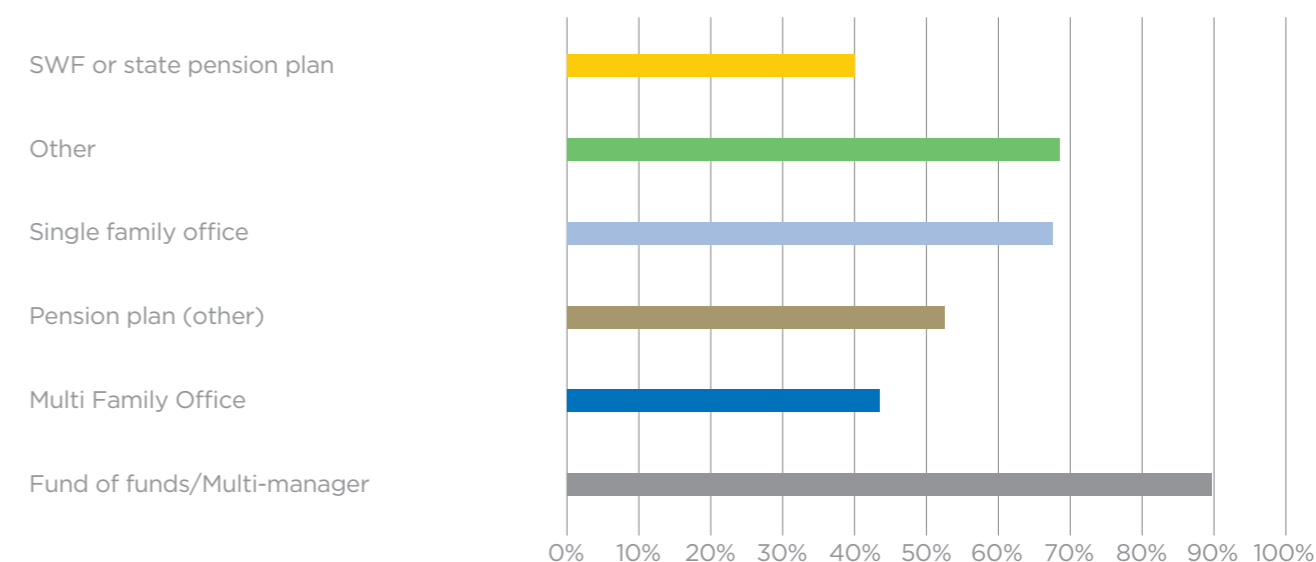
Asia-Pacific	16%
Europe ex-UK	35%
North America	26%
Rest of the world	5%
UK	18%

5 <http://www.pionline.com/article/20161207/ONLINE/161209896/massprim-approves-search-to-start-building-emerging-hedge-fund-manager-portfolio>

6 <https://hfm.global/hfmweek/news/albourn-launches-emerging-manager-programme/>

7 <https://www.prnewswire.com/news-releases/paamco-introduces-innovative-seeding-platform---paamco-launchpad---with-inaugural-partner-employees-retirement-system-of-texas-300671842.html>

Fig 5. Amount of AUM allocated to hedge funds by allocator type



Respondents from allocator types ‘Insurance Company’ and ‘Endowment and Foundations’ did not supply significant data.

“How does a manager make themselves most attractive to allocators? What is an allocator looking for from an emerging manager and how can an allocator help a smaller fund to grow?”

Allocator view

In conjunction with Edgefolio, we also presented our findings to global allocators that represent a wide range of potential investments whose size of investment tickets range from tickets under \$10m to greater than \$300m tickets. We have gathered their key feedback and comments from the roundtable sessions.

Manager analysis

Closer examination of the strategies and structures of hedge fund managers

In this section:

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Manager respondents by strategy

Over 70% of all respondents have their flagship (or primary) funds fall into the six mainstream strategies that we selected, namely equity long/short, global macro, fixed income credit, CTA/managed futures, event driven and multi-strategy.

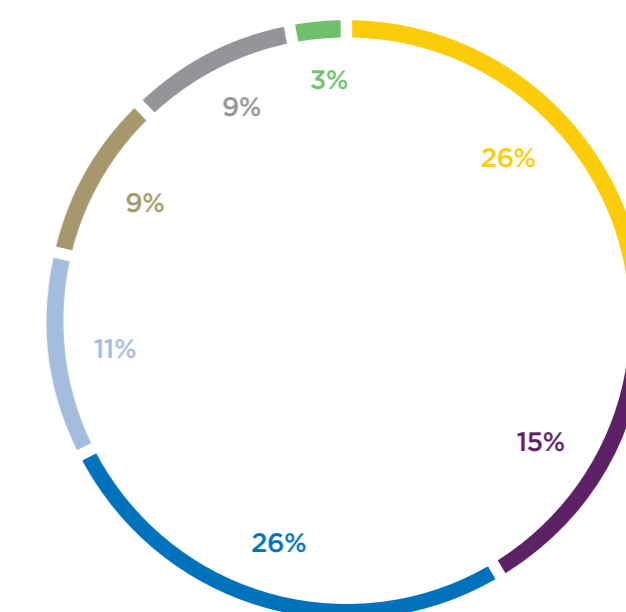
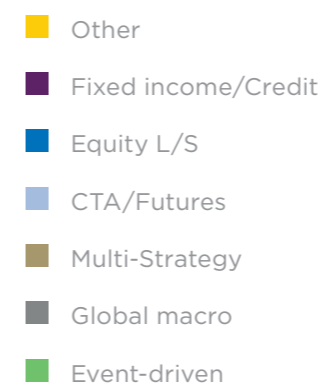
Long/short equity is the most popular investment strategy representing 26% of the total of all respondent firms. Further, this estimate is similar for each of the manager groups that we surveyed (the emerging manager, or the more established managers) suggesting that long/short equity, as the oldest and arguably the most understood of all hedge fund strategies, continues to have an enduring appeal to allocators and hedge funds alike.

‘Other’ Strategies

Just over one quarter of all the respondents pursue “other” strategies. Among these strategies include FX volatility, private credit, life insurance, cryptocurrency, structured credit and various risk premia. This is indicative of the industry moving from being product-led to a more solution based one, where managers are working more in step with investors to deliver specific niche style strategies to better complement their risk and return appetite. Advances in technology are also acknowledged across hedge funds, with systematic type strategies becoming more popular and signs that the crypto trend is also growing.

Upon closer examination of start-up and emerging managers, “other” strategies account for closer to one third of responses. Within this population, more kinds of strategies make their way into this catch all category. These include; FX volatility, Systematic arbitrage, relative value volatility, private credit, asset swapped convertible bond, systematic macro, global long only, life insurance, greater China long/short, cryptocurrency, commercial real estate, structured credit, and risk premium.

Fig 6. Strategy of the flagship fund.



Allocators

The equity long/short strategy continues to be the runaway strategy leader of choice across all the investors we spoke with. Historically, it was the first hedge fund strategy to be created and continues to be the most popular hedge fund strategy among allocators.

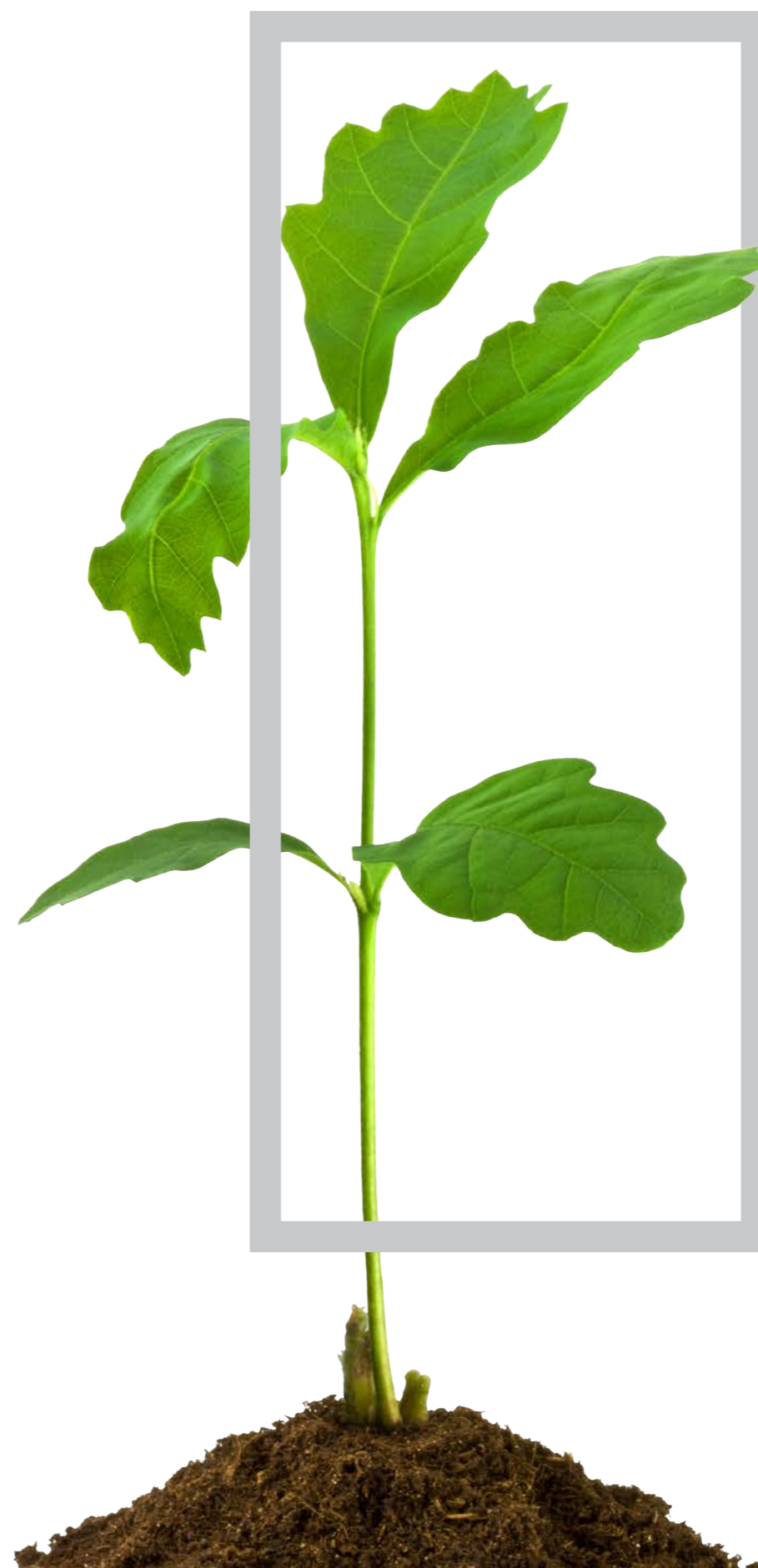
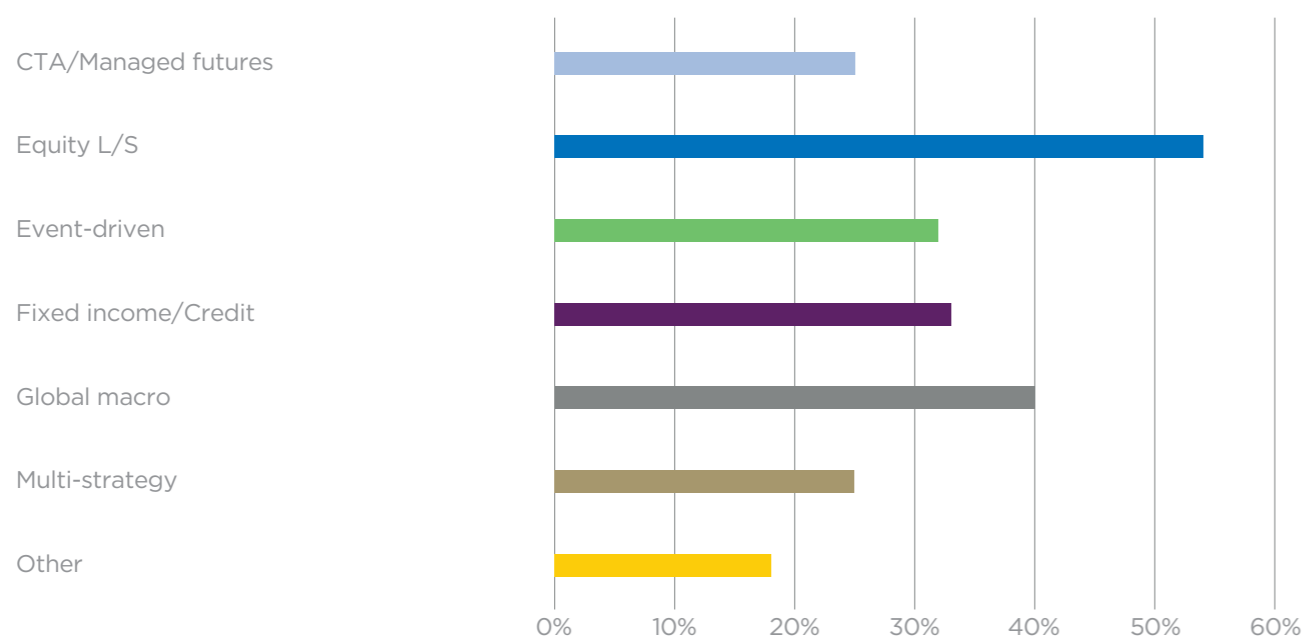
Arguably, it is one of the easier strategies for investors of all types to comprehend. The successful management of a fully integrated portfolio of long and short investment positions can help to increase portfolio returns even in difficult market conditions. The investors we spoke with mentioned that the long/short strategy was invested in with either a geographic theme – Europe, China or wider Asia – or via a sector-based approach: technology, sustainability.

Historically, hedge fund managers that have employed the equity long/short strategy have proven to be very adaptable, as these funds are able to generate returns in both up and down markets or even flat and trendless markets. Global macro strategies also continue to be attractive to investors. The versatility of the strategy includes managers

having no limitation in terms of the types of investment, asset classes, markets and jurisdictions they can invest in. Over time, the unconstrained mandate of this investment strategy has proven to deliver solid risk-adjusted returns and an attractive investment diversification. Managed futures and CTA strategies have also received strong interest from investors in recent years. The appeal of uncorrelated returns, together with greater liquidity and transparency that the strategy offers, has been a significant factor in the growth of managed futures and related risk premia strategies.

As highlighted in our *Alive & Kicking* report, investors like to have more tailored investment solutions. As per the findings of this survey, 18% of all investor respondents (or just under one in five investors) cite “niche strategies” as being their most prominent allocation over the course of last year. We expect this trend to continue with investors increasingly choosing bespoke solutions that match their unique risk and return demands over off the shelf fund products. Allocators commented that emerging managers needed an edge to differentiate themselves in a crowded space, and that running a niche strategy is a good way to do so, especially within a technical sector.

Fig 7. Strategies that were most prominent in 2017 allocations (allocator respondents selected all that applied)



Allocator view

“Equities are one of the largest assets classes, combine that with the long/short as the most established strategy and you can have a key component to a portfolio.” [c. \$100m tickets]

“2017 was a focus on equities with a sustainability focus, with a geographic focus on Europe. This shifted in 2018 to a more defensive view to generate income when markets go down, using a multifactor quant approach to diversify investments.” [c. \$100m tickets]

“As a smaller allocator I have not invested in CTAs in the last few years due to returns. Furthermore we do not have an edge when diligencing multi-strategy products with complex books.” [c. \$250-300m tickets]

Manager respondents by structure

Most hedge funds are still set up as a Cayman, BVI or other offshore fund structure. This choice of structure is led by the allocators who predominantly prefer an offshore structure as an investment vehicle.

The regimes of offshore structures permit much more flexibility in the investing and risk management tools that the fund may use, as well as being more suited to an international institutional investor base. Further benefits of having an offshore structure include the expertise and concentration of fund servicing businesses, the relatively low cost of establishing and managing such funds and client demand for simple and flexible collective investment structures which only certain jurisdictions (like those that are established offshore) allow.

Allocators

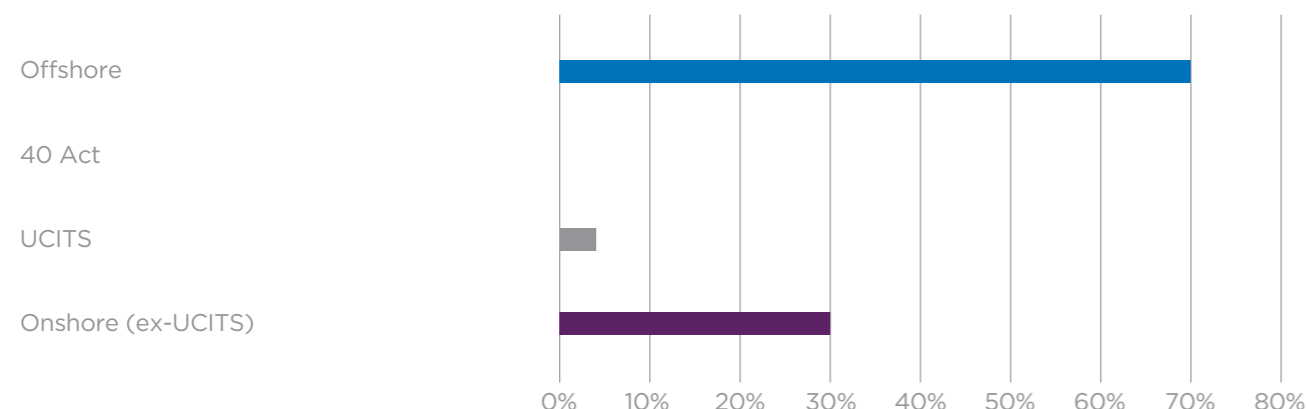
Allocators feel that offshore fund structures, especially Cayman, not only offer potentially higher return profiles than UCITS, but also the ability to run strategies that are less liquid. This is because of the lack of constraint in offshore funds for daily/weekly dealing which is a pre-requisite in the UCITS structure.

UCITS offers allocators the upside of having greater liquidity and lower risk, as well as a lower investment threshold. As a liquid structure however, this can correspond to a perceived lower return profile, as certain strategies do not fit the UCITS criteria.

Managed accounts provide greater transparency and control. However, the minimum investment for a managed account can be greater than other structures and thus too high for smaller allocators.

Furthermore, the prohibitive cost of the investment process can be a turn-off to smaller allocators, something which is not as important for larger allocators.

Fig 8. Structure of the flagship fund (manager respondents selected all that applied)



Allocator view

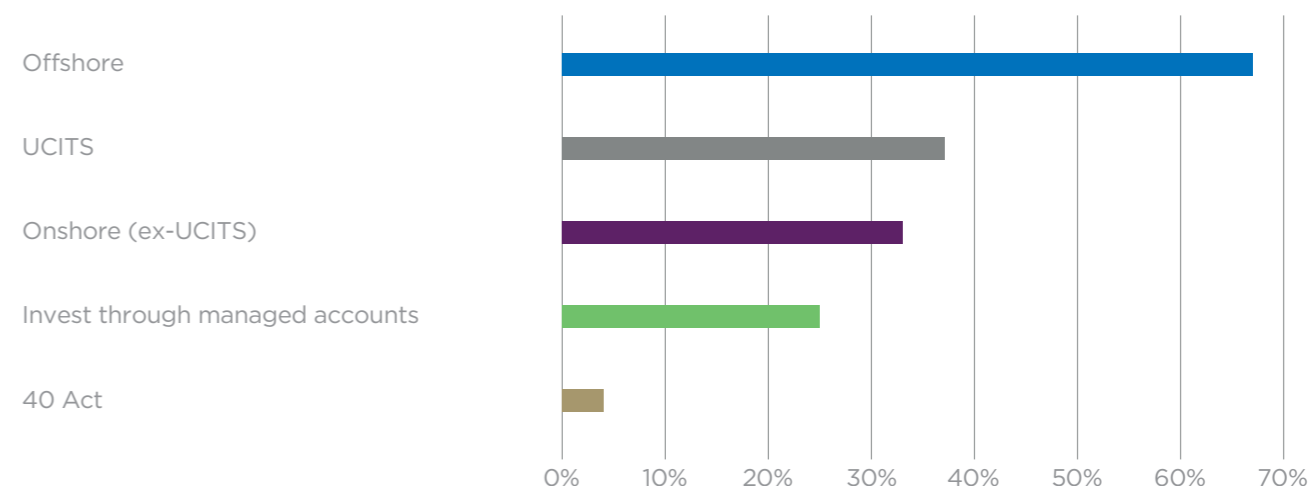
“As a smaller allocator, managed accounts are more expensive and more cumbersome. We invest in UCITS and Cayman where the management company is in a European jurisdiction. We find that UCITS does not fit with PMs who have a concentrated portfolio.”
[c.\$10m tickets]

“We invest in UCITS, and Cayman structures with weekly liquidity. We avoid Credit or Real Estate products in a UCITS structure as it makes no sense.”
[c.\$100m investment per manager]

“Managed accounts are good as they are compliant but we have found the fees to be higher than a fund structure.”
[c.\$100m investment per manager]

“As a Middle East based allocator we prefer offshore... and a managed account structure for our smaller investments.”
[c.\$100m investment per manager]

Fig 9. Hedge fund structures predominantly allocated to (allocator respondents selected all that applied)



Year-on-year comparisons

Emerging manager data 2017 vs 2018

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In last year's paper we highlighted the key performance indicators representative of the universe of emerging managers (i.e. managers that run an aggregate of no more than \$500m AUM).

We have taken the opportunity to revisit the emerging manager data, to provide a year on year comparison across several data points.

Breakeven

A key finding from last year's *Alive and Kicking* report was that, contrary to conventional wisdom, it is possible for a hedge fund manager to breakeven⁸ (a fundamental and necessary step to creating a sustainable business) without having to manage several hundred million dollars of assets. In fact, we found that emerging managers could breakeven with, on average, \$86m.

Since then, the past year has witnessed great regulatory change, the winding down of quantitative easing and concomitant return of volatility. Despite all this, our research shows that it is still possible for a small or emerging manager to breakeven with only \$85m in assets.

We find this very reassuring given the onslaught of new regulatory costs over the last 12 months. Most obviously MiFID II⁹ and the advent of GDPR¹⁰ have received much coverage, yet seem to have added little cost to this group of managers.

Fig 10. Comparison overview

	2017	2018
Number of respondents	120	102
Average AUM	\$133m	\$122m
Average headcount	8	8
Average breakeven AUM	\$86m	\$85m
Average management fee	1.43%	1.40%
Average performance fee	15.81%	17.08%

⁸ We define breakeven as the amount of total revenue required to cover the total costs needed to operate the business as a going concern.

⁹ Markets in Financial Instruments Directive (MiFID) is EU legislation to regulate firms who provide services to clients linked to 'financial instruments'. A revised version of the legislation 'MiFID II' took effect in January 2018.

¹⁰ General Data Protection Regulation (GDPR) standardises data protection law across all EU countries and took effect at the end of May 2018.

Fig 11. Fund breakeven point by size in 2017

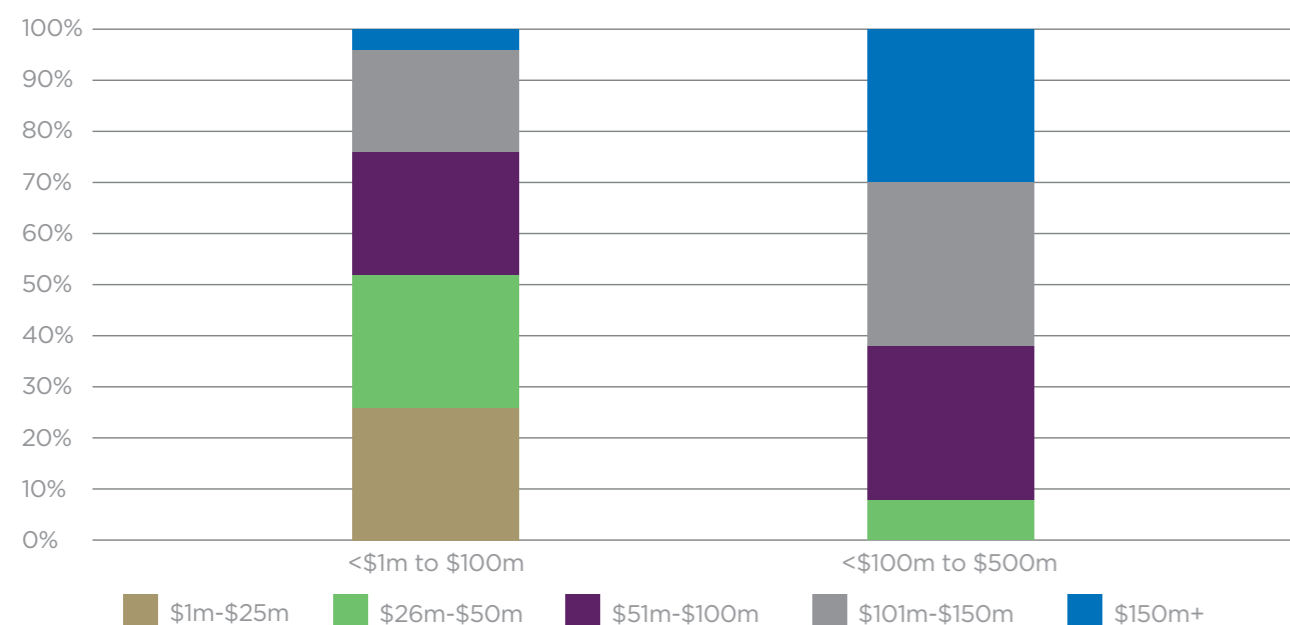
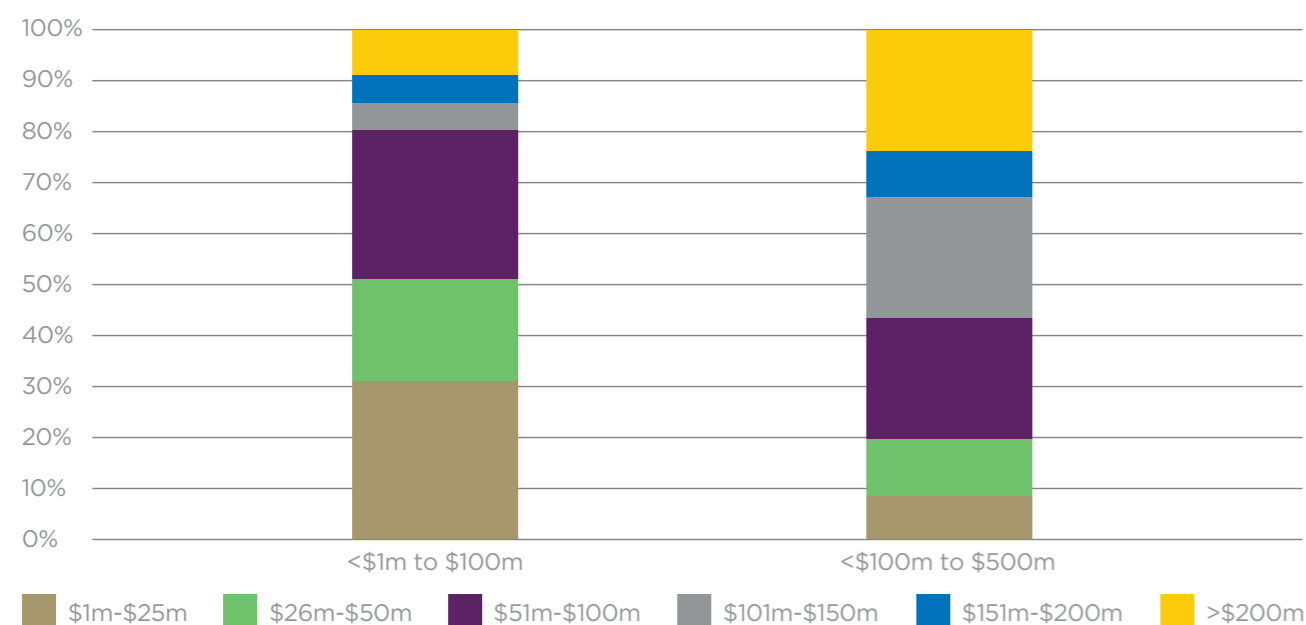


Fig 12. Fund breakeven point by size in 2018



Management fees

When analysing the management fee by strategy (fig 13), it appears that fees are holding up and have even increased slightly for managers running equity long/short and event driven funds.

Upon closer examination of the respondent sample, hedge funds that pursue equity long/short and event driven strategies charge among the highest management fees, with an average management fee of 1.49% and 1.50% respectively. At the other end of the fee spectrum, we observe fee pressures being most acute among emerging managers who operate CTA managed futures or global macro strategies. The strategy that has borne the brunt of fee pressure is the CTA strategy, where the average management fee has decreased by 35bps to 1.14%.

It was a surprise to find that global macro and managed futures strategies now charge, on average, the lowest management fee, having decreased by 36bps to 1.15%.(average combined fee of Global Macro and CTA/Futures strategies).

In discussion with our manager roundtable, it was suggested that pricing pressures appear to be the most acute in global macro and CTA managed future strategies. This is likely to be due to the emergence of an increasing variety of smart beta, risk premia style strategies in the past year, which are similar in their characteristics to CTA and systematic global macro style strategies.

These investment strategies are designed to give investors access to the same broad diversified set of risks normally derived from investing across a universe of hedge fund strategies, but with greater flexibility in a low-cost format. Arguably, this can offer investors a more appealing risk-return profile for a fraction of the price, in comparison to the more traditional hedge fund options.

Fig 13. Average management fees by strategy compared 2017 v 2018

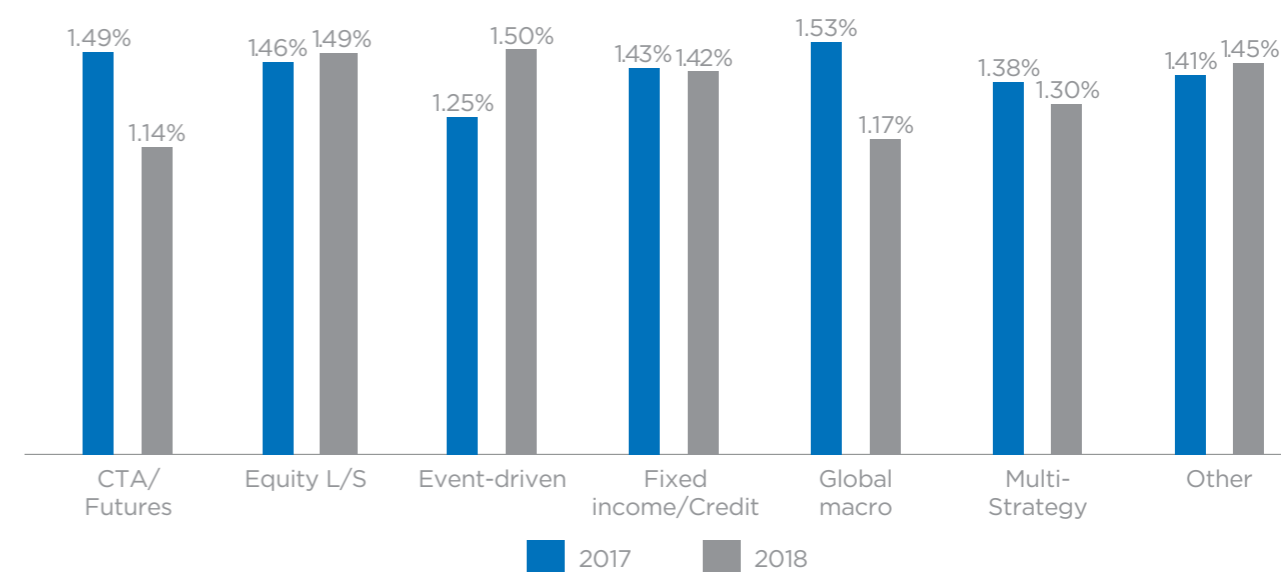


Fig 14. Management fees charged in 2017

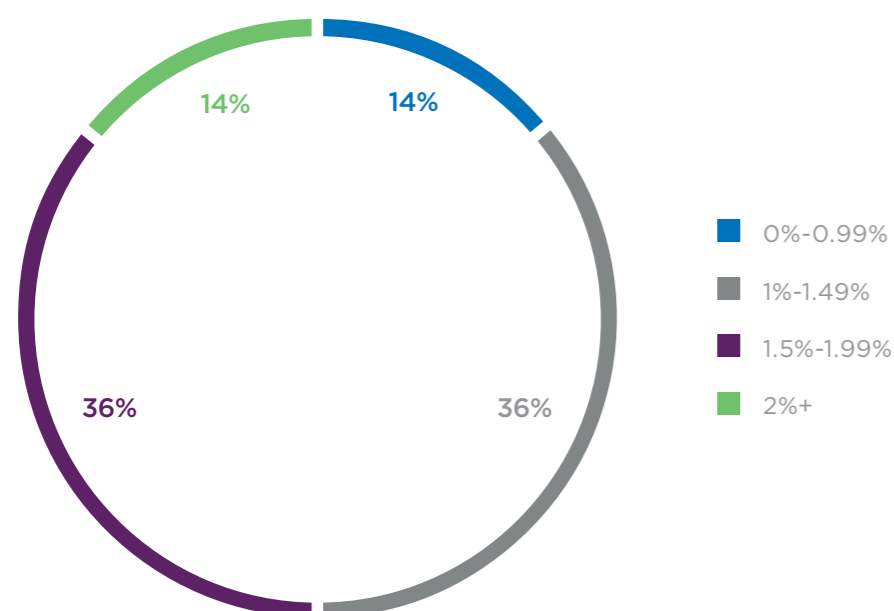
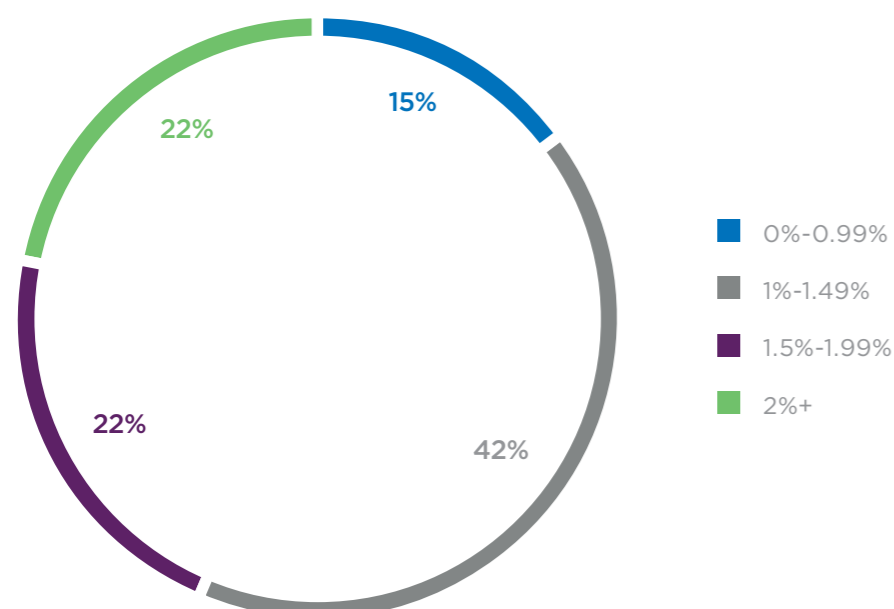


Fig 15. Management fees charged in 2018



Performance fees

Our analysis also defied the popular opinion that performance fees are in a terminal state of decline.

The percentage of managers charging a full 20% for their performance fee now accounts for 45% of the total number of manager respondents and almost 80% of managers are charging over 15% for their performance fee (fig 17).

We think this reflects the push for managers and allocators to be more focused on the fund(s) performance.

This development manifests itself too in the broader use of performance hurdles, high watermarks, and fee clawbacks across the various fund structures that we examined.

While there is a well-documented debate in the press and industry on downward pressure being applied to management fees, there are signs that managers and investors are seeking to redress any reductions to management fees by raising performance fees. Examples of these can be found in 1&30 arrangements, and other similar schemes where a reduced management fee is offset by an increase to the performance fee. These innovative compensation deals aim to find an equitable meeting point between the interests of the manager and the investor.

Fig 16. Average performance fees by strategy compared 2017 v 2018

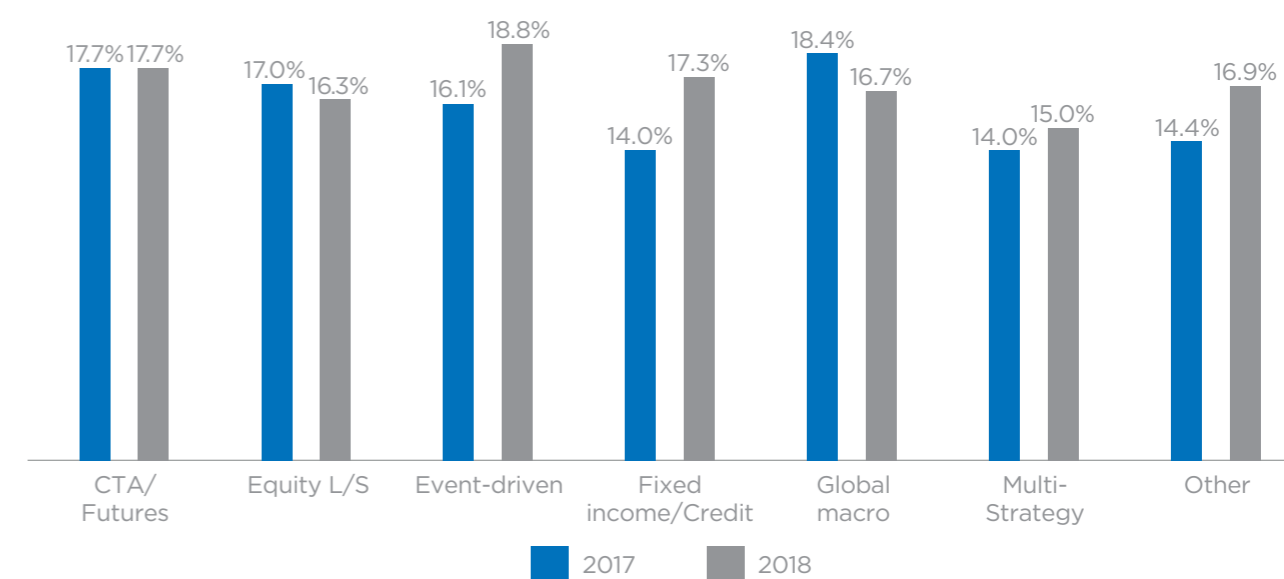


Fig 17. Performance fees charged for flagship fund in 2017

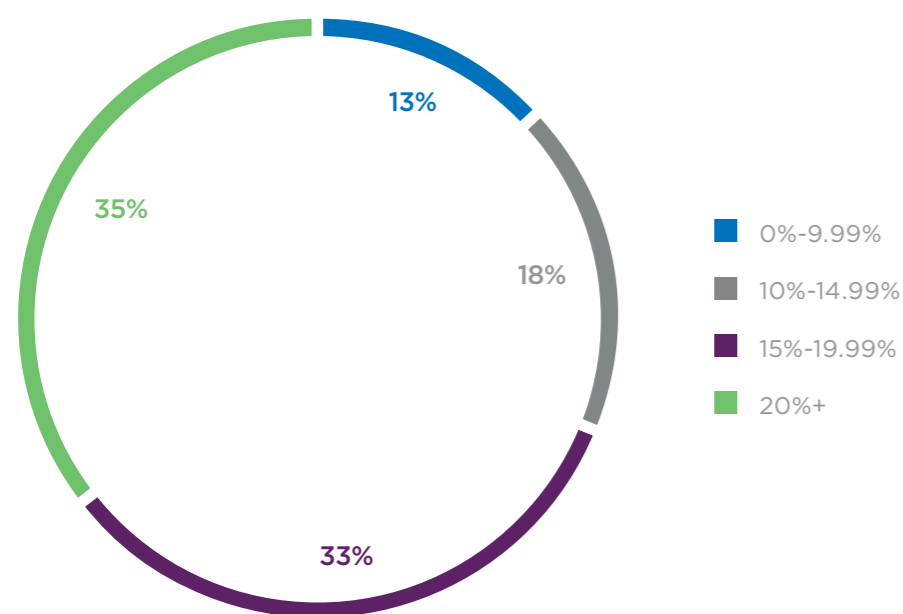
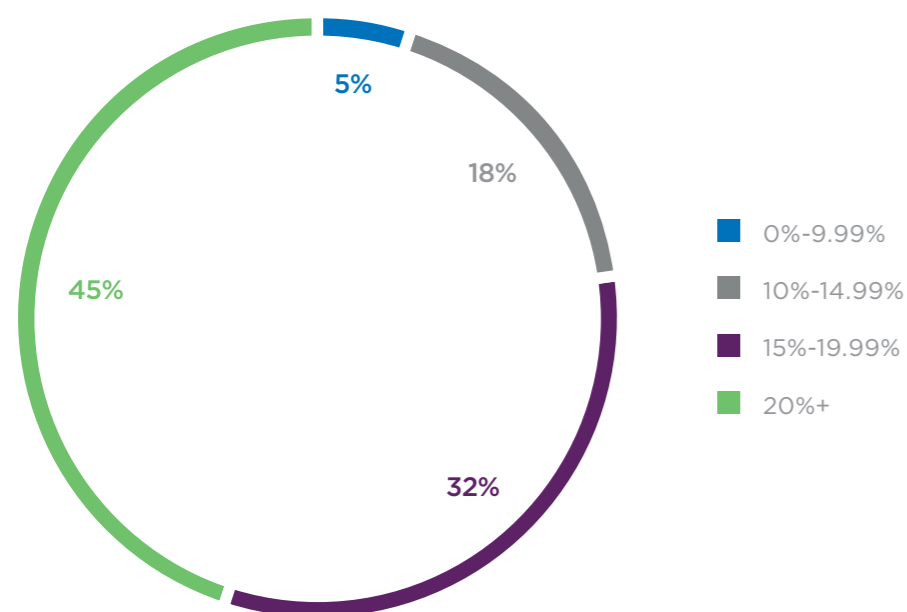


Fig 18. Performance fees charged for flagship fund in 2018



Shooting for growth

What managers are focusing on to increase their AUM

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Most managers want to grow

Fundraising

Growing the size of their assets is a key consideration for many managers. It is not surprising that 94% of managers with less than \$100m AUM are actively marketing their fund to prospective investors.

Indeed, 89% of our emerging manager respondents (under \$500m); 93% of managers with AUM of between \$500m and \$1bn; 85% of billion-dollar managers reported that they are currently looking to raise capital for their fund(s). The desire for a hedge fund to increase assets is constant across all AUM levels, which also means that competition for asset allocation will continue to remain tough throughout the life of a manager, even after they become established. However, it is important to note that there are different types of investors who are interested in investing in small and emerging managers, rather than larger, more established managers.

Responses to the survey indicate that family offices and high-net-worth investors are inclined to invest with small and emerging managers, whereas endowment and foundations alongside pensions are more likely to invest with the larger managers. See fig 42 and fig 43 on page 51 for further details.

Fig 19. Managers currently fundraising

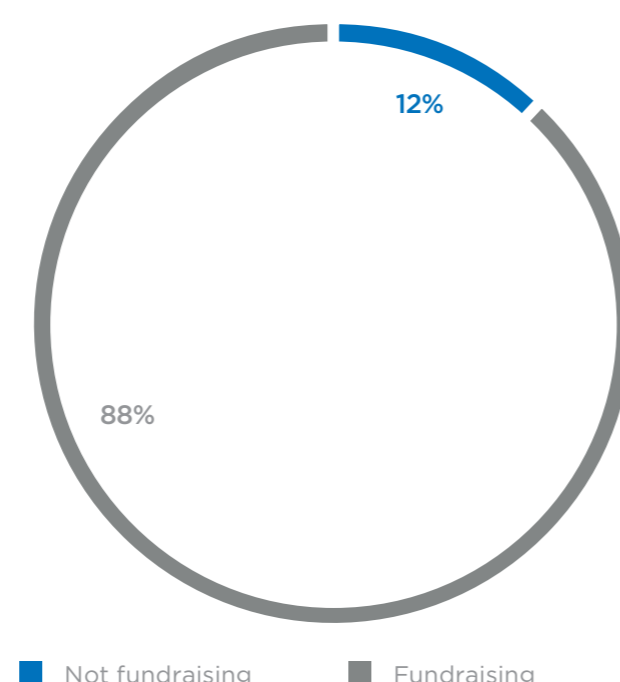
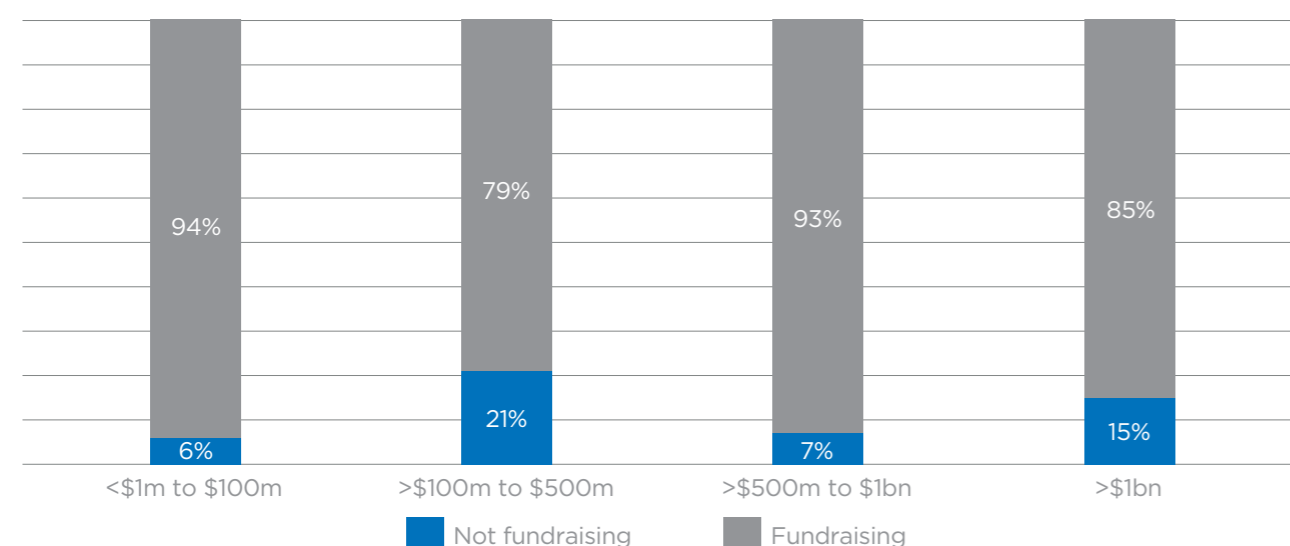


Fig 20. Managers currently fundraising by AUM level



Most managers invest in marketing

Marketing investment

Managers face something of a trade-off when it comes to the approach they take to capital raising for their fund(s): how much of their budget (derived from their management fee) should they spend to help grow their assets?

Deploying effective marketing

One simple measurement that managers use is to consider their absolute marketing spend as a percentage of their management fee revenue. Over the past several years, the costs of running an asset management firm have increased substantially, largely because of the growth in regulatory obligations. Ensuring that marketing does not consume a disproportionate amount of management fee revenue is crucial for the ongoing development of hedge funds of all sizes.

Upon closer examination of this measure, managers that run less than \$100m AUM deviate furthest from the 11% average (marketing spend as a percentage of the fund's management fee revenue) reported across all the manager respondents. From the 73% of manager respondents that do invest in marketing, the average spend for these managers is 19% (of their management fee). This excludes some firm outliers, where more than 60% of their management fee is dedicated to marketing spend.

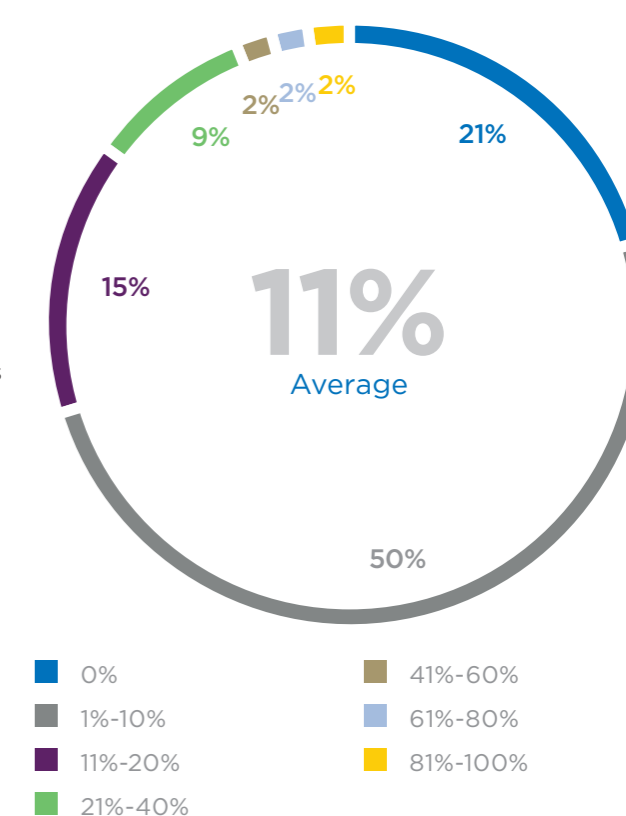
Shooting for critical mass

The passing of the \$100m AUM barrier is widely regarded as being a key threshold for a hedge fund to meet. In passing this mark, the hedge

fund opens itself up to a greater field of potential opportunities where they can receive capital investment.

This is often seen as the first milestone on the way to becoming a billion-dollar fund. At the \$100m level the array of allocators who can allocate to you increases (as their ticket size is no longer a prohibitive amount of your assets). Conversely, the largest number of respondents who do not spend on marketing is 27% in the sub \$100m category. Insights from our manager roundtable suggest that these managers prefer to focus on building a robust fund track record before marketing more widely to external investors. Another possible explanation is that with funds that have lower levels of assets under management, the fund's principals (which would include the CEO, CIO or COO) could be taking on the role of marketing for the fund and not be reporting it as an actual spend.

Fig 21. Percentage of management fees spent on marketing





Most managers hire an in-house marketer early on

There are no hard and fast rules as to what other roles that managers should outsource and at what size of AUM.

The Chief Operating Officer (COO) function is the least outsourced across all managers (of all sizes) emphasising our belief that this as an inherently important internal role for the fund, irrespective of whether it is starting up or more established.

A number of functions are consistently outsourced. Most obviously the Chief Technology Officer (CTO) role is almost universal across funds of all AUM size.

Once funds reach more than \$500M AUM, our data shows they tend to bring the Chief Legal, Chief Risk and Chief Compliance Officer roles in-house.

Internal resources vs outsourcing

Upon close examination, not one manager with greater than a billion dollars AUM nor any manager running between \$100m and \$500m AUM outsourced their marketing function. The managers that we spoke to were very clear in their belief that investment is required in the marketing function right from the start of the fund's life and is integral to the development of managers of all sizes.

The part of the emerging manager community that manages less than \$100m AUM has an easy counter-argument in that they simply cannot afford an in-house dedicated marketing resource. Indeed, this is the essential chicken-and-egg dilemma confronted by managers starting out; do the fund principals work with the limited resources they have to combine their principal roles at the fund and also market it, or do they set aside a dedicated marketing budget to outsource or hire an internal expert?

Billion-dollar club

On marketing spend:
"In the sub-\$100m band I'm surprised it's not at least 50% of management fee revenue."

Fig 22. Managers who have a dedicated internal resource or outsource the following function



Allocator view

“The manager I allocate to I know directly, or get to know them from different sources. For me it’s less about how much they spend on marketing but how they spend their time marketing.” [c.\$100m investment per manager]

Billion-dollar club

On hiring a marketer:
“Hiring a marketer is incredibly important, it’s the second key hire that you should make; in the first instance you need to hire a COO and then the marketer”

How to make it big - part one

Lessons that the smaller manager can learn from their larger peers

In this section:

How established managers made it big.

Make every effort to underwrite your business for the immediate future

Breakeven points

As a hedge fund grows, so too does the level of assets under management it needs to breakeven. While a start-up and emerging manager can breakeven with \$85m of assets under management, our research shows that firms who manage between \$500m and \$1bn in assets require nearly double

that, with the average breakeven point being an estimated \$176m.

Although breakeven appears to be achievable at a relatively modest level of AUM, much of the feedback we received from larger managers was to note the need for enough working capital within the business to subsidise the first few years of growth. Many fund principals are prepared to go for a considerable time without paying themselves a salary, and many have invested their own personal wealth. Successful managers know that they are committed for the business for the long-haul, they must be prepared to endure lean years at the beginning, irrespective of performance as investment might not arrive for a number of years. The managers we spoke to referred to having at least enough working capital to support two, if not three years of sub-scale AUM.

It is worthwhile noting that there were fewer managers in the \$500m to \$1bn category than there were in any other size category, and this is representative of the industry as a whole. It appears that once a fund has passed the \$500m threshold it is more likely to continue growth towards \$1bn.

“What are those managers, with greater than \$500m AUM doing that could inspire those looking to grow their business?”

Fig 23. Average breakeven by strategy (AUM \$millions)

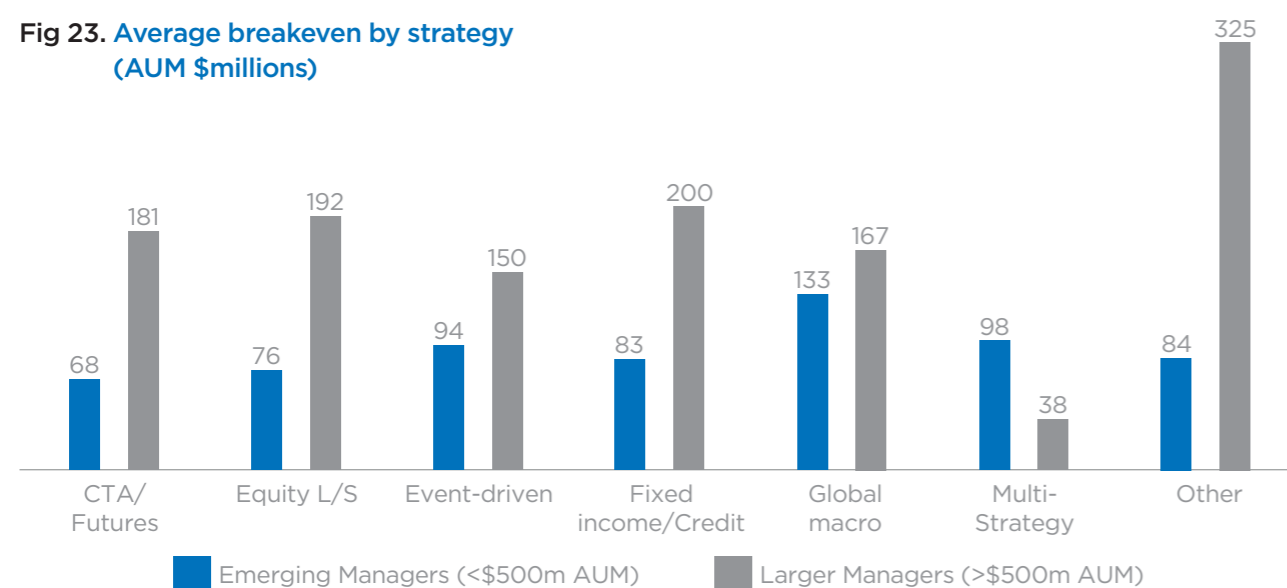
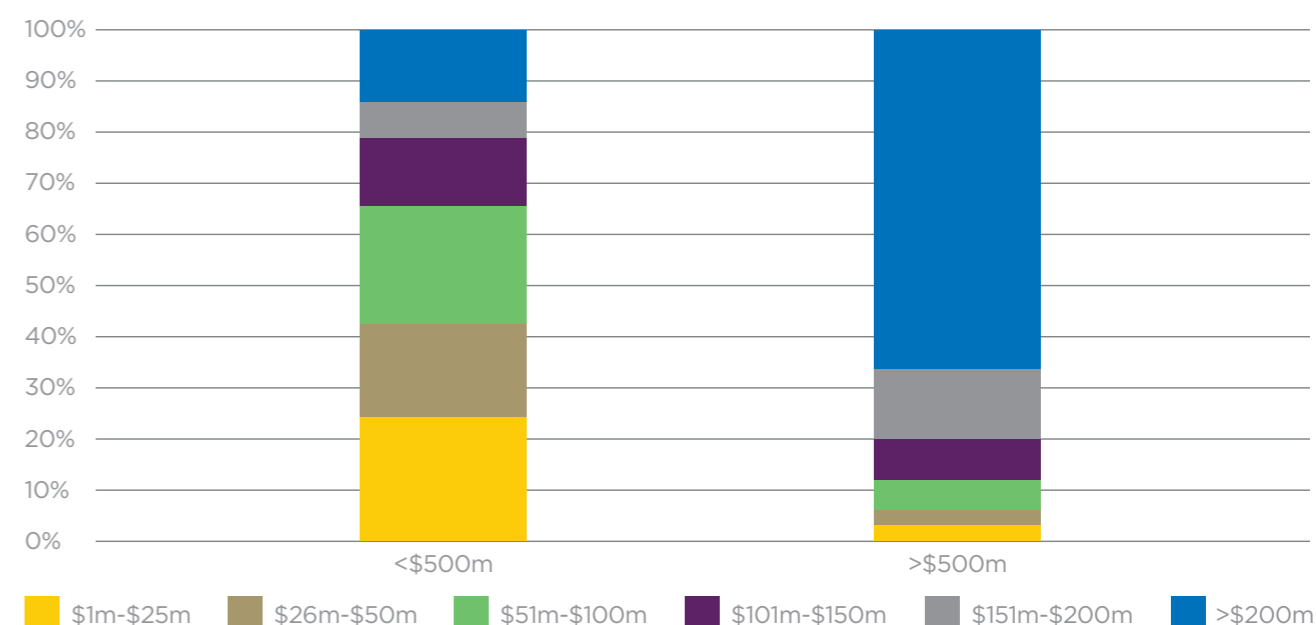


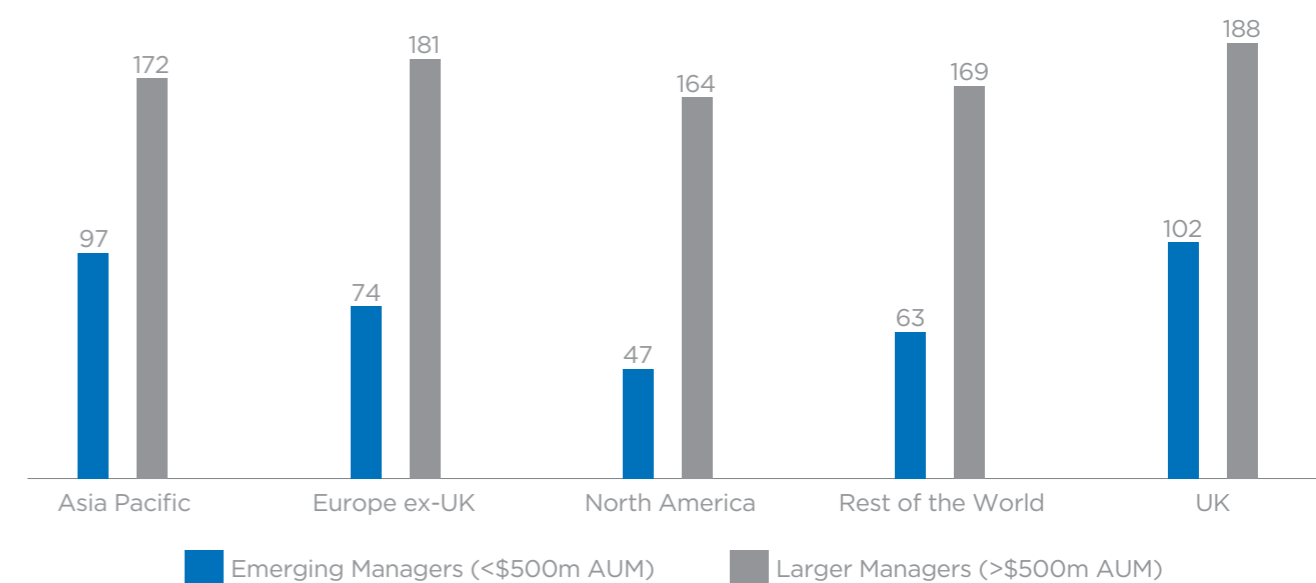
Fig 24. Breakeven range



Billion-dollar club

On planning for survival: “It was helpful that there were three founding partners that could all invest in the company for the first three years.”

Fig 25. Average breakeven by region (AUM \$millions)



Be flexible to attract investment

Management fees

Reaching a certain level of assets under management is not the only factor a fund manager has to take into consideration when understanding how best to breakeven. Much depends on the revenue that the firm can generate through fund(s) fees and compensation, that it derives from its fund(s) performance.

As discussed earlier, fees and compensation have been under intense scrutiny with many of the

largest allocators pushing for new and innovative fee structures – which are often geared to creating alignment with the fund's performance fee.

The emerging manager respondents (those with an AUM of less than \$500m) operate with a less flexible fee strategy than their larger peers. We see that 20% of emerging managers still charge a management fee of 2% or above, versus only 8% of the larger manager respondents (fig 26).

This may reflect the smaller manager's reliance on the management fee to support the basic running of the business.

Allocators understand the smaller managers position and offer leniency at initial investment. However, as a managers assets grow, it would be wise to promptly address the possibility of a decrease in management fees to provide a new solution for allocators within one or two years.

Fig 26. Management fee range

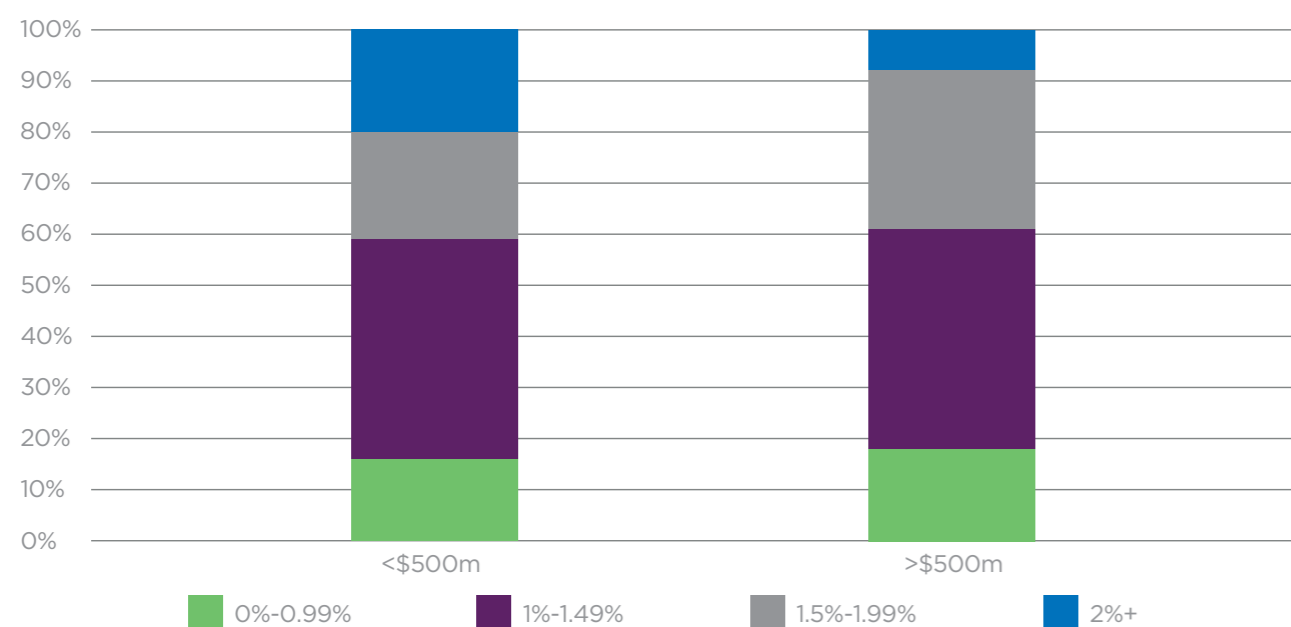


Fig 27. Average management fee by strategy

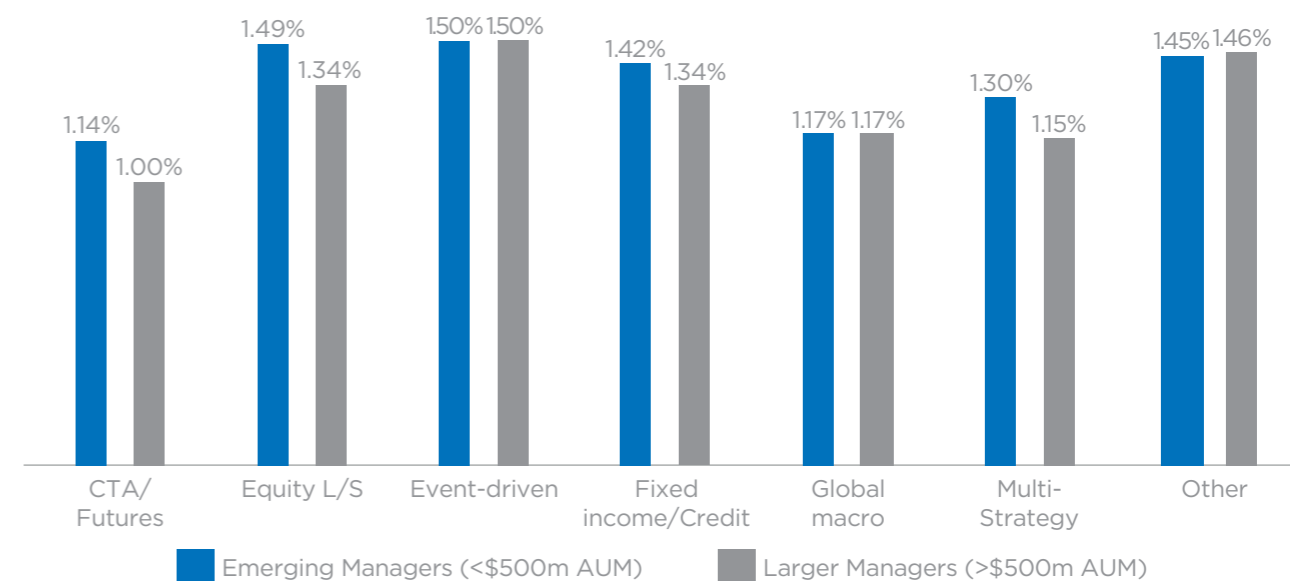
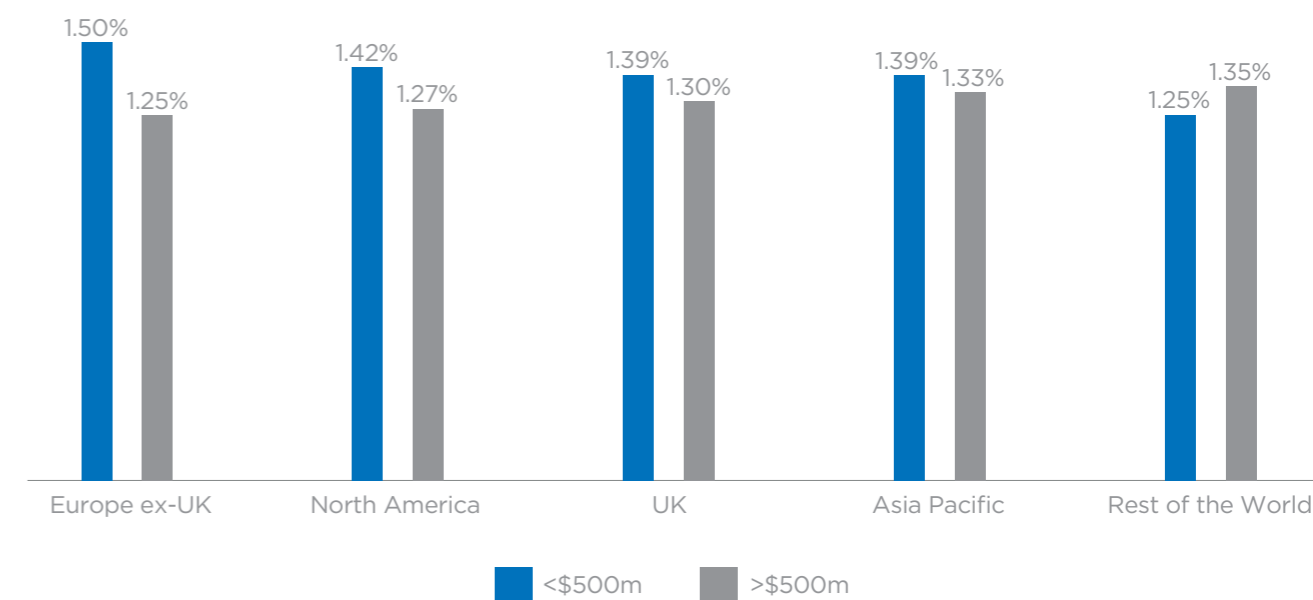


Fig 28. Average management fee by region



Billion-dollar club

On management fees:

“We expect risk premia to go sub-1% and 0% performance.”

“For emerging managers there’s more leeway. For them, I even think 2-and-20 is coming back. This, of course, should ratchet down though pretty quickly as AUM of the fund grows.”

“If the performance is there then investors are willing to pay.”

Billion-dollar club

On performance fees:

“By keeping their management fees low but their performance fees relatively standard emerging managers can lower the potential risk for allocators that may be hesitant to invest. That way, allocators would only have to pay larger fees if the manager delivered the promised performance.”

Fig 29. Performance fee range

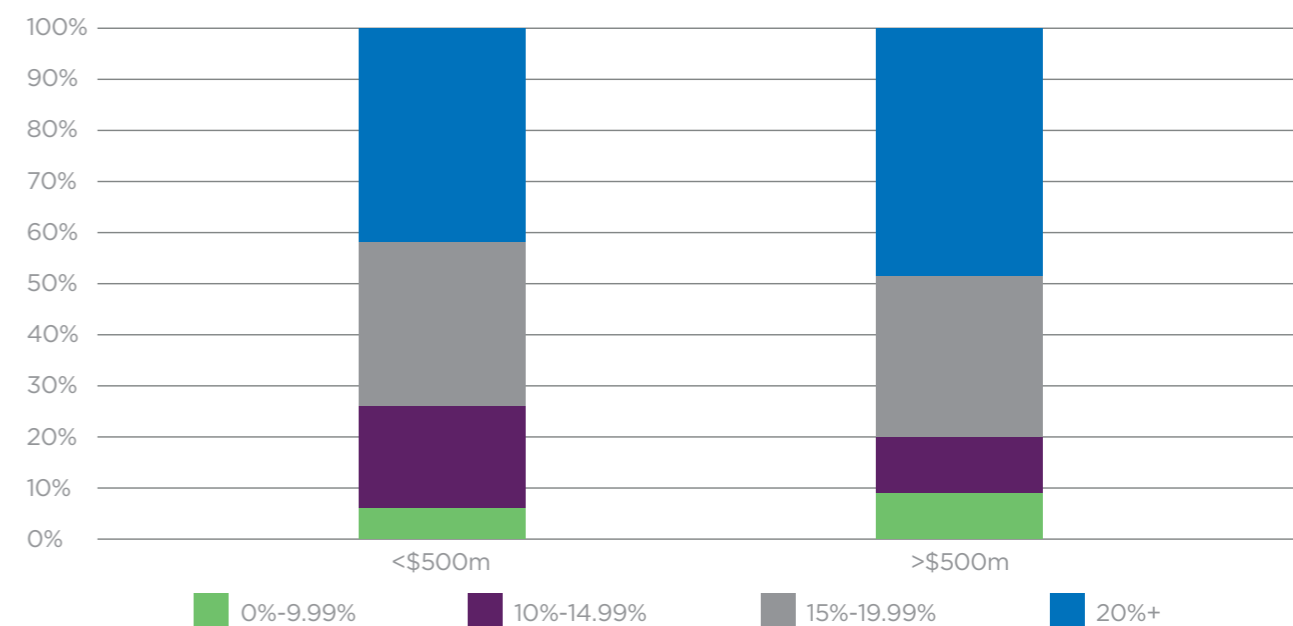
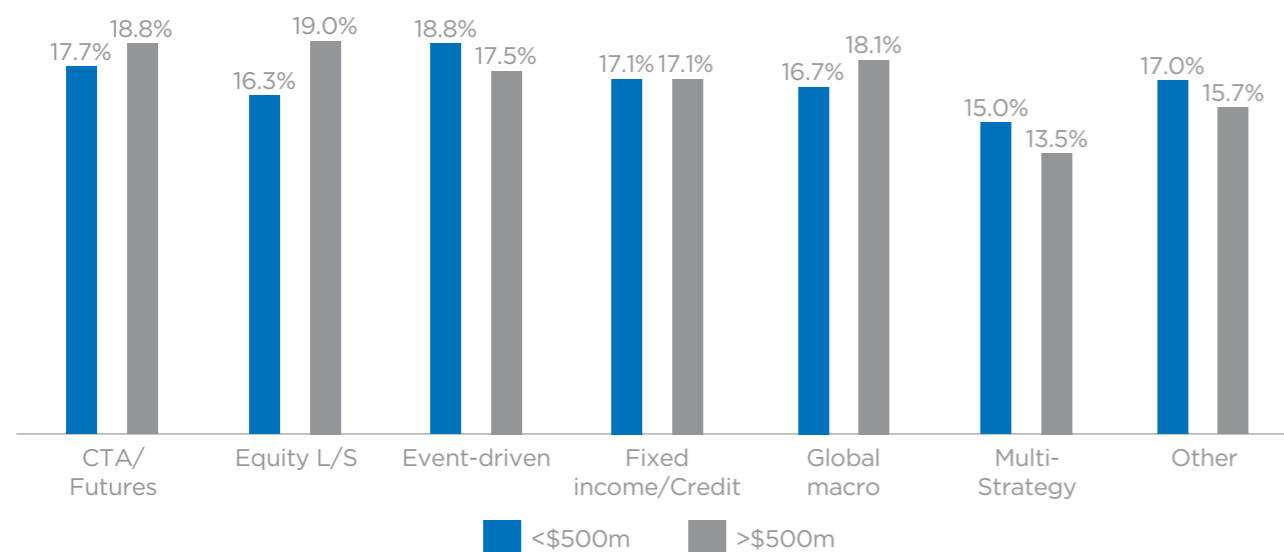


Fig 30. Average performance fee by strategy



Build it and they will come

Headcount

One of the key reasons why a hedge fund's breakeven grows as its AUM grows is because of its need to maintain enough highly qualified staff to manage the firm's assets. A hedge fund firm's headcount tends to jump quite dramatically as it grows its business.

Our research shows that, on average, an emerging manager (those with AUMs of \$500m or less) employs nine members of staff, suggesting a relatively lean organisation.

Emerging managers are not afraid to make use of outsourcing to maximise their firm's resources: half of those that we surveyed reported outsourcing their Chief Legal Officer (CLO),

while a third outsourced their Chief Compliance Officer (CCO) and Chief Risk Officer (CRO).

Emerging managers recognise the need to be nimble as they grow their assets and realise that allocators are increasingly accepting of firms outsourcing certain functions — *This is a trend that we explore in greater depth on pages 32 and 44.*

As a hedge fund business grows, and surpasses the billion-dollar (AUM) threshold, staff size also grows exponentially. Across the billion-dollar firms that we spoke to, they employ an average of 44 personnel in their firm supporting the various functions of the business from the front to the back-end.

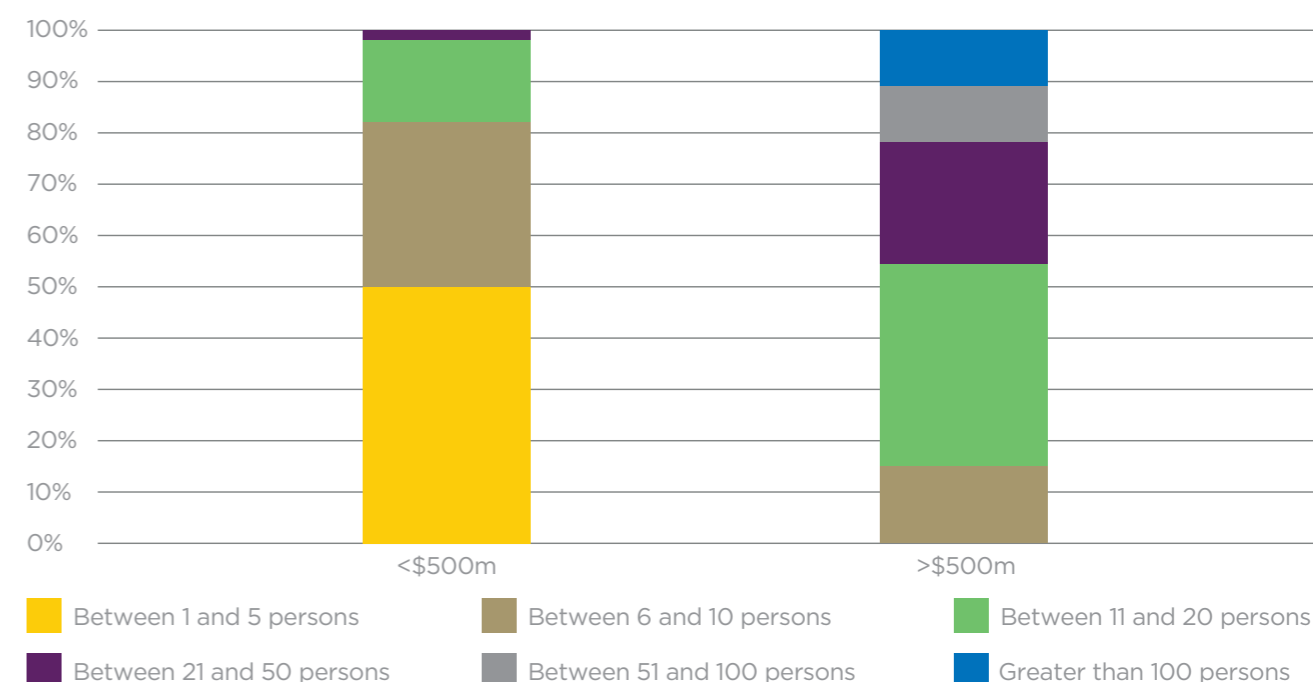
It is not surprising that only 4% of such firms reported outsourcing their CCO function, and that not a single such manager (irrespective of its size) reported outsourcing their Chief Operating Officer (COO) function.

The challenge for any hedge fund business, size notwithstanding, is how best to balance an institutional infrastructure that can support managing a billion-dollar AUM base in the most efficient manner possible. From the managers that we spoke to, they are the first to admit that there is no exact science that matches the optimum

approach. Rather, when building the business, consideration should be given to investing in key headcount early (key roles of COO, marketing) and outsourcing those roles with a less immediate need (CCO, CLO, etc.).

The larger managers we spoke to highlight the value of their business being flexible enough to scale down costs during the early stages of a fund's life without creating operational disruption.

Fig 31. Headcount range



Allocator view

"PM's can easily overvalue their portfolio skills and undervalue running a business." [c.\$100m investment per manager]

Fig 32. Average headcount by strategy

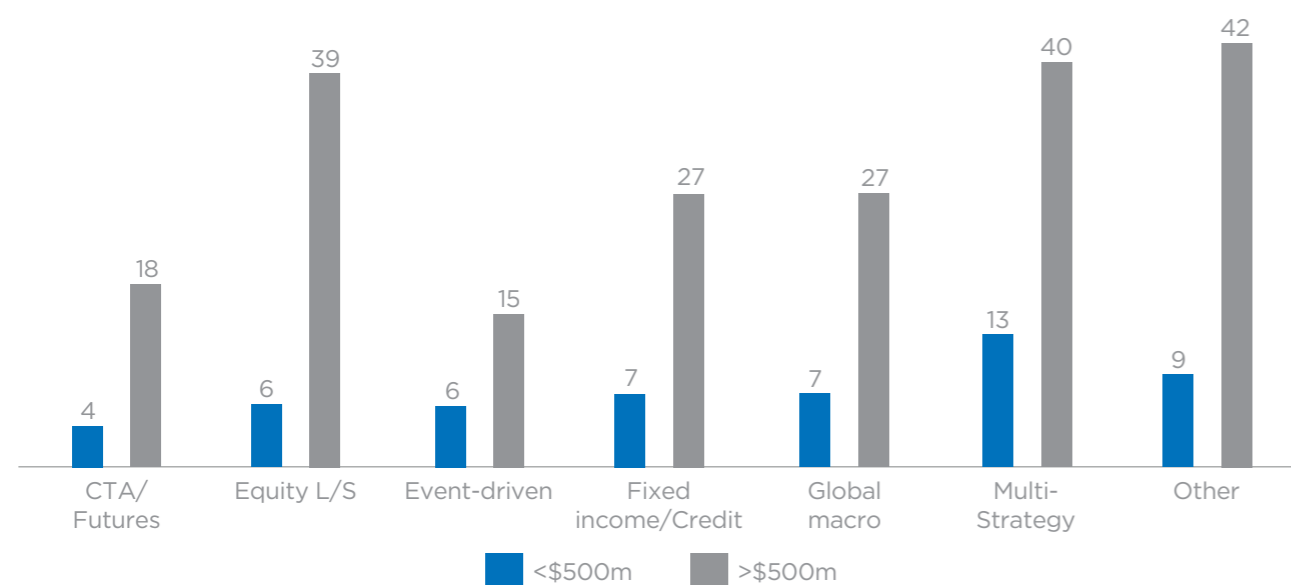
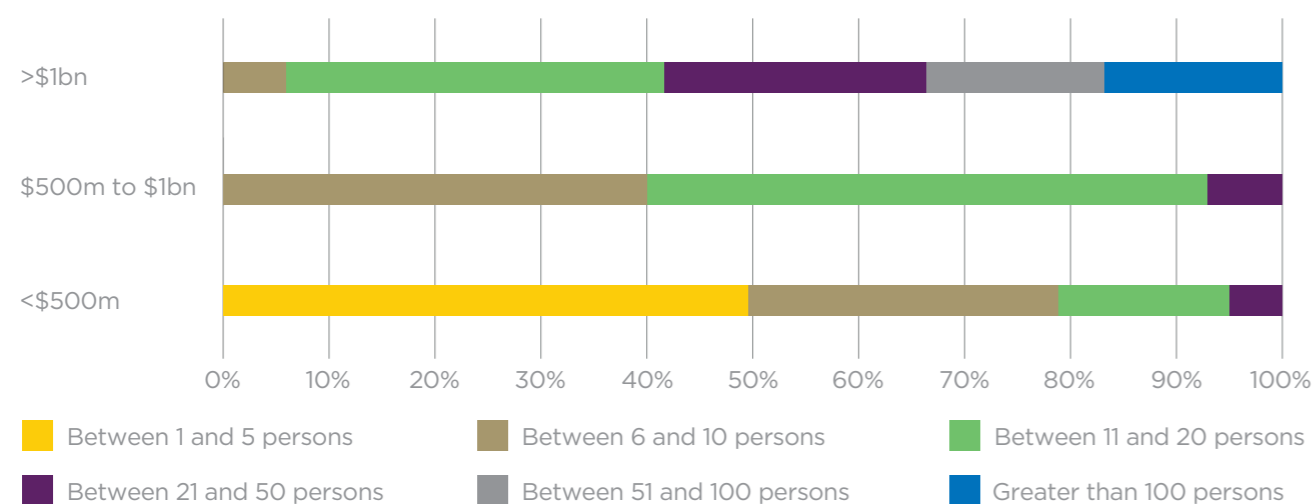


Fig 33. Headcount range by AUM



How to make it big - part two

Lessons that managers can learn from investors when considering how best to build their business

In this section:

What allocators want to see managers do before they invest.

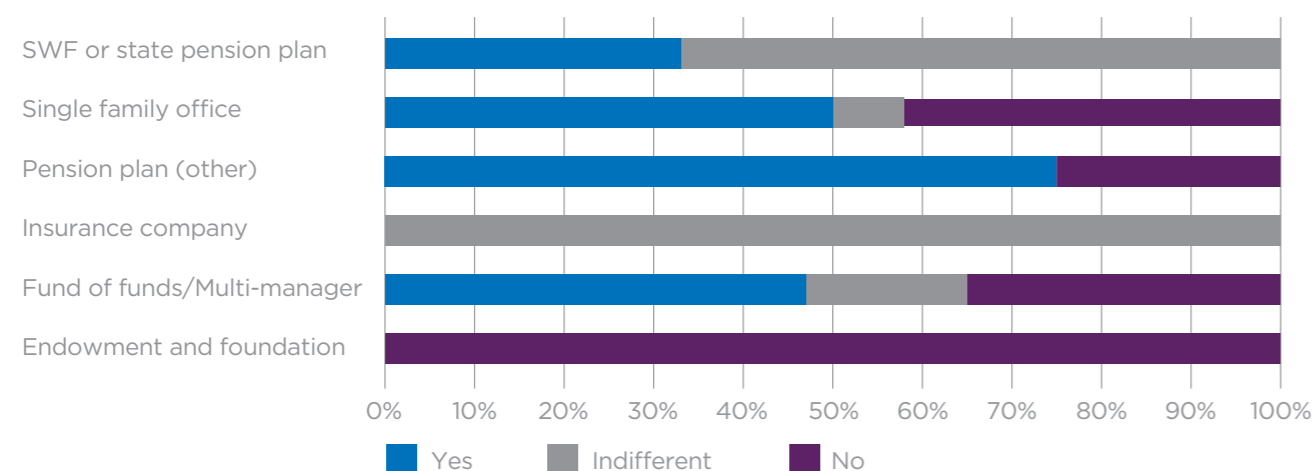
Don't be afraid to outsource but know when to build a permanent team

Outsourcing

60% of respondents do not find that excessive outsourcing influences their investment decision, or are indifferent to outsourcing.

Although allocators view outsourcing as part of the evolution of the emerging manager: as the fund grows assets, the key functions of running the fund are expected to be brought in-house to reduce risk and increase control.

Fig 34. Allocators that find excessive outsourcing to influence their investment decision



Allocator view

"I invest early in managers who have an edge, not another "me too" fund which won't compete against more established managers. I need to see managers that can explain performance so that I can clearly see the difference between luck and a repeatable alpha generating process." [c.\$100m investment per manager]

"Clearly risk management is key, especially so on the people side. I have seen funds run by one project manager where everything is outsourced which presents too great a key man risk for me. There needs to be a minimum of two people running the fund and a further two running operations, risk, back office etc." [c.\$10m investment per manager]

Focus on managing these three kinds of risk

Risk management

Poor risk management practices are by far the largest reason for an allocator not to invest in a fund. Allocator comments on why this is the case centred on three broad themes: investment risk, manager risk and operational risk.

01. Investment risk

The allocators we spoke to saw investment risk as the risk around fund performance and how the fund would fit within a wider portfolio. Smaller funds were considered to be more likely to have long holding periods and high volatility. Allocators also showed some concerns that they might not gain more from paying fees to invest in a fund rather than holding a position themselves.

02. Manager risk

Managers require a good reputation, as well as the ability to maintain the reputation going forward to raise further assets. Typically managers who are transparent (in sharing information pertaining to the fund or the firm) are favoured by allocators. This will be assessed in initial meetings.

03. Operational risk

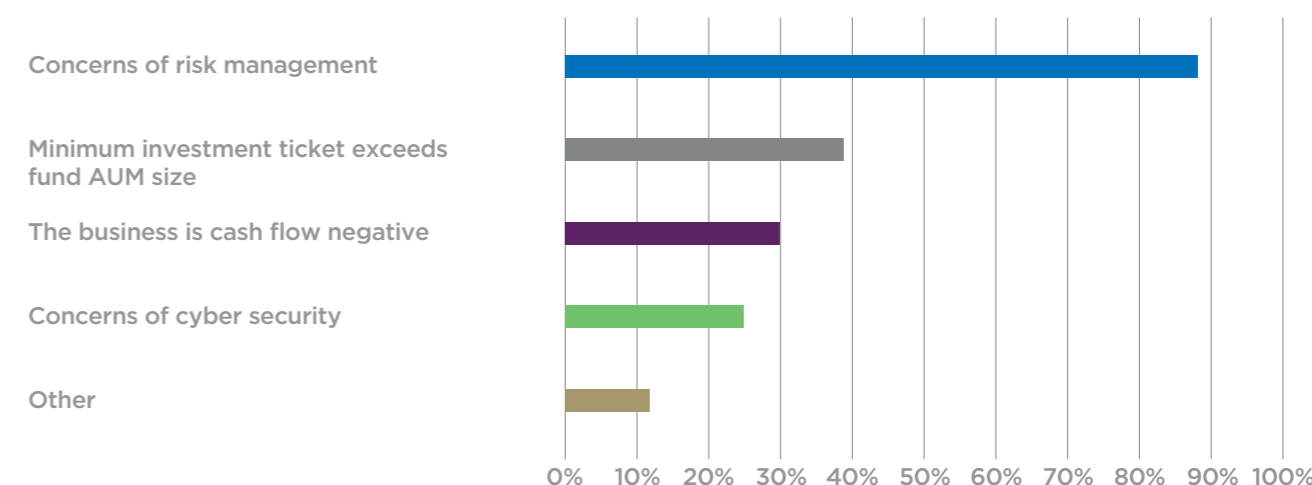
A fund requires a solid operational risk management structure to ensure responsibilities and processes are clear as well as the overall infrastructure. This becomes critical for institutional investors who demand comprehensive operational due diligences.

Allocator view

"Before I invest I need to be confident that the manager can generate alpha, and can manage downsides when performance is low." [c.\$100m investment per manager]

"For start-ups the founding team and how they get on is key, any squabbling during initial meetings is a straightforward no." [c.\$100m investment per manager]

Fig 35. Absolute reasons that would stop allocators investing in a fund

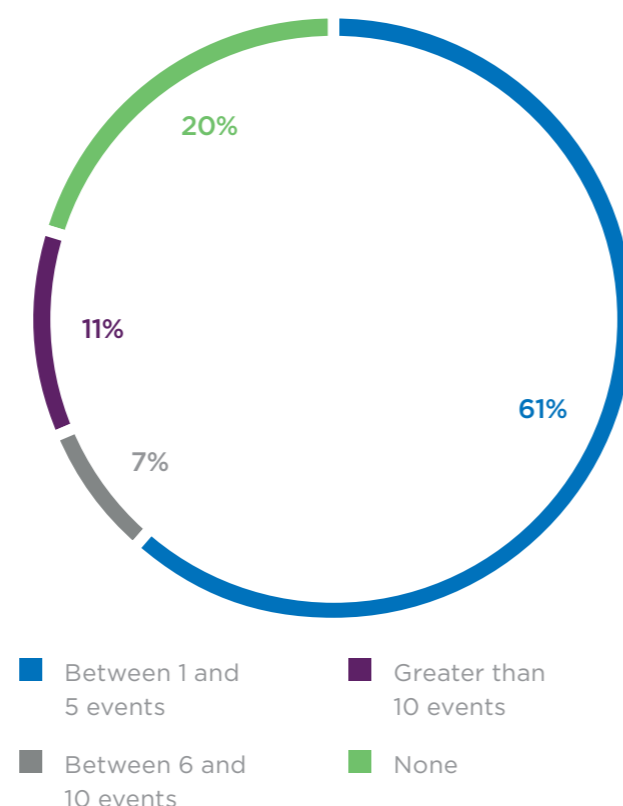


Be a networker, but don't rely on it

Networking

Most allocators attend 1-5 capital introduction/fund networking events a year. Few of the investors that we spoke to attend more than 10 capital introduction events a year.

Fig 36. Number of capital introduction/fund networking events that allocators attend a year.

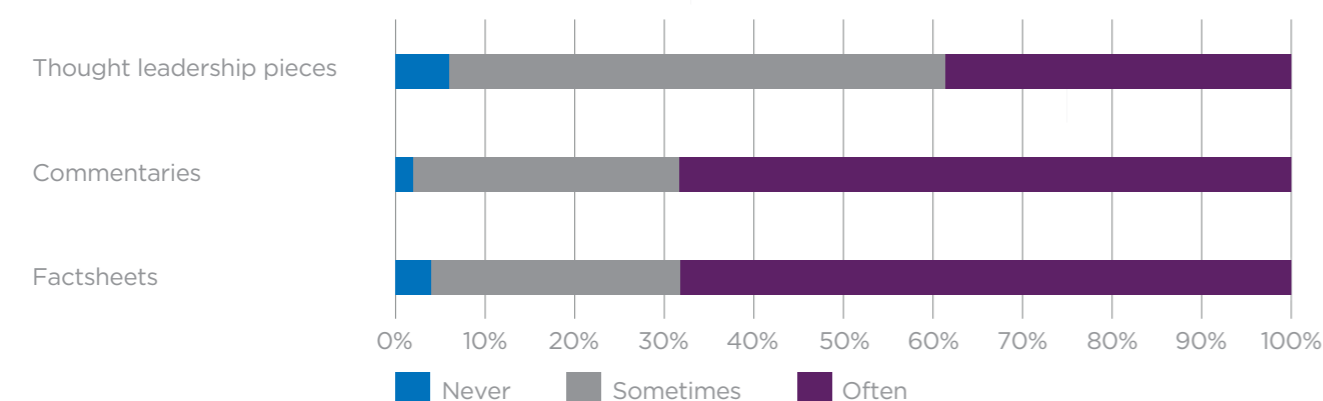


Continue to communicate

Marketing communications

Overall, allocators do read fund marketing pieces and related marketing documents that are sent to them by the fund.

Fig 37. Allocators that read marketing collateral that hedge funds and related parties provide.



Understand your audience's needs

Fund sizes considered by allocators

One of the classic conundrums for the emerging manager is how to get to a critical mass of size (AUM), to attract more capital to build their business. Many of the largest allocators that we spoke to cite that they have to do as much work allocating to a smaller manager as they do when allocating to a member of the billion-dollar club. If the investor is more wary of making an allocation to a start-up, then they are more likely to choose the established manager. Equally, many allocators are constrained as to what percentage of a manager's assets they can have in the respective fund that they invest in. In a lot of cases, the minimum ticket size that they have exceeds the total AUM of the emerging manager, so they can't even consider investing in smaller managers. We explored this dilemma in figs 38 and 39. There is an almost equal split of those who will, and those who won't invest in a manager running

less than \$50m of AUM (fig 38). Fund of funds and family offices, are more inclined to invest in these smaller funds (fig 39).

Fig 38. Smallest fund sizes that allocators would consider

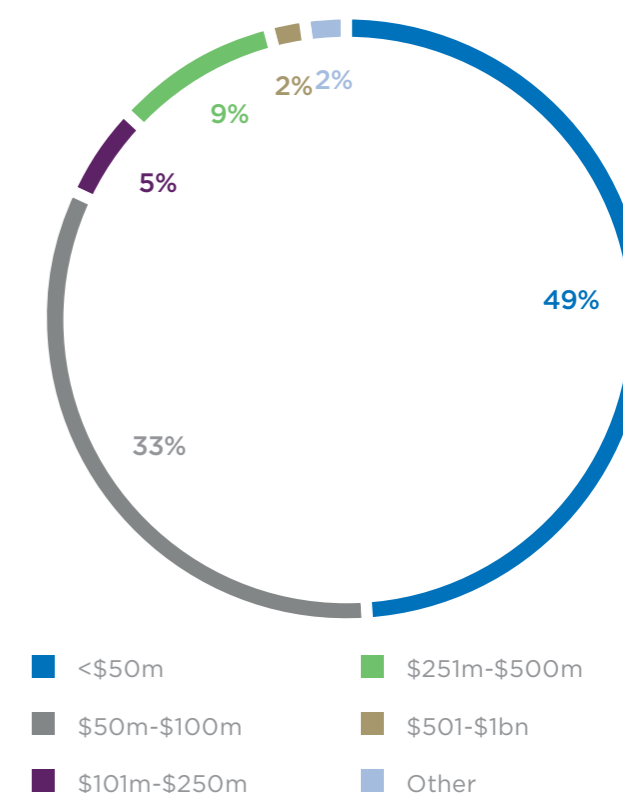
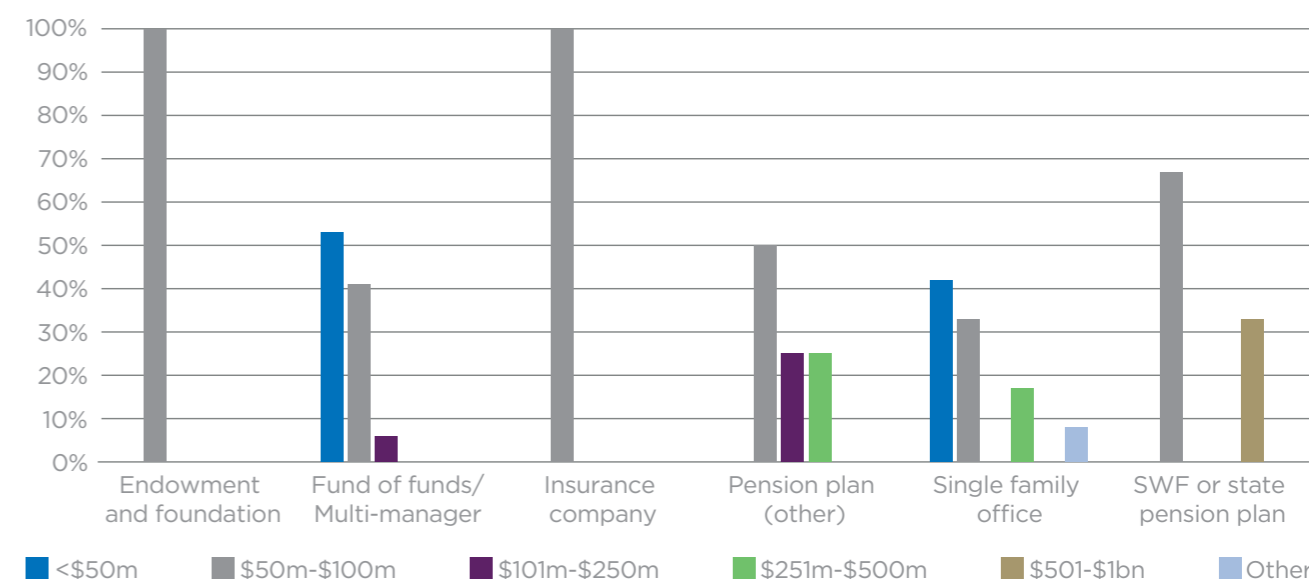


Fig 39. Smallest fund sizes considered by allocator type

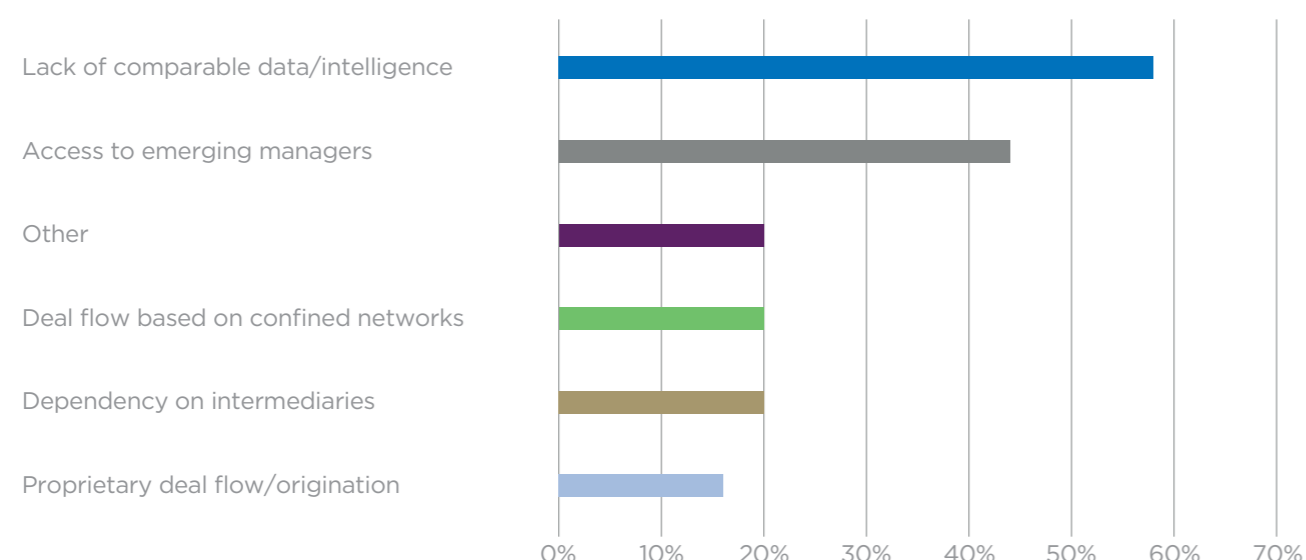


Make your fund visible with data and presence

Allocator challenges

Lack of comparable data and the manual nature of the due diligence process is a major challenge to the allocation process for those hedge funds that manage below \$1bn. It is also interesting to see that accessing emerging managers is seen as a challenge. Considering we have shown that the personal network is a preferred route to investment for most allocators, those funds wishing to grow should focus on approaching potential investors and networking to ensure they have established personal contact with allocators and are visible at events.

Fig 40. Challenges faced by allocators when identifying opportunities of hedge funds with AUM of less than \$1bn (respondents selected all that applied)



Allocator view

“Finding managers before they get too big is a key challenge for allocators. Once a fund gets too big, the smaller allocators lose their access to the portfolio managers, which is a key investment making criteria.” [c.\$10m investment per manager]

Billion-dollar club

On visibility: “Plan your investor and research what they are looking for and don’t be afraid to contact them and initiate contact. They might just be looking for you.”

Build your track record

Performance

It is difficult for the allocator to make an investment in the absence of a proven fund track record. The allocator wants to see proof of performance to understand that the strategy is viable and therefore give some indication towards future performance.

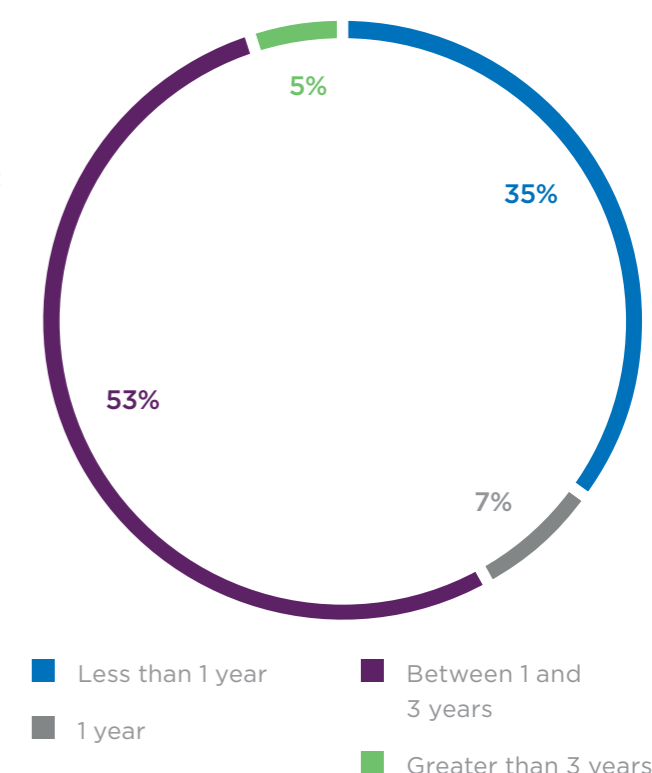
However, for investments in early stage funds and in the absence of a long track record, it is important to consider the following three things: strategy and approach to risk; openness and access to the portfolio manager for information sharing and the correlation of a fund to a market.

In most cases at a minimum the allocator demands at least a 1-3-year track record. However, from the conversations held with fund of funds, multi-manager platforms and family offices, there is more flexibility on their part. Some of them will consider making an allocation to funds that have a performance track record of less than a year.

These are most likely to be funds run by second generation fund principals, who have already built a significant track record at a previous fund familiar to the investor.

Track records taken from previous employers may not be fully reliable. A trader may be a top performer in a Tier 1 bank, however they will need to demonstrate they can actually run the strategy as a standalone new organisation. Some may not be able to sustain alpha generation without the research and infrastructure previously afforded to them; when working within a larger infrastructure.

Fig 41. Length of track record required by allocators of prospective managers.



Allocator view

“Track record is important. I also look at the manager’s pedigree and where they were before. If a manager spins out of a Bluecrest or Millienium it’s a different story to trader or PM leaving a bank.” [c.\$250m investment per manager]

“When allocating I have a process of meeting managers, developing ideas and tracking both them as a team, and as a fund.” [c.\$100m investment per manager]

The path to growth

The tried-and-tested road map to becoming a billion dollar manager

In this section:

How to branch out into billions.

In conclusion, we do think the independent manager can break into the billion-dollar club on a standalone basis.

We initially thought that there would be a limited number of standalone hedge funds that manage over \$1bn. However, upon closer analysis of manager respondents to the survey, an estimate of only 25% are actually divisions of larger fund management groups. So, approximately 75% are standalone hedge funds that would have started out as small independent asset managers and have 'made it big' by joining the billion-dollar club.

We believe that the responses to our survey lay out a road map which will help small and emerging managers on their journey to becoming a billion-dollar manager.

Target the right investors

When we asked managers to whom are they marketing, we saw (fig 42) that the smaller managers, those with AUM of less than \$100m, and even those with AUM of less than \$1bn, are primarily targeting family offices and high net worth individuals.

The very largest managers are targeting more the Institutional market – pensions, endowment and foundation market.

Fig 42. Type of allocator targeted by managers with less than 500m

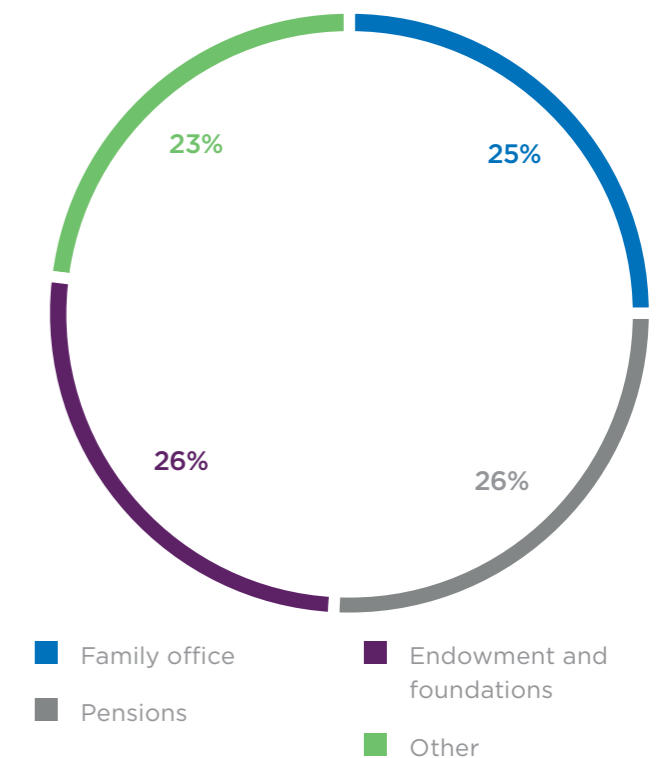
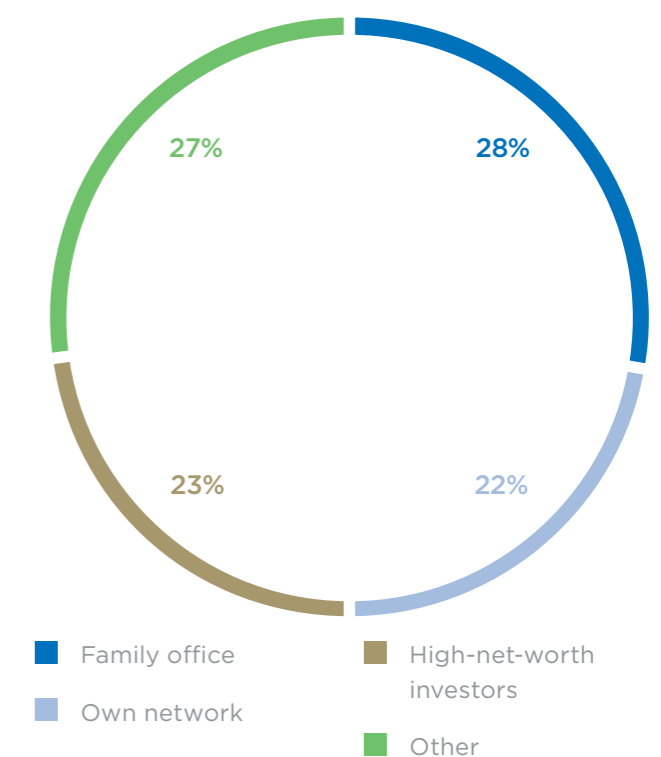


Fig 43. Type of allocator targeted by managers with more than 500m

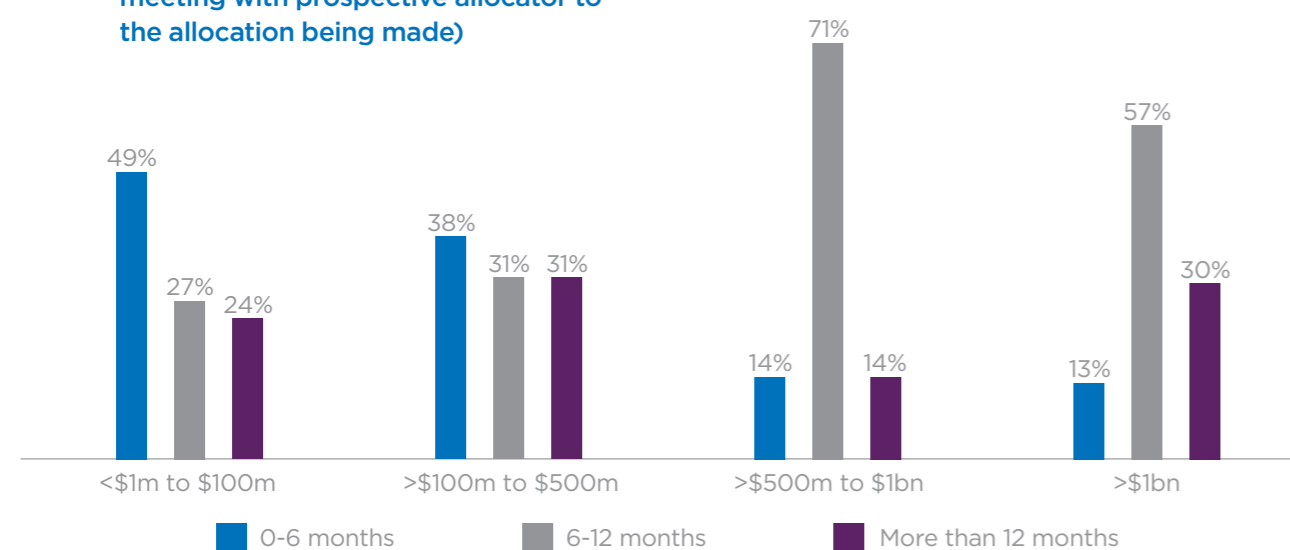


Concentrate on the optimum investor to see a quicker conversion of investment

Pairing these findings with the data shown in fig 44 we see that the smaller manager is correct to target the family office and high-net worth sectors as these appear to 'convert' quicker into investment.

Our roundtable group of managers were keen to advise that it's not necessary to accept every potential investor and that it is possible to turn investors down politely. Therefore, it would be worthwhile devising an investor strategy from the beginning to both focus your efforts in the right areas and to help you keep to your growth plan.

Fig 44. Average length of time taken to close an investment into a fund (from initial meeting with prospective allocator to the allocation being made)



Billion-dollar club

On customer conversion: "The 0-6 month conversions for emerging managers is because the ticket size is small. We didn't start speaking properly with Institutional Investors until year 3, going into year 4 and even year 5"

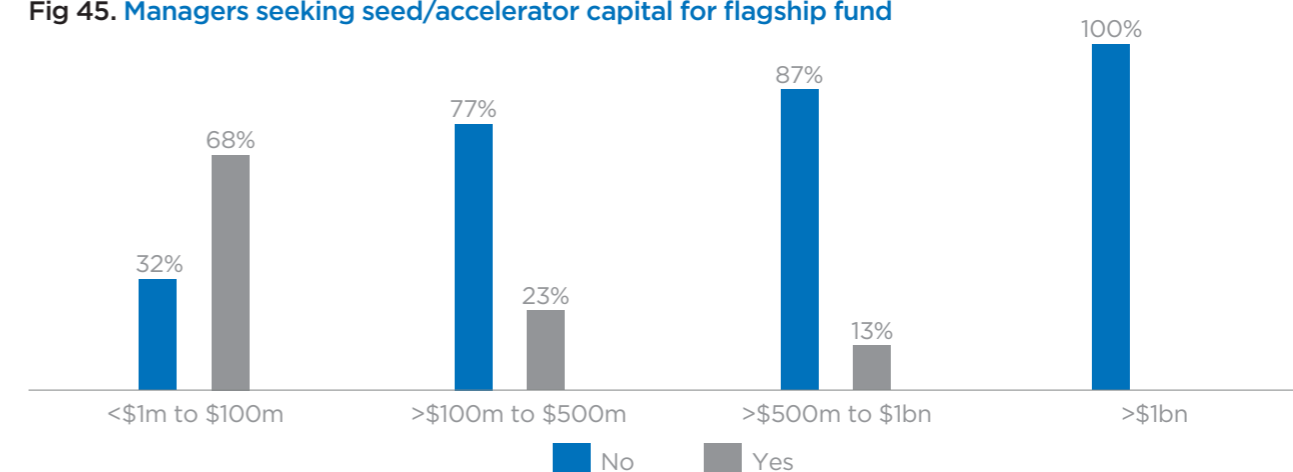
Use seed capital to accelerate your business

Seed/accelerator capital is clearly an efficient way to accumulate investment capital, and by extension jump-start the AUM for your fund, albeit this comes at a price.

Almost 70% of all manager respondents that run up to \$100m AUM are currently looking for seed/accelerator capital (fig 45). It can be very important for smaller funds to grow to a level not only at which larger allocators consider investing, but also provides

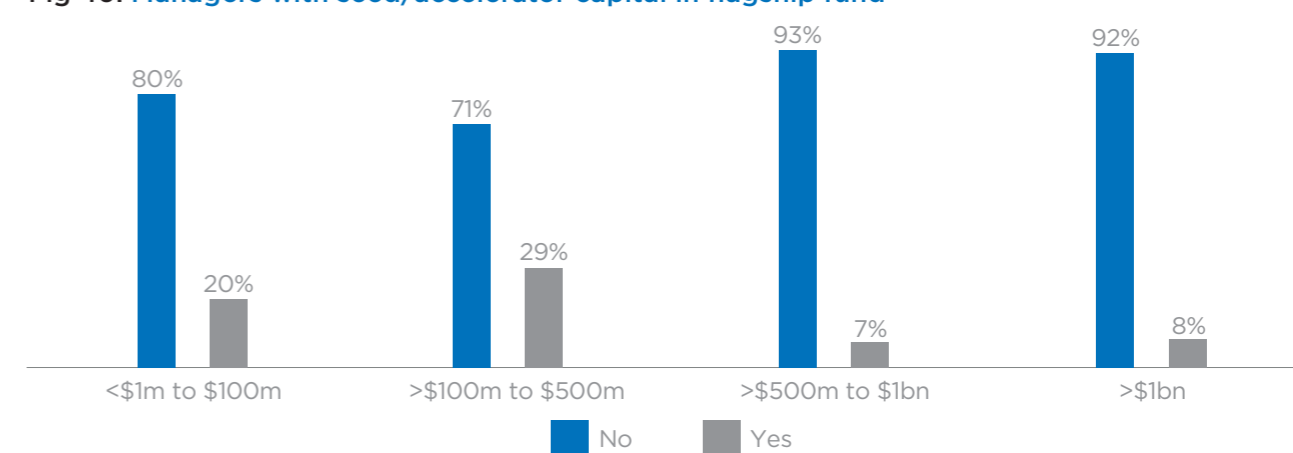
a core revenue stream to cover overheads for the foreseeable future, make additional hires and work on further growth plans. Not surprisingly, as the size of a fund's AUM grows there is less interest in seeking seed/accelerator capital (just 13% for the \$500m to \$1bn, and zero above \$1bn). At larger AUMs the manager has reached their own individual 'critical mass' and is less interested in giving away more economics for more investment.

Fig 45. Managers seeking seed/accelerator capital for flagship fund



This is reflected in the reported total amount of seed/accelerator capital in the funds, which logically decreases as the funds grow and it is diluted by other 'regular' fee assets.

Fig 46. Managers with seed/accelerator capital in flagship fund





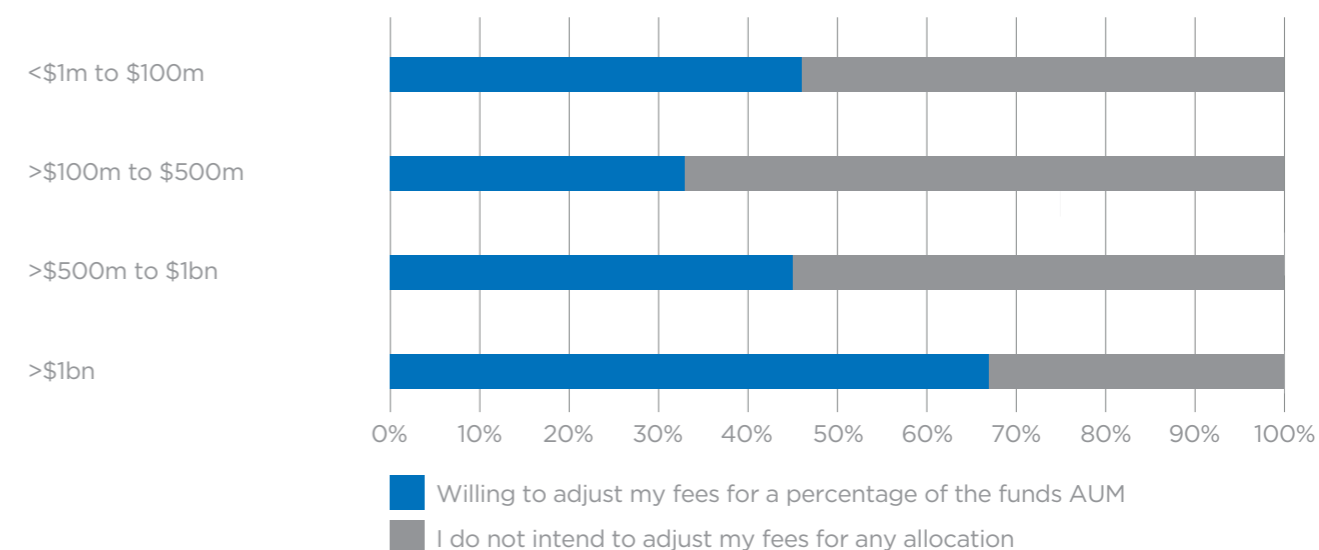
Be flexible on the fees that you charge

Smaller managers are still the mostly likely (67%) to offer management fee reductions for a significant percentage of the fund's AUM.

Of these smaller managers most would only consider reductions for investments greater than 10%. There is clearly a willingness to offer a discount, but only in return for a significant percentage of AUM.

Even 40% of the larger manager respondents are still willing to consider fee discounts for larger investments. Perhaps this is because they are targeting pension plans and other investors with larger ticket sizes.

Fig 47. Managers who would/would not adjust their management fee for a significant percentage of the funds AUM

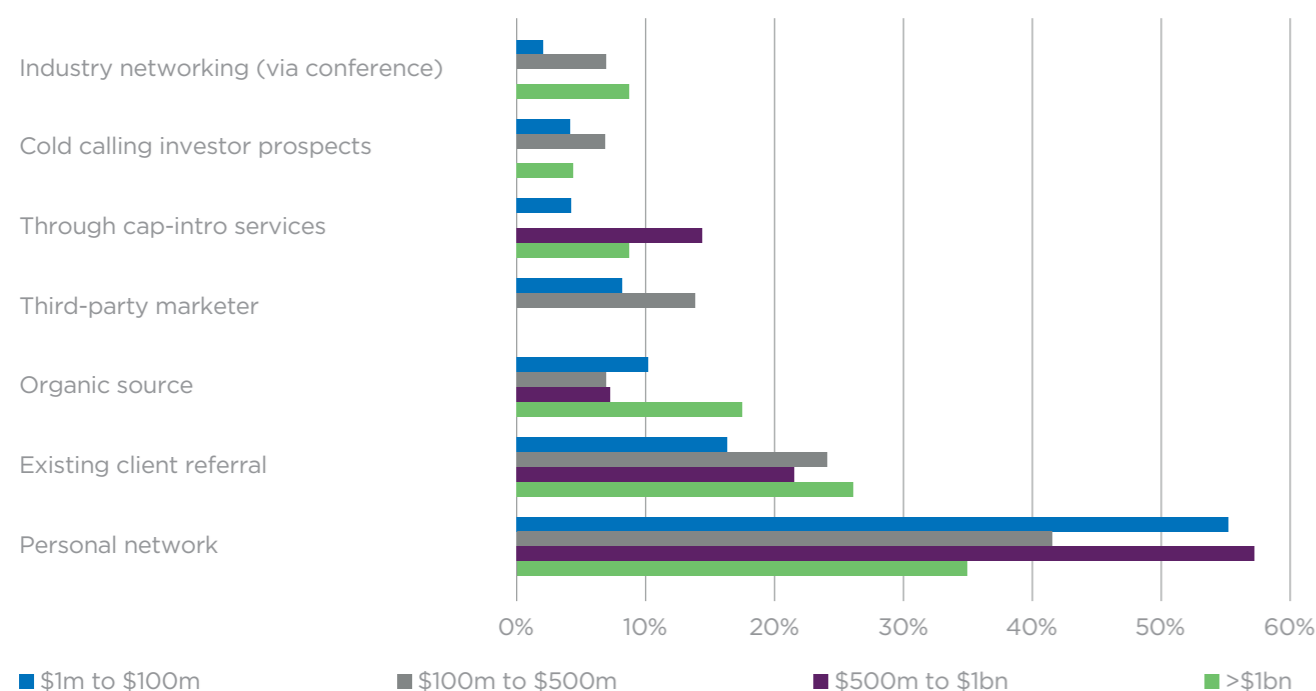


Use and expand your personal network

Searching for potential investors can be an arduous task, but our analysis finds that it needn't be.

Our survey showed that every size of manager was most likely to have used their personal network to source their most recent investment.

Fig 48. Managers source of most recent investment



We also find that emerging managers might not want to spend time on the more potentially time-consuming methods.

This is especially true when trying to source capital introduction services (cap-Intro). Only 4% of emerging managers sourced their last investment from cap-Intro versus 25% of \$500m+ managers.

When looking to follow the best-practices of established managers, we found another interesting trend; 0% of this group sourced their last ticket from third-party marketers.

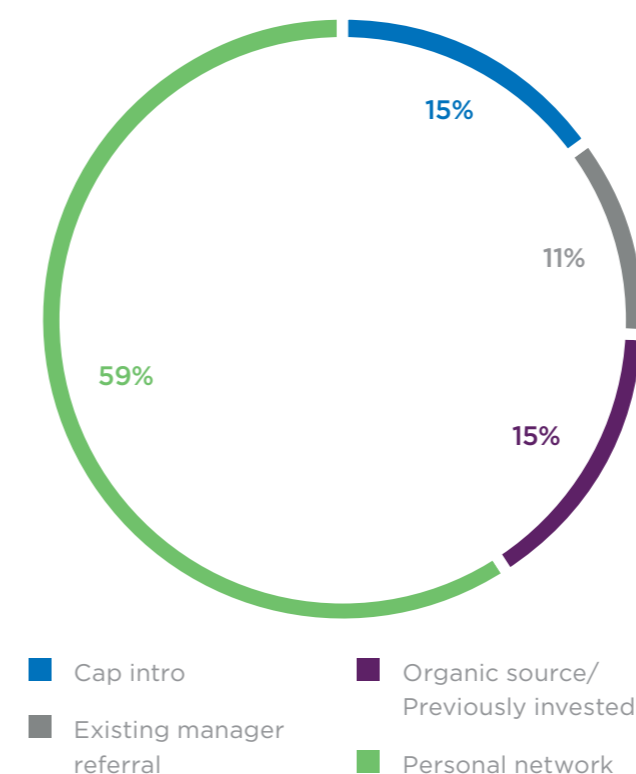
Allocators

This is reinforced by the allocators themselves. When we asked the allocators where their last investment was sourced, they agreed that the personal network was the most important.

Based on anecdotal evidence and industry experience, the yearly cost to be a client of a bulge bracket prime broker, and therefore benefit from their capital introduction services, is around \$500,000.

However, managers can take comfort from the survey results, that show allocators do not have a preference towards funds that are introduced through these capital introduction services. It might be more beneficial, and cost effective, for a manager to expand their personal network organically.

Fig 49. Allocator's source of most recent allocation



Allocator view

“Meeting the key founding partners and portfolio manager is key, and maintaining that access during and after the investment process is far more important.”
[c.\$10m investment per manager]

Billion-dollar club

On seeding: “The ultimate aim of seed is revenue stream. Bespoke Seeds do exist, you can find seed companies willing to seed with \$5m. Smaller seeders tend to be below the radar, but they are there.”

Have skin in the game

At all levels of AUM, managers retain considerable equity in their funds, with 40% of \$1bn+ managers holding 5% or more of flagship fund capital.

At the other end of the spectrum, more than two thirds (69%) of the smaller sub \$100 managers hold more than 5%+ of flagship fund capital, with 60% holding 10% or more.

Investors are united in saying that it is critical, for any fund that they invest in, to have the principals demonstrate that they too have skin in the game.

The allocators want to know they are investing alongside the manager and that if they perform they both benefit, and if they lose money it hurts both equally.

“100% of Allocators demand that the fund principal has their own money invested in their flagship fund.”

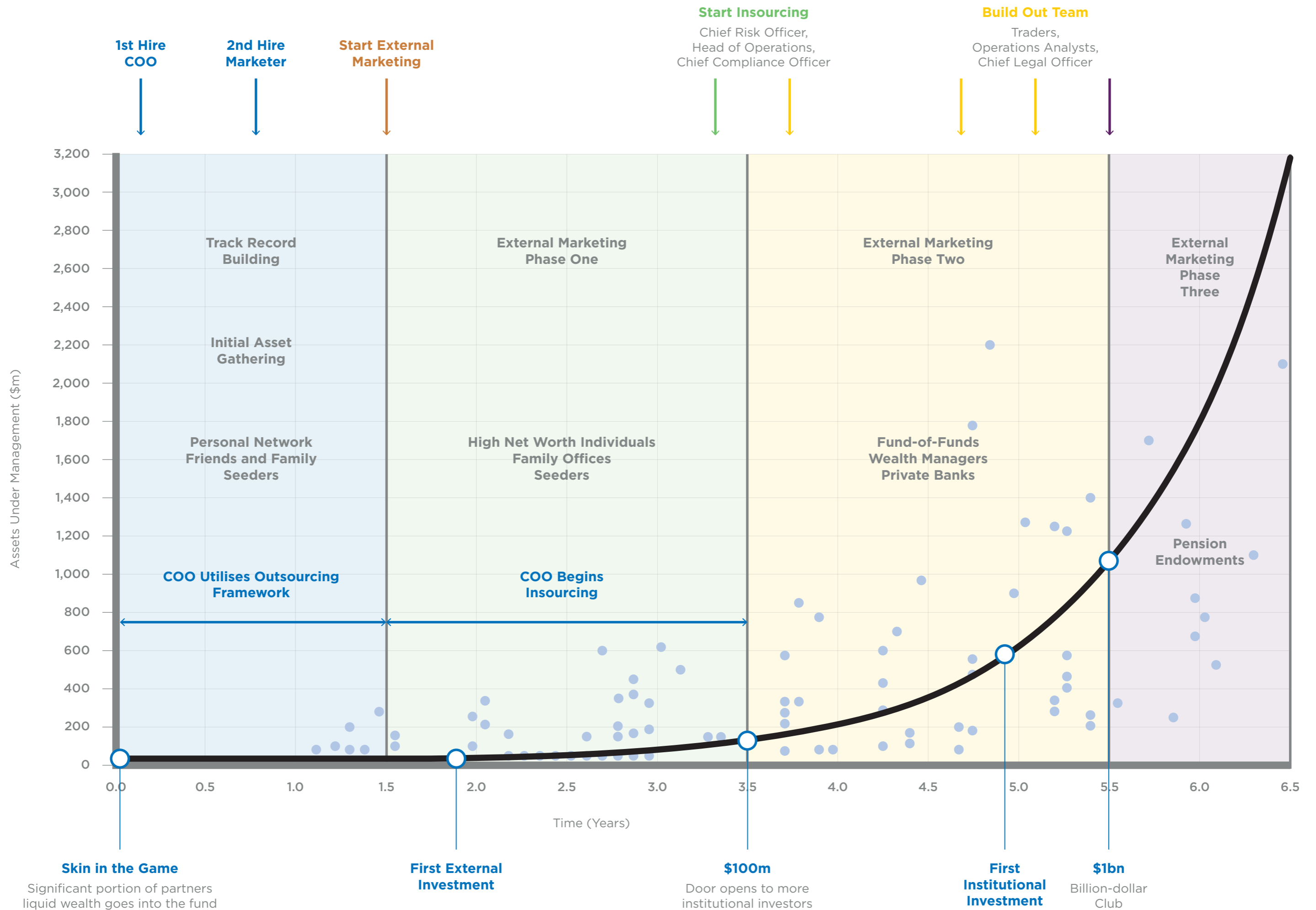
Fig 50. Average percentage owned by the fund's principle



Allocator view

“When launching a new fund it's hugely important that principals invest their own money.” [c.\$250m investment per manager]

The roadmap



About AIMA.



Tom Kehoe, CAIA
Global Head of Research

www.aima.org

AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than \$2 trillion in assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 80 members that manage \$500 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

About GPP.



Sean Capstick
Head of Prime Brokerage

www.gpp.group

GPP is a multi-award winning financial services firm that provides prime brokerage to hedge funds, asset managers, proprietary trading firms and other professional investors at all stages of their life cycle.

A high touch alternative to the bulge bracket traditional prime brokers, GPP offer a full support service to access the global financial markets via our multi-asset class trading platform, which provides trade execution, margin financing, securities lending, clearing and custody services.

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

About Edgefolio.



Rowen Pillay
CEO

www.edgefolio.com

Edgefolio is an industry-leading technology business that serves the Asset Management industry across institutional investors, prime brokerage, fund managers and family offices.

Leading firms work with Edgefolio to address their challenges centred on cap intro transformation, fund marketing and fund discovery, who benefit from the founders' experience and the advisory board's deep expertise.

Customers are based in North America, Europe and Asia-Pacific, where an office was recently launched in Hong Kong.

Edgefolio is proud to lead the digital wave that is transforming the way the industry works, towards greater efficiency, transparency, and an overall higher standard of excellence.

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GPP

101 Wigmore Street, London W1U 1QU

T: +44 207 399 9450

E: gpp@gpp.group

W: www.gpp.group

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