



LOOKING UNDER  
THE HOOD

CAPITAL SOLUTIONS  
HEDGE FUND INTELLIGENCE

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## I. STUDY OVERVIEW

For this second quarterly content piece in 2011, the Strategic Consulting team decided to look under the ‘hood’ (or ‘bonnet’, for British English speakers) of Hedge Funds (HFs) to better understand their organization, practices, and economics. Our goal, going into this endeavor, was to help hedge fund CEOs and COOs by analyzing key aspects of their business and by providing some objective benchmarks across their peers for them to compare themselves to.

In this document, we explore three key topics:

- i. Organization Size and Structure
  - a. What is the typical organization size given a level of assets under management (AUM)?
  - b. What is the typical split between the investment team and other functions?
  - c. How do others organize / incentivize the investment team?
  - d. What business functions are typically outsourced for a firm size?
- ii. Compensation Structure
  - a. What is the menu of choices for paying / retaining people?
  - b. What is the current adoption rate of different retention tools?
  - c. What are typical management company ownership patterns?
- iii. Economic Drivers
  - a. What are the typical financial metrics for managers of a certain size?
  - b. What is the average management company cost structure?
  - c. What is the level and types of expenses charged to investors?
  - d. What financial metrics drive a HF manager’s enterprise value?

### Methodology

With the above questions in mind, Strategic Consulting took a three-pronged approach to gathering the required information for analysis:

- We conducted detailed one-on-one interviews with 54 HF managers at the CEO, COO or CFO level.
- We received responses from an additional 111 HF managers by means of a web-based survey to augment our data set and address some size and strategy biases in our sample of interviewed managers.

- We analyzed relevant data from existing research and publications (e.g., compensation reports by executive search firms, financial filings of listed HF managers).

Figure 1 depicts the distribution of the 54 HF managers we interviewed along three dimensions: asset size, domicile, and main strategy.

- The 54 managers represent \$200bn in AUM, or about 10% of the entire HF industry.
- These managers are fairly well distributed across AUM size categories, with 20 managers in the less than \$1bn AUM size category, 21 in the \$1–5bn range, and 13 managers with more than \$5bn. Compared to the overall industry, there is a skew towards mid-sized / large managers in our sample.
- The geographical breakdown is broadly in line with the industry.
- They represent a diversity of major strategies, albeit with a slight skew towards fixed income / credit and multi-strategy HFs.

Figure 2 shows the distribution of the 111 HFs that participated in the web-based survey along the same three dimensions: asset size, domicile, and main strategy.

- 88% of them have less than \$1bn in AUM.
- ~40% are Macro and CTA managers and nearly one-third are Equity Long-Short.
- There is a domicile bias towards North America, but there are also 16 managers based in Africa and South America (regions not covered in our interview sample).

## II. EXECUTIVE SUMMARY

The following are the key findings on the topics addressed in the study.

### Organization Size and Structure

- The median HC for HFs by AUM size among our participants is ~15, ~30 and ~125 for HFs with <\$1bn, \$1–5bn and \$5bn+ in AUM, respectively.
- Smaller HF managers benefit from economies of scale as they grow, as evidenced by the steady rise in the ratio of assets to headcount (AUM / HC), although these scale benefits tail off after the \$5bn AUM mark.
- Investment professionals (IP) consistently account for just over 50% of HC for HF managers with AUM less than \$5bn, but this percentage drops to just over 40% for managers with \$5bn+ in AUM, implying more investment in infrastructure at larger managers.

FIGURE 1: INTERVIEW PARTICIPANT PROFILE

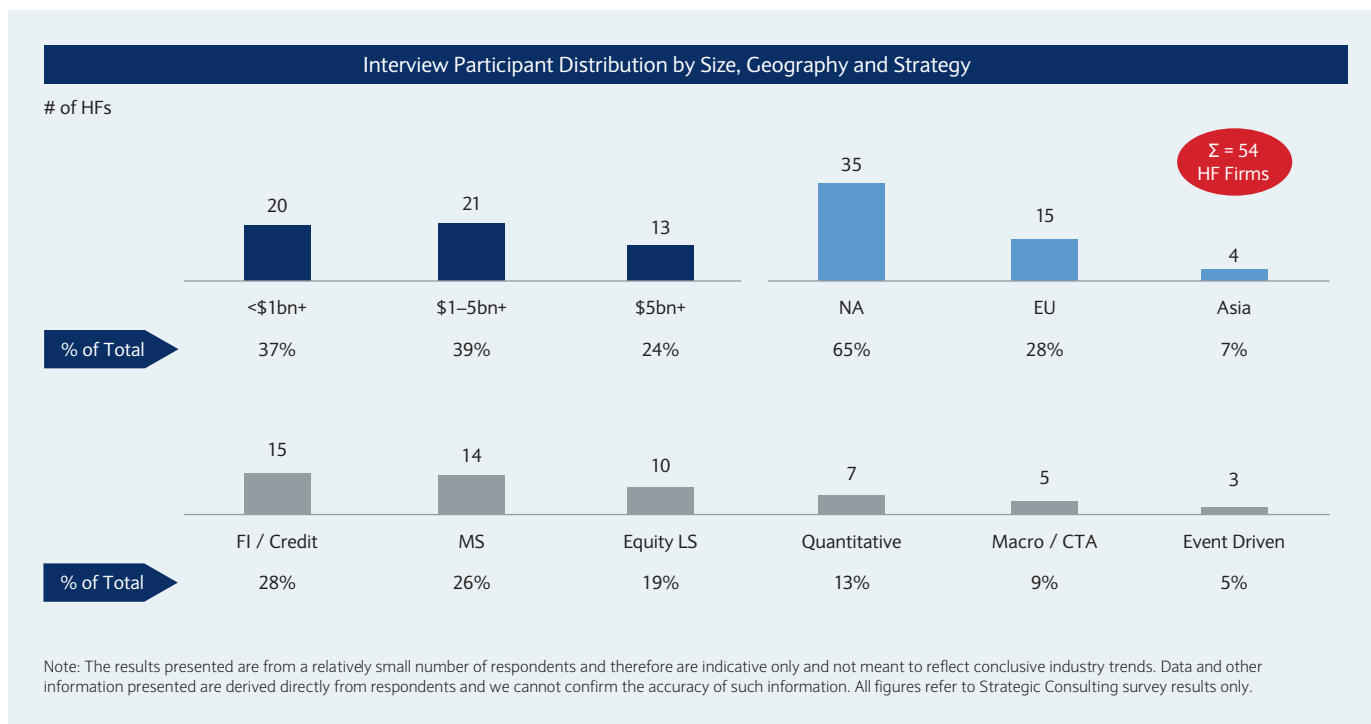
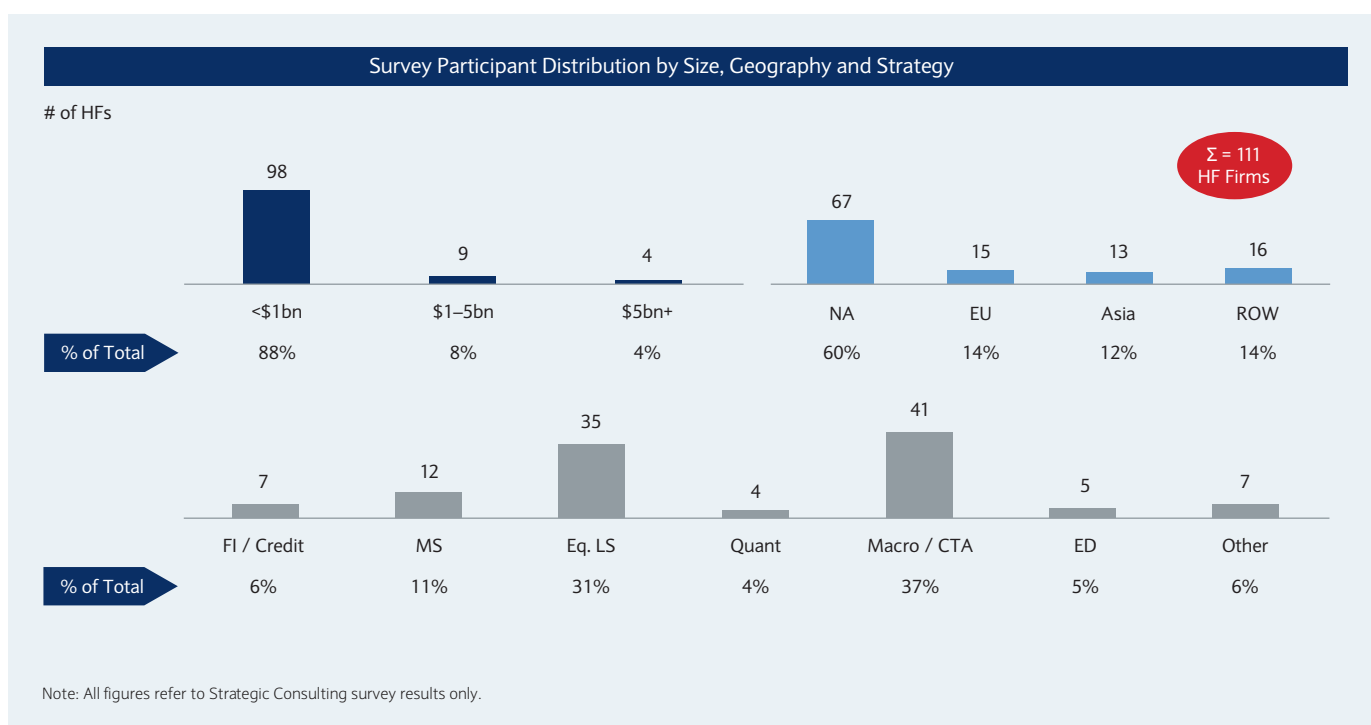


FIGURE 2: SURVEY PARTICIPANT PROFILE



- Managers bring functions in-house that were previously outsourced once they hit certain asset levels, e.g., legal counsel around the \$1bn mark, HR / IT support at ~\$5bn; above \$5bn, typically only fund legal services and fund administration are outsourced.
- HF managers have, on average, 2 Prime Brokers (PBs) by the time they hit \$1bn in AUM, and 4–5 by the time they reach \$5bn, with the number of products offered most likely to impact the number of PBs in the \$1–5bn AUM bucket.
- We identified four alternative organizational models for investment teams, based on investment approach and incentive structure; managers usually select one of these models based on their AUM levels, number and types of products offered.

### Compensation Structure

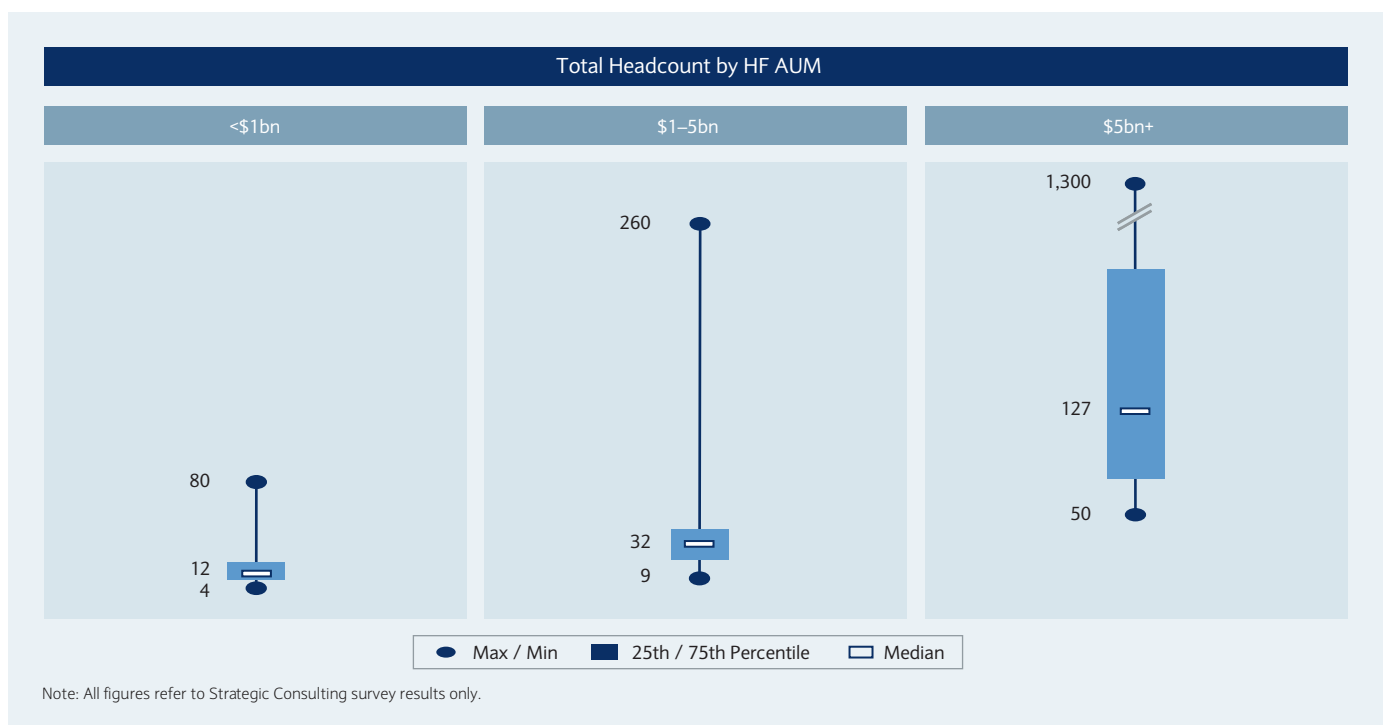
- Retention tools like deferred compensation and profit sharing are already more popular than generally assumed, with ~45% and ~25% of HF managers, respectively, adopting them, and adoption being even higher at managers with more than \$5bn in AUM.
- Management company ownership as a reward / retention tool becomes more widespread as AUM grows: nearly half (46%)

of managers with more than \$5bn in AUM operate in an open ownership model, where it is customary for individuals to be promoted or hired as partners.

### Economic Drivers

- Managers, on average, operate with a 41% management fee margin<sup>1</sup>. This margin is lower for HF managers with less than \$1bn in AUM (23%) compared with managers in the \$1–5bn AUM range (54%), implying economies of scale; however, it drops back to 41% for the \$5bn+ managers as costs per head grow faster than management fees per head.
- Within the same asset range, the management fee margin varies significantly depending on the complexity of the business. Using number of products as a proxy for complexity, we found that managers with a low number of products have margins 17–30 percentage points higher than managers with a greater number of products (and the same asset base).
- Fixed compensation tends to account for 50–55% of the fixed cost base for managers with less than \$5bn in AUM, but drops to less than 50% for managers with more than \$5bn, while the cost share of technology / research / data increases significantly.
- On average, HFs with a 1.5% management fee charge 1.5x more in fund expenses vs. HFs with a 2% management fee.

FIGURE 3: ORGANIZATION HEADCOUNT (HC)



1. Defined as: 1 - fixed costs/management fee.

- The enterprise value of HF managers is based on a bifurcated fee multiple where the earnings from management fees (after fixed costs) attract a significantly higher multiple than the earnings from performance fees (after variable costs).

### III. ORGANIZATION SIZE AND STRUCTURE

#### IIIA. Organization Size

The first issue we address relates to HF managers' total headcount (HC): what is the typical HC for HFs of a certain size? Figure 3 shows the median total HC in our sample for HF managers at three different AUM levels (<\$1bn, \$1–5bn, and \$5bn+). It also shows the range between the 25th / 75th percentile and the maximum / minimum for each AUM size. A few observations on the data:

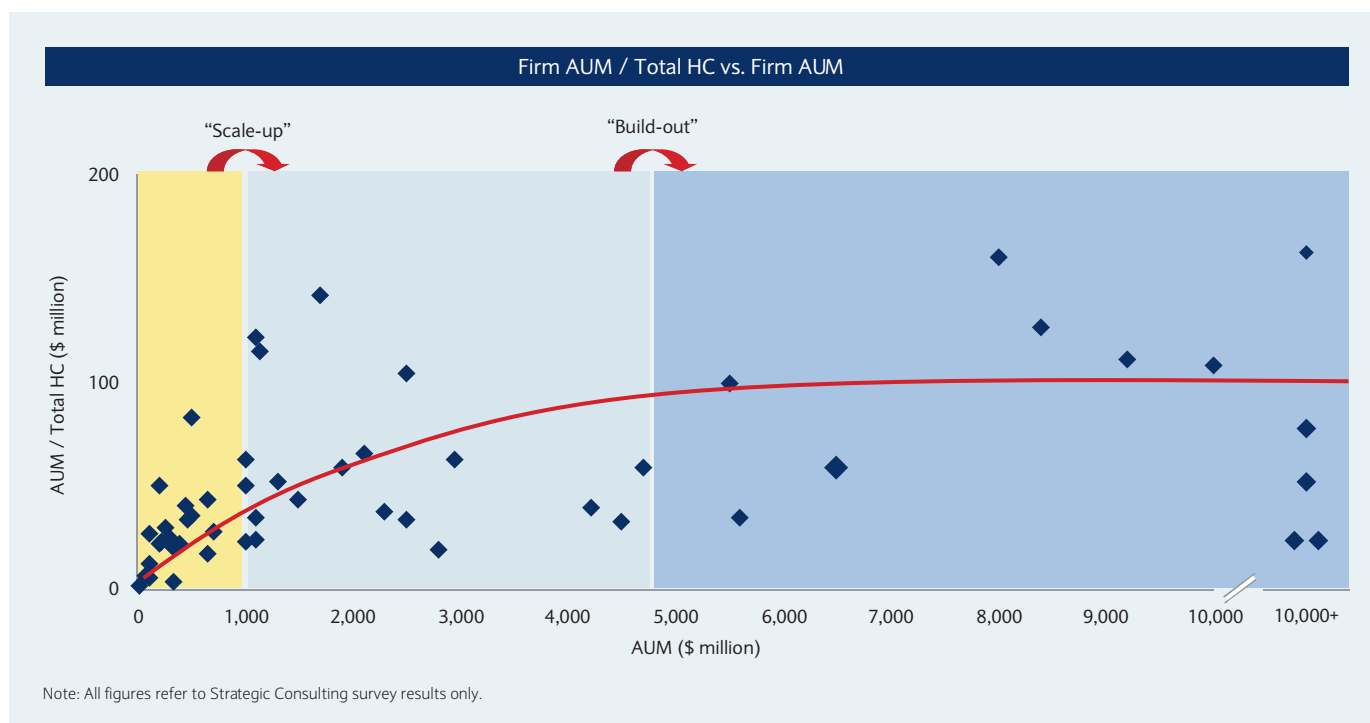
- The median headcount is 12, 32 and 127 people for HF managers with <1bn, \$1–5bn, and \$5bn+ in AUM, respectively.
- The 25th / 75th percentile range is relatively narrow, but increases sharply after the \$5bn AUM mark, pointing to the growing divergence in business models adopted by the largest HFs (e.g., human capital-intensive vs. scale-based, discussed later in the document).
- Extreme outliers exist at the upper end (and, to a lesser extent,

at the lower end) of the distribution. These managers are not necessarily very inefficient (or hyper-efficient); they simply have distinct organizational models; for example, some have a significant amount of proprietary capital (allowing the firm to employ higher HC as they keep most performance gains vs. only ~20%); others leverage support functions from a parent company / shareholder, hence requiring lower HC in the management company itself.

This information on total HC also allowed us to test whether economies of scale exist in the HF business, a point explicitly discussed in our interviews. In order to do this, we depicted the managers in our sample on a graph where the horizontal axis represents the total AUM managed and the vertical axis the ratio between AUM and HC (Figure 4). The line represents the best fit for the data on the page. If economies of scale existed, we would expect the line to move upwards (i.e., a higher AUM / HC as AUM grow). The hypothesis of economies of scale is thus confirmed, but only up to a certain point:

- For smaller HF managers, the AUM / HC ratio increases rapidly as AUM grows, as they are able to increase assets with minimal additional headcount. In fact, AUM / HC for managers with \$1–5bn in AUM is on average 90% higher than for managers with <\$1bn in AUM.

FIGURE 4: ASSET GROWTH AS A FUNCTION OF HEADCOUNT



- The ratio keeps growing in the \$1–5bn range, but its growth slows down, as managers in this AUM range have already reached a very high level of scale efficiency.
- Beyond the \$5bn AUM mark, scale efficiency becomes elusive: the average AUM / HC for managers with \$5bn+ in AUM is only 12% higher than for HFs with \$1–5bn in AUM. Firms with more than \$5bn in AUM tend to choose one of two business models for further growth:
  - Option 1: a scale model, potentially building a long-only business or ‘adjacent’ products like Collateralized Loan Obligations (CLOs) with potentially lower fee structures, but without adding significant additional headcount. Most of the firms appearing on the top right in Figure 4 have chosen this model.
  - Option 2: a human capital-intensive model, i.e., adding multiple product teams, which would likely reduce headcount efficiency (measured by the AUM / HC ratio) but would bring higher revenue margins relative to the scale model. This is represented by the firms in the bottom right of the picture.

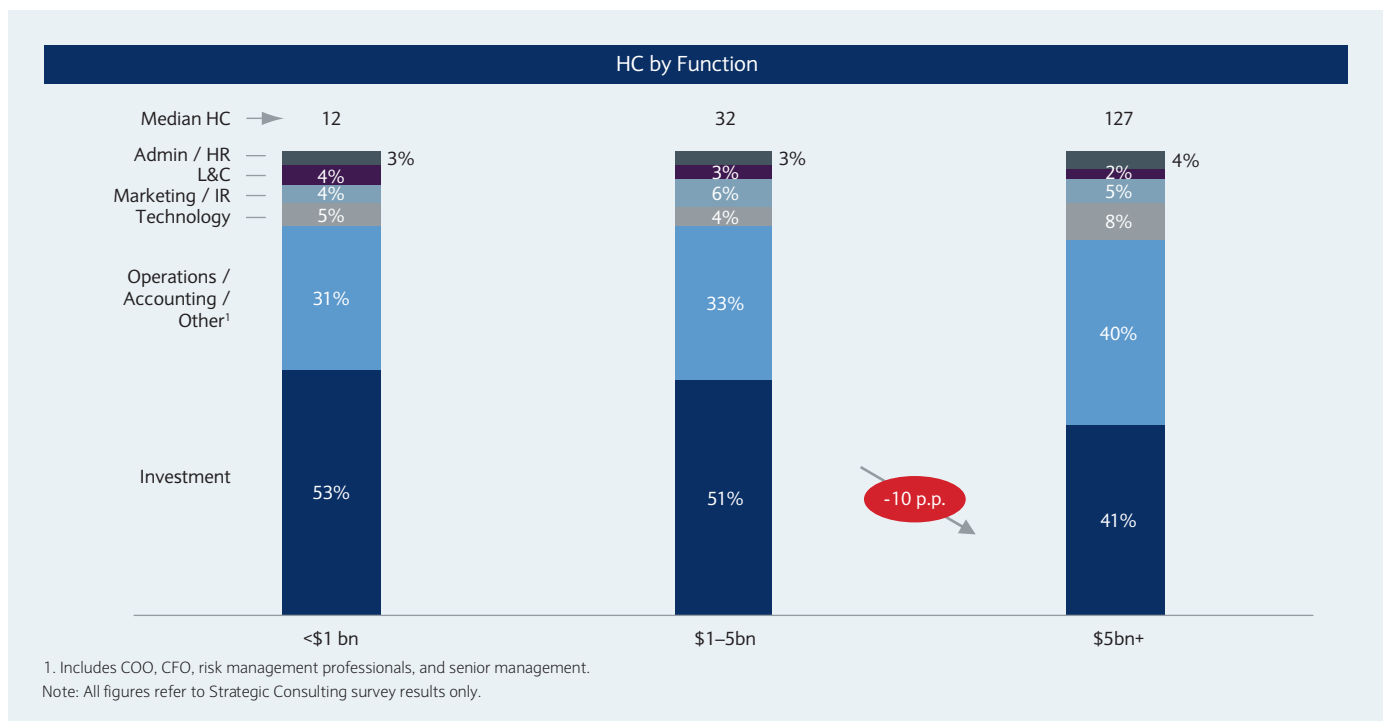
is relatively consistent for managers with less than \$5bn in AUM, as investment professionals account for just over half of the headcount. However, the share of investment professionals decreases 10 percentage points for managers with more than \$5bn in AUM, pointing to greater investment in infrastructure.

Also, the increased share of non-investment professionals as a percentage of total HC is due to the fact that managers tend to bring functions in-house that were previously outsourced once they hit certain asset levels. For managers in our sample, legal counsel is often brought in-house at the \$1bn mark. Administration of payroll and benefits are typically ‘in-sourced’ when the organization reaches 50+ in HC, which usually occurs around the \$3–5bn AUM range. Finally, IT support (e.g., 24/7 maintenance, disaster recovery) is generally brought in-house when managers pass the ~\$5bn mark. There are a couple of exceptions to this ‘in-sourcing process’: Marketing is generally in-house even at very low AUM levels (although some managers also rely on third-party marketers). Fund-related legal services and fund administration are always outsourced to third-party providers, with the latter being widely considered to be best practice by investors.

### IIIB. Organization Structure

Next, we analyzed how the total HC breaks down across various functions. As depicted in Figure 5, the functional split

**FIGURE 5: INVESTMENT VS. NON-INVESTMENT TEAM SIZES**



Continuing on the theme of service providers, we also tested managers' preferences for the number of Prime Brokers (PBs) they employ. The decision to employ additional PBs is usually driven by a desire for counterparty diversification, growth in trading volumes, and/or specialized product / service needs. Figure 6 shows the average number of PBs employed by AUM (x-axis) and number of products (y-axis). Key takeaways:

- Managers employ 3 PBs on average, but the number varies depending on AUM levels and number of products offered.
- HF managers on average have 2 PBs before reaching \$1bn in AUM, and 4–6 by the time they reach the \$5bn mark.
- For managers in the \$1–5bn AUM bucket, the number of products is a key driver of the number of PBs: managers with 1–4 products have ~3 PBs on average while managers with 5+ products have 5 or 6 PBs.

### IIIC. Organizational Models

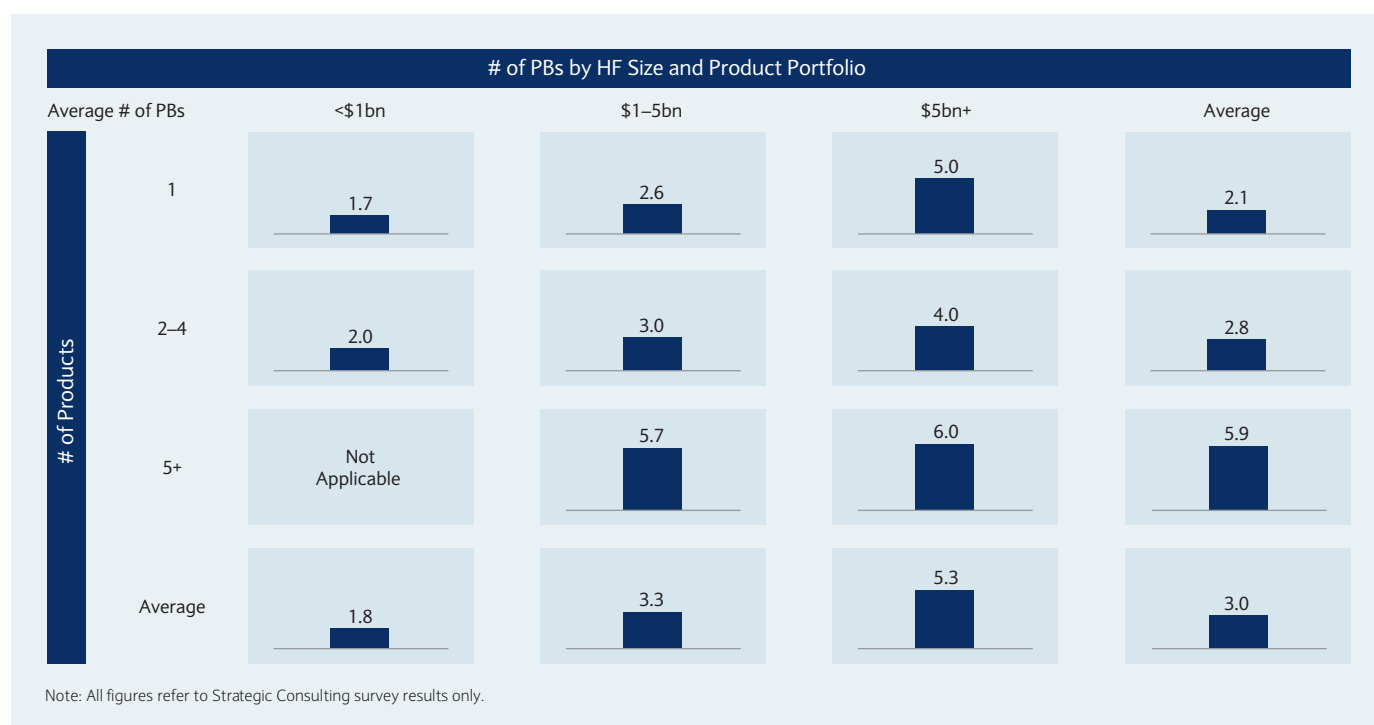
To identify the organizational models HF managers adopt for their investment professionals, we segmented HF firms along two dimensions: the degree of centralization in their investment decision making and the degree of discretion in their individual incentive structure (bonus payment). We categorized the

investment approach as either 'centralized' or 'decentralized', with the centralized approach being defined as including the following three possibilities: (1) there is a sole Portfolio Manager (PM) making investment decisions; (2) the investment approach is 'consensus driven' / 'committee based'; (3) it is 'quant / model-driven'. In all other cases, the investment approach is defined as decentralized – usually implying multiple PMs who can independently put on most trades, multiple portfolios and no strong 'house-views'. In our sample, 74% of managers fell into the centralized category, while 26% fell into the decentralized category. We categorized the incentive structure as 'discretionary' if the bonus of the non-partner IPs is not explicitly tied to their individual P&L. If, on the other hand, even a few IPs have their bonus payout explicitly linked to their individual P&L, we categorized those managers as having a 'formulaic' incentive structure. In our sample, 60% of managers have a discretionary incentive structure, while 40% have a formulaic incentive structure.

The four resulting organizational models are depicted in Figure 7:

- Paternalistic. This model is characterized by a centralized investment approach and a discretionary incentive structure.

FIGURE 6: PRIME BROKER (PB) RELATIONSHIPS



Usually, HF managers pursuing this model have a single product (83% in our sample) and have less than \$5bn in AUM (93% of funds in our sample). 'Free flow of ideas among IPs' is typically mentioned as a source of investment edge stemming from a flat organization and a team approach, reinforced by a 'one bonus pool for all' pay structure.

- Caste. This model is characterized by a centralized investment approach and a formulaic incentive structure for at least some IPs. Managers pursuing this model have a similar profile to those following the 'Paternalistic' model in terms of AUM and product mix, with slightly lower AUM (63% of the funds have less than \$1bn vs. only 43% for the 'Paternalistic' model) and slightly higher number of products (only 63% are single product vs. 83% for the 'Paternalistic' model). One critical issue for this model is how to ensure that the formulaic payout for select individuals does not harm the collaborative team culture that is key for smaller funds and for successful, centralized decision making.
- Federation. This model is characterized by a decentralized investment approach and a discretionary incentive structure. It represents mostly mid- to large HF managers with a collection of funds / strategies. Part of the manager's edge is internal diversification. The discretionary bonus can potentially

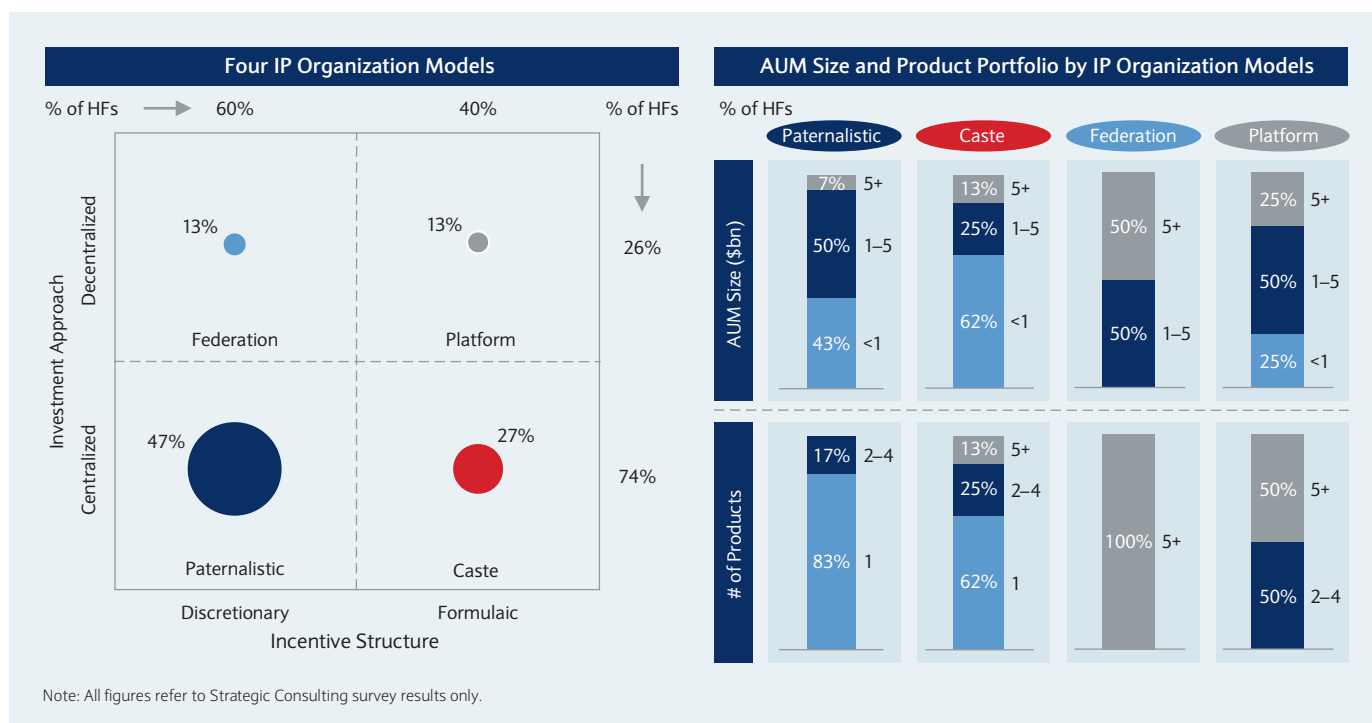
take away from the competitive intensity but, if executed appropriately, works well for true multi-strategy, large funds.

- Platform. This is typically a multi-manager setup, with a decentralized investment approach and a formulaic incentive structure. There is a natural skew in the adoption of this model towards mid- and large managers. The transparent, formulaic IP bonus structure fosters a highly competitive culture and has the potential to attract the best talent.

#### IV. COMPENSATION STRUCTURE

An often discussed trend in the industry (partially driven by a regulatory push on the sell-side) is the increased use of retention tools like deferred compensation, and profit sharing for non-partners. We explored the adoption of such tools in our sample. As depicted in Figure 8, we found that 44% of managers currently have a deferred compensation program. Adoption is strongly correlated with firm size: 75% of managers with \$5bn+ in AUM have such a program in place, while only one-third of managers with less than \$1bn have one in place. Less than a quarter of managers have a profit-sharing program for non-partners; similar to the adoption trend in deferred compensation programs, it is the larger HF managers that are more likely to have profit-sharing

FIGURE 7: INVESTMENT PROFESSIONAL ORGANIZATIONAL MODELS



programs: 43% of managers with AUM >\$5bn in our sample have one vs. only 18% of HF managers with less than \$1bn in AUM.

Deferred compensation helps retain key talent by increasing exit costs and also sometimes provides the manager with the ability to claw back some or all of the deferred compensation, if needed, either for the benefit of investors or to offset netting risk. Deferred compensation programs can be structured in different ways depending on four variables: eligibility, percentage of the bonus deferred, deferral time frame, and choice of the placement vehicle in which to invest the deferred compensation. For the managers in our sample (Figure 9):

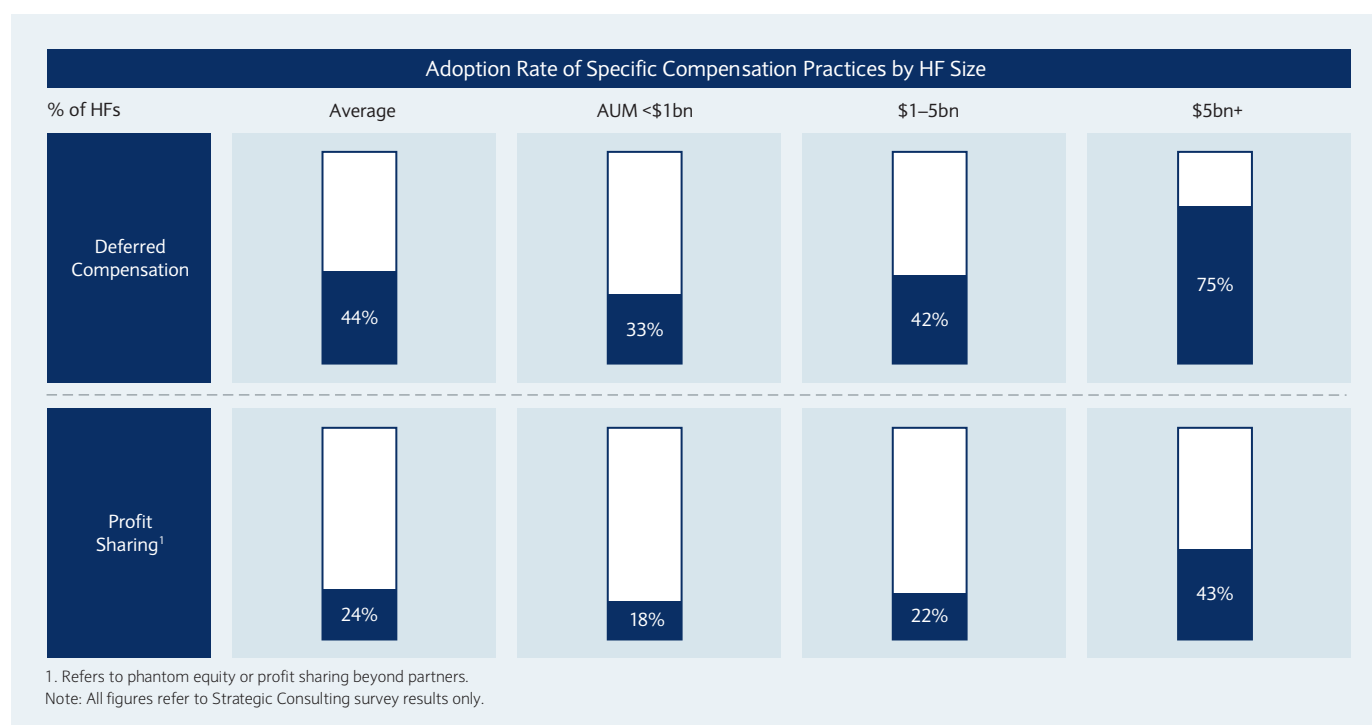
- 50% of the programs only affected ‘senior’ individuals (usually defined through the establishment of a relatively high total compensation threshold); 30% only included investment professionals, and 20% included all staff.
- 30% or 50% of the bonus are the most common deferral levels.
- 1 year and 3 years are the most popular time frames for deferred compensation, with multi-year payouts typically spread evenly across years.
- 60% of managers hold the deferred portion of compensation on their balance sheet, while the remaining 40% invest it into one of their funds.

An ownership stake in the management company is a tool often used for retention purposes. We identified three ownership models among the managers we interviewed (Figure 10):

- ‘Tight Ownership’, where a small number of partners own the management company and partnership is not usually open to new individuals.
- ‘Open Ownership’, where the firm promotes staff to the partnership periodically based on performance, typically highlighting this promotion as a hiring or retention tool.
- ‘External Ownership’. Listed companies or subsidiaries of other companies.

The Tight Ownership model is the most common, with 67% of all managers adopting it, vs. 23% for the Open Ownership model and 10% for the External Ownership model. For smaller managers (with AUM less than \$1bn), the Tight Ownership model is by far the most common (85% of managers), while the Open Ownership model is more common for managers with more than \$5bn in AUM. Furthermore, there is a marked difference in the adoption of different models across North America and Europe, likely driven, at least in part, by differences in tax considerations.

FIGURE 8: COMPENSATION PRACTICES



## V. ECONOMIC DRIVERS

### VA. HF Managers' Income Statement

Apart from few exceptions, the structure of HF managers' income statement is fairly consistent among the participants in our sample. Total revenues are comprised of management fees and performance fees. Management fees are a function of the total AUM and of the fees charged (as a % of AUM). Performance fees are a function of AUM, of the investment performance (as a % of AUM) and of the fees charged (as a % of investment performance). Total cost consists of fixed costs (all day-to-day costs necessary to run the business, including base salaries for all staff and bonuses for non-investment staff), which tend to be covered by the management fees, and variable costs (bonuses paid to senior professionals, but not including any payouts to partners), which are covered by the performance fees. The 'Operating Income' is what's left of the revenues after deducting all costs, and is available to the partners / owners to (1) pay themselves, (2) invest back into the business (e.g., open new offices, make infrastructure investments) and (3) potentially absorb netting risk in those cases where the fund overall has not received performance fees, but some PMs have performed well and need to be paid.

Figure 11 shows our estimate of the average income statement for the managers in our sample for the year 2010. These are estimated based on the actual information disclosed to us by the managers coupled with two key assumptions:

- We applied a 20% discount to the nominal management fee structure for all participants where such information was not provided directly.
- We modeled the distribution of performance fee based on the assumption that 50% is paid out in variable compensation (bonus) to investment staff, and 50% goes to the partners / owners as part of the 'Operating Income'. Although the exact split of the performance fee varies from year to year depending on a number of variables (e.g., performance, number of owners / partners relative to senior investment professionals, level of formulaic vs. discretionary payments), based on our conversations with managers, we believe that a 50:50 split is a reasonable assumption.

In Figure 11 we show that managers with less than \$1bn in AUM have, on average, \$12mm in revenues, \$8mm in costs and \$4mm in operating income. The corresponding numbers for managers in the \$1–5bn range are \$77mm, \$36mm and \$41mm, respectively, and for managers with more than \$5bn

FIGURE 9: DEFERRED COMPENSATION

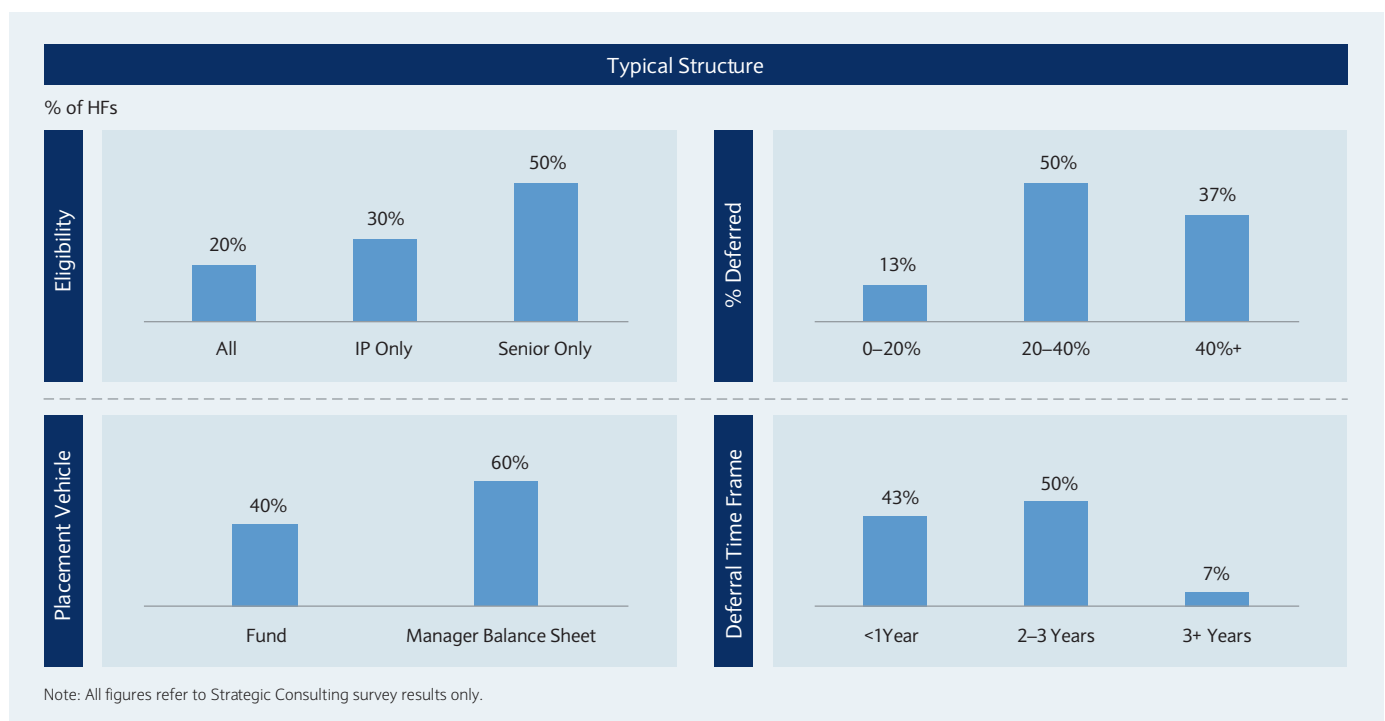


FIGURE 10: MANAGEMENT COMPANY OWNERSHIP

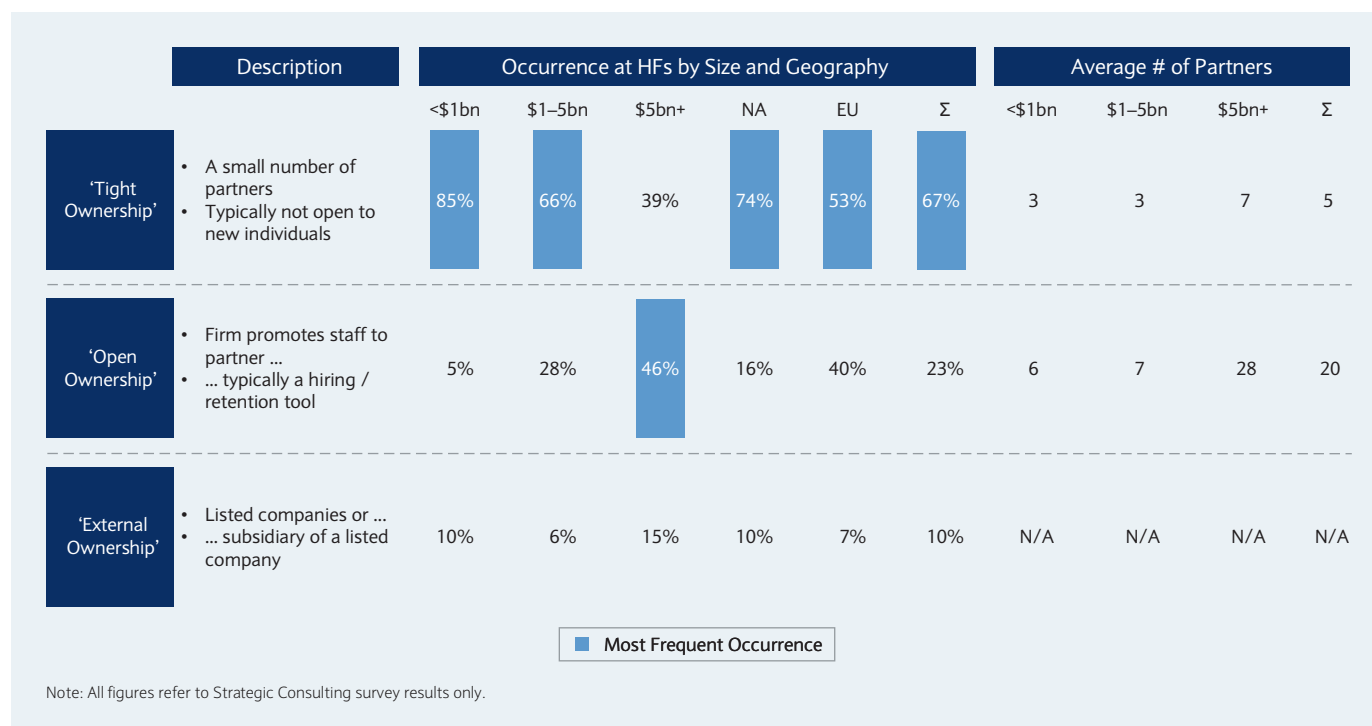
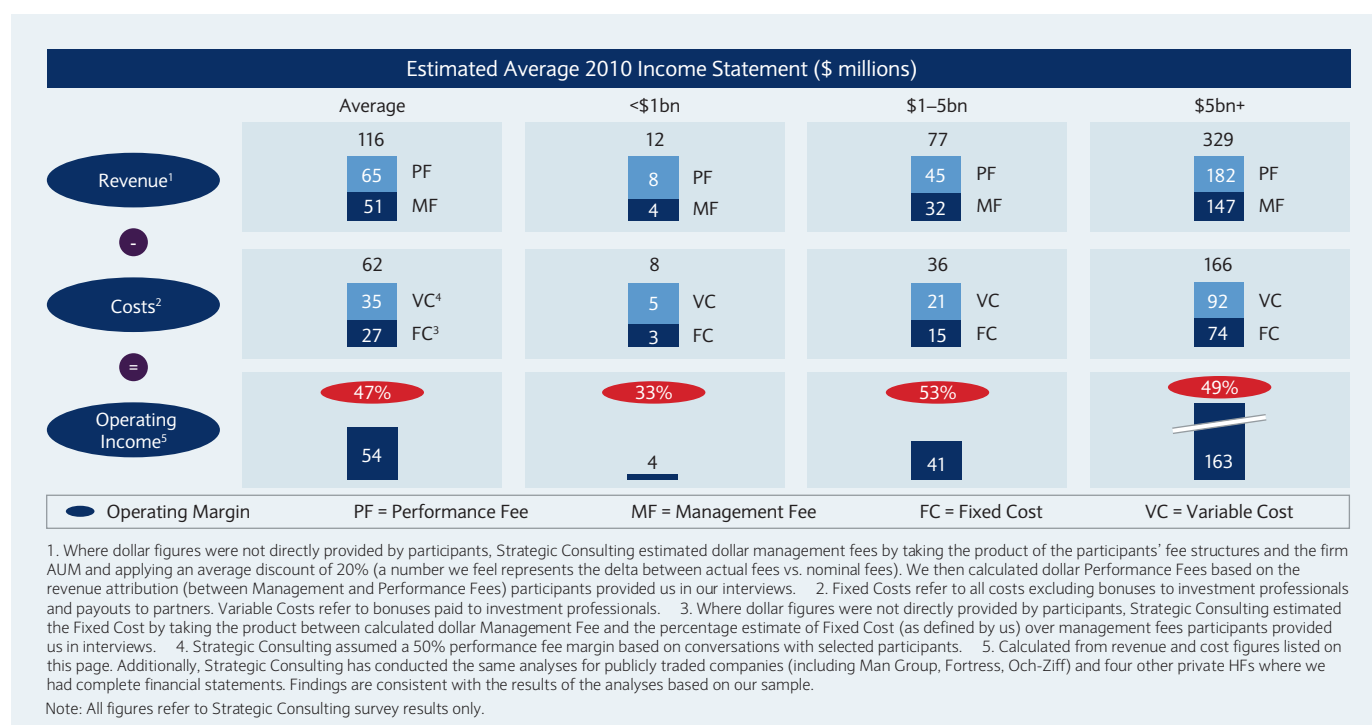


FIGURE 11: OPERATING INCOME



in AUM are \$329mm, \$166mm, and \$163mm, respectively. This last set of numbers is skewed by a few very large managers in our sample: the median revenue for this group is in fact ‘only’ \$183mm. Other interesting highlights:

- Management fees grow in importance as AUM grows: in our sample, going from 33% of revenues for HF managers with less than \$1bn in AUM, to 45% of revenues for managers with 5bn+ in AUM.
- The operating margin (operating income on revenues) is 47%, on average, and varies from a low of 33% for sub-\$1bn managers to a high of 53% for \$1–5bn managers. That said, HFs (in particular, the smaller ones with a single product) exhibit volatile operating margins: it does not take much (a year of particularly good or bad performance, a few allocations / redemptions) to move the margin in one direction or the other.

### VB. Operating Income Ratio Analysis

We recognize that the foregoing P&L numbers, although interesting, do not allow a manager to draw meaningful conclusions for his or her own business. To allow that, we need to (1) identify key business ratios that allow for a fair benchmarking, and (2) analyze the contribution of the management fee separately from the contribution of the performance fee, as

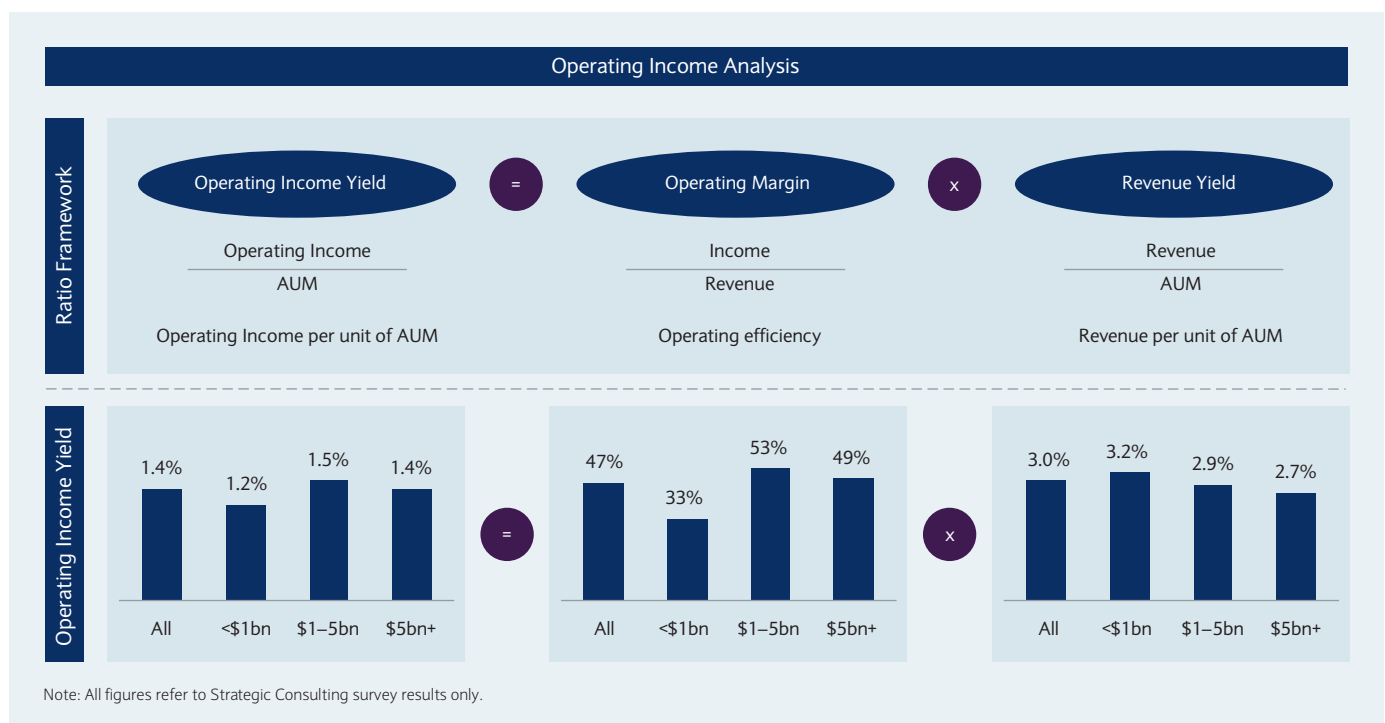
the higher variability of the latter may distort the results of the analysis. Figure 12 shows a framework, which is based on three key ratios:

- Operating Margin, or the percentage of revenues the manager retains after paying for all costs.
- Revenue Yield, or how much revenue the business generates per unit of AUM.
- Operating Income Yield (OIY) – Operating income the business generates per unit of AUM, which is the product of Operating Margin and Revenue Yield.

A few observations:

- HF managers with AUM <\$1bn have the highest revenue yield but, lacking scale, they also have the lowest operating margin, resulting in the lowest OIY across the three AUM size brackets.
- HF managers with AUM in the \$1–5bn bracket show higher revenue yield, operating margin and, consequently, OIY than HFs with AUM >\$5bn.
- HFs with AUM >\$5bn have, on average, the lowest revenue yield. As we will see later, this is due to their higher propensity to also have long-only or other assets with lower fee structures and – in our sample – a slightly lower investment performance vs. managers in the other brackets.

FIGURE 12: OPERATING INCOME YIELD



As the P&L of HF managers is the sum of two different elements: the income on the management fee (after paying fixed costs) and the income on the performance fee (after paying variable costs), we split the formula into the two components, in order to understand what is really going on “under the hood” (or bonnet). Figure 13 shows the results of this analysis:

- The ‘Management Fee Yield’ (MFY) and the ‘Performance Fee Yield’ (PFY) represent, respectively, how much in management fees and performance fees the business generates per unit of AUM.
- The ‘Management Fee Margin’ (MFM) and the ‘Performance Fee Margin’ (PFM) represent, respectively, the percentage of management fees the business manages to retain after paying for all its fixed costs, and the percentage of performance fees the business manages to retain after paying all its variable costs.

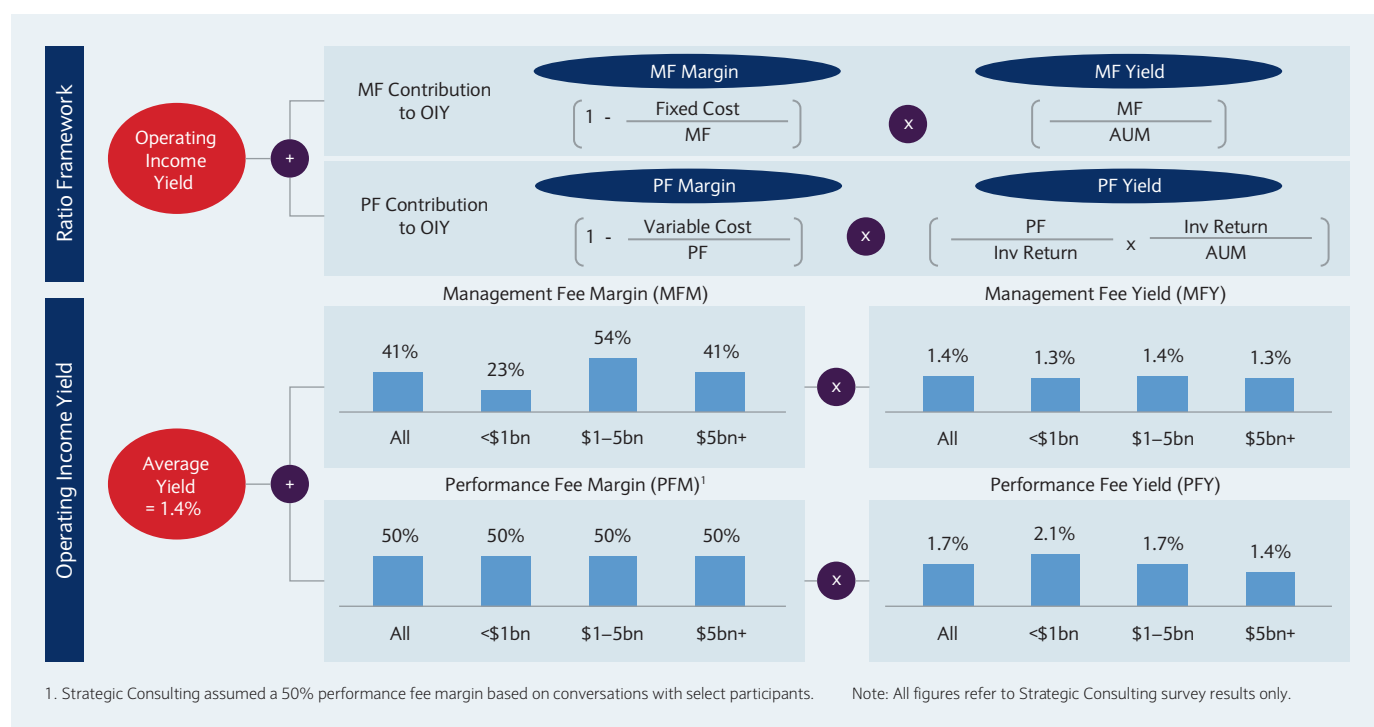
There are some interesting takeaways from looking at the resulting numbers:

- The MFY, at 1.4% on average, is significantly lower than the estimated notional 1.8% management fee for the industry<sup>2</sup>. This is not surprising if we think of all the assets with ‘special fee deals’ (e.g., day-one investors, partners’ money, managed

accounts, large investors, etc.) or that are in long-only or other lower fee products. Also, the MFY show little difference across size categories. This masks some underlying differences, such as certain HF managers with \$5bn+ in AUM having a higher percentage of lower fee business (e.g., long-only), fully compensated by a higher fee level on their HF assets vs. smaller managers.

- The PFY is 1.7%, on average. Assuming 20% performance fee, that means a gross investment return of 8.5% (approximately) for our sample. Looking at how the PFY changes across manager size brackets, there appears to be a clear inverse relationship between manager size and PFY. As mentioned before, this is due to two factors: a higher percentage of long-only or other low fee assets for larger managers, and a slightly higher average investment return in 2010 for smaller managers vs. larger ones in our sample.
- The MFM is 41%, on average, meaning that fixed costs ‘eat up’ almost 60% of the management fees, on average. HF managers with AUM \$1–5bn have more than 2x the MFM of managers with less than \$1bn in AUM (54% vs. 23%), the result of the economies of scale that we observed during the analysis of the AUM / HC ratios; however, while we pointed out that the AUM / HC ratio flattens out after the \$5bn AUM mark, the decline in MFM is much more steep.

FIGURE 13: MANAGEMENT/PERFORMANCE FEE CONTRIBUTION



2. Also see our report titled “28 Months Later”, published in August 2010.

### VC. Fixed Cost Structure

As discussed before, variable costs for managers are essentially compensation-related. The structure and composition of managers' fixed cost base is more diverse and is worth some analysis. Figure 14 shows this composition overall and by size bucket in our sample. This composition is remarkably similar for smaller managers (with less than \$1bn in AUM) and mid-sized managers (with AUM between \$1bn and \$5bn): fixed compensation at around 55% of the total cost base is the largest category followed by Technology / Research / Data at around 15%. The largest managers (with more than \$5bn in AUM) spend relatively less on fixed compensation (48%) and more on technology / research (21%).

Marginal variations exist by strategy and domicile (not shown). For example:

- Quantitative managers spend relatively less on compensation (43%) and more on technology (22%).
- North American firms spend relatively less on travel (5%) than Asian firms.

### VD. Management Fee Margin Analysis

So far, we have looked at some averages in the context of the operating income ratios and the fixed costs. In Figure 15, we

show not only the average MFM by AUM size, but also the 25th / 75th percentile range, and the minimum and maximum MFM for each AUM size. Our assertion that MFM tends to increase for managers who move from the <\$1bn range to the \$1–5bn range, and then decreases as they move above \$5bn in AUM, appears to be corroborated by also looking at the 25th / 75th percentile ranges. Having said that, significant differences exist in the MFM within the same size bucket for multiple reasons:

- Absence of scale at some of the smaller managers in the <\$1bn category (hence a negative MFM).
- Different number and complexity of products for the same level of AUM.
- Choice of fee model (e.g., some managers rely on performance fees to pay for part of their fixed costs).

The assertion that a higher number of products for the same asset level tends to impact the MFM is one we specifically wanted to test. Figure 16 shows the results. For each of the three size buckets we compare the average MFM for managers with a low product concentration (i.e., more products for the same AUM) with the MFM for managers with high product concentration (i.e., fewer products for the same AUM). The definition of 'low' and 'high' for each size bucket is given in the note to Figure 16.

**FIGURE 14: HF FIXED COST STRUCTURE**

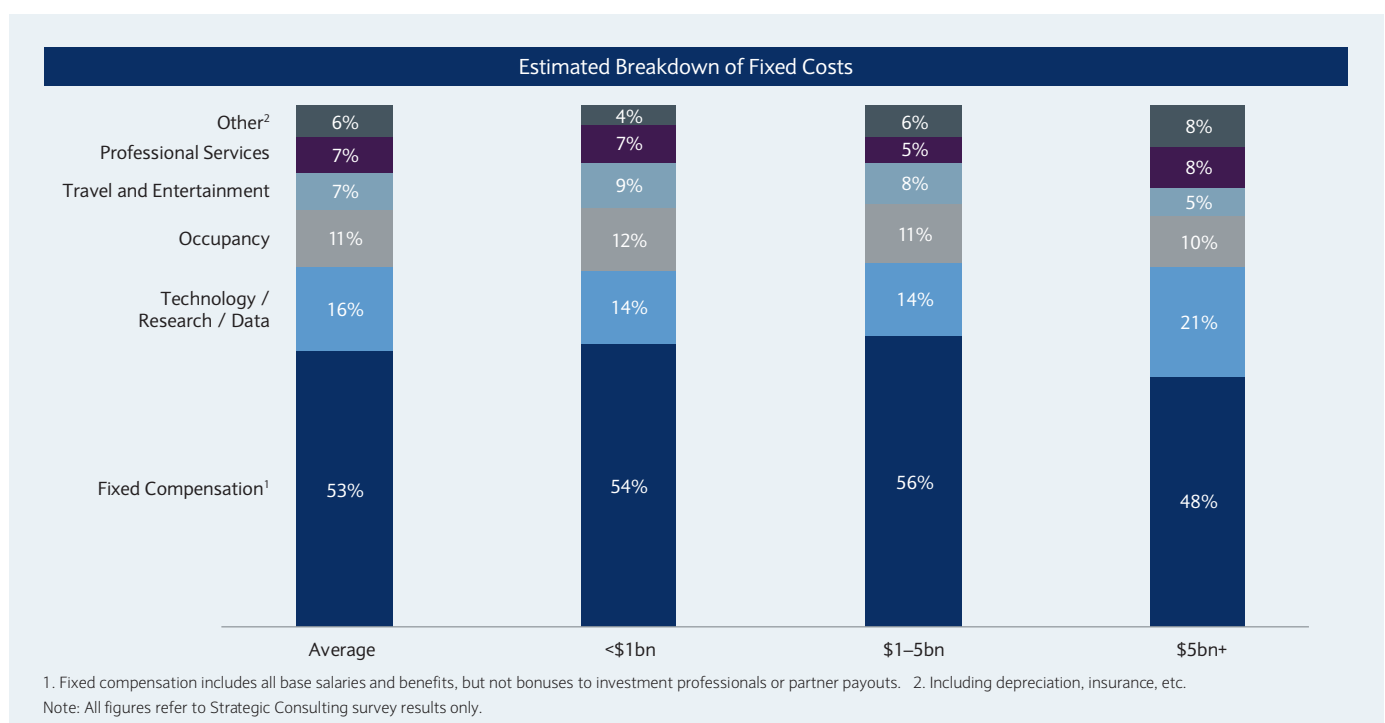


FIGURE 15: MANAGEMENT FEE MARGIN VARIABILITY

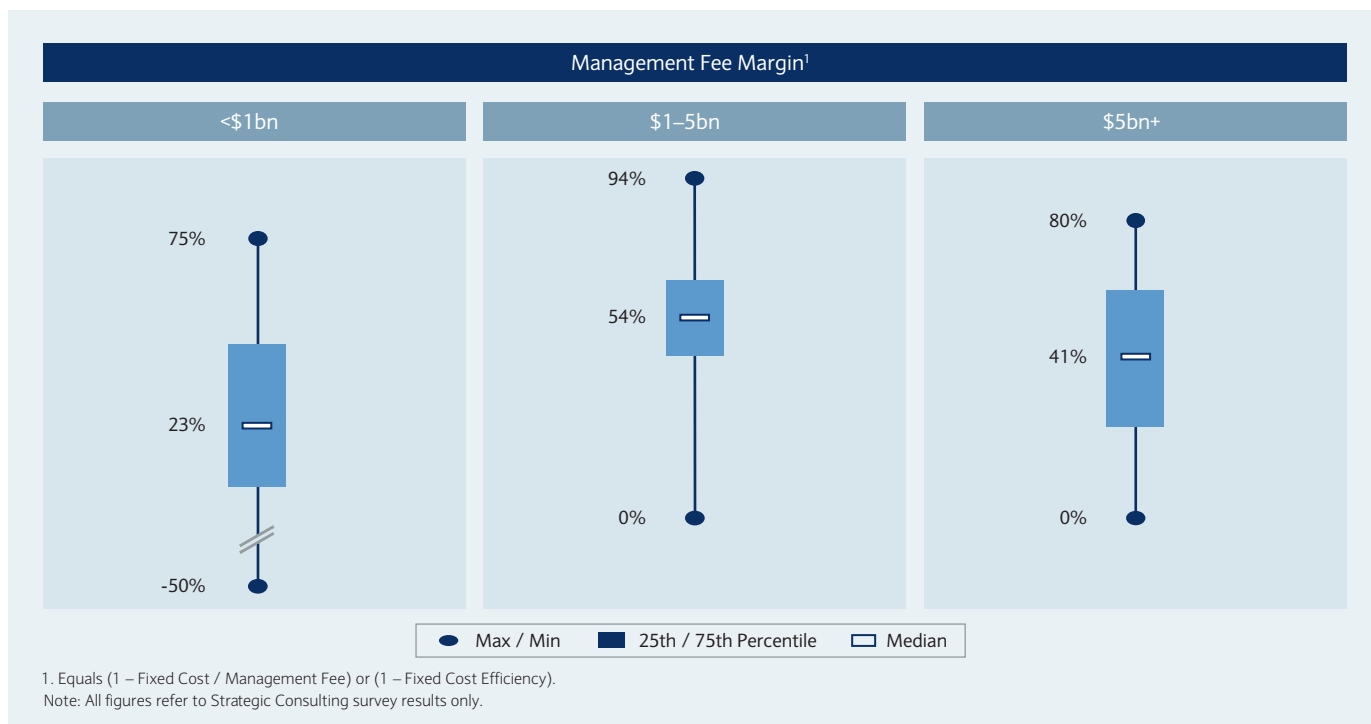
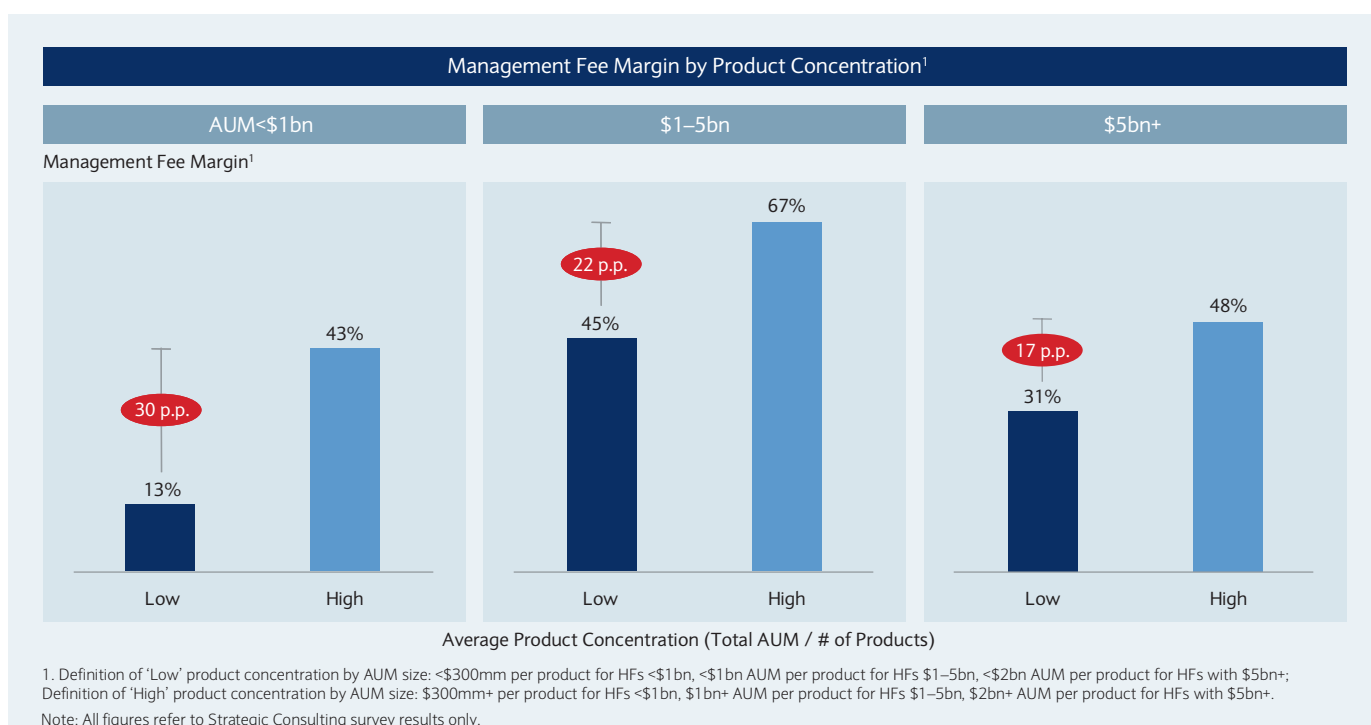


FIGURE 16: PRODUCT CONCENTRATION VS. MANAGEMENT FEE MARGIN



A few points to note:

- Across AUM size categories, HF managers with ‘High’ product concentration indeed exhibit average MF margins that are higher by 17 to 30 percentage points relative to ‘Low’ product concentration managers.
- The gap in MFM between managers with ‘High’ and ‘Low’ product concentration becomes somewhat less pronounced as AUM levels grow.

Given these findings, managers should be thoughtful about launching multiple products to achieve scale, particularly if they are below \$1bn in AUM.

### VE. Fund Expenses

Another analysis we conducted was on fund-level expenses, by which we mean all those expenses (e.g., fund administration, directors’ fees) which are paid by investors on top of the management and performance fees. Figure 17 shows these fund expenses as a % of AUM for HFs in the three different size categories. A few points to note:

- As a percentage of AUM, Fund Expenses decline significantly with rising AUM – 78 bps for HFs with <\$1bn, 41 for HFs with \$1–5bn, 36 for \$5bn+.

- Administration fee is typically the largest component, ranging from 30% to 50% of total fund expenses.
- Fund expenses for European funds in our sample are markedly lower than fund expenses for North American funds (not shown).
- HFs with a 2% management fee tend to have 50% fewer fund expenses versus HFs with a 1.5% management fee, making up for a portion (approximately 25 bps) of the higher management fee structure. Specifically, HFs with a 2% management fee structure are more likely to absorb research / data expenses vs. charging them to the Fund.

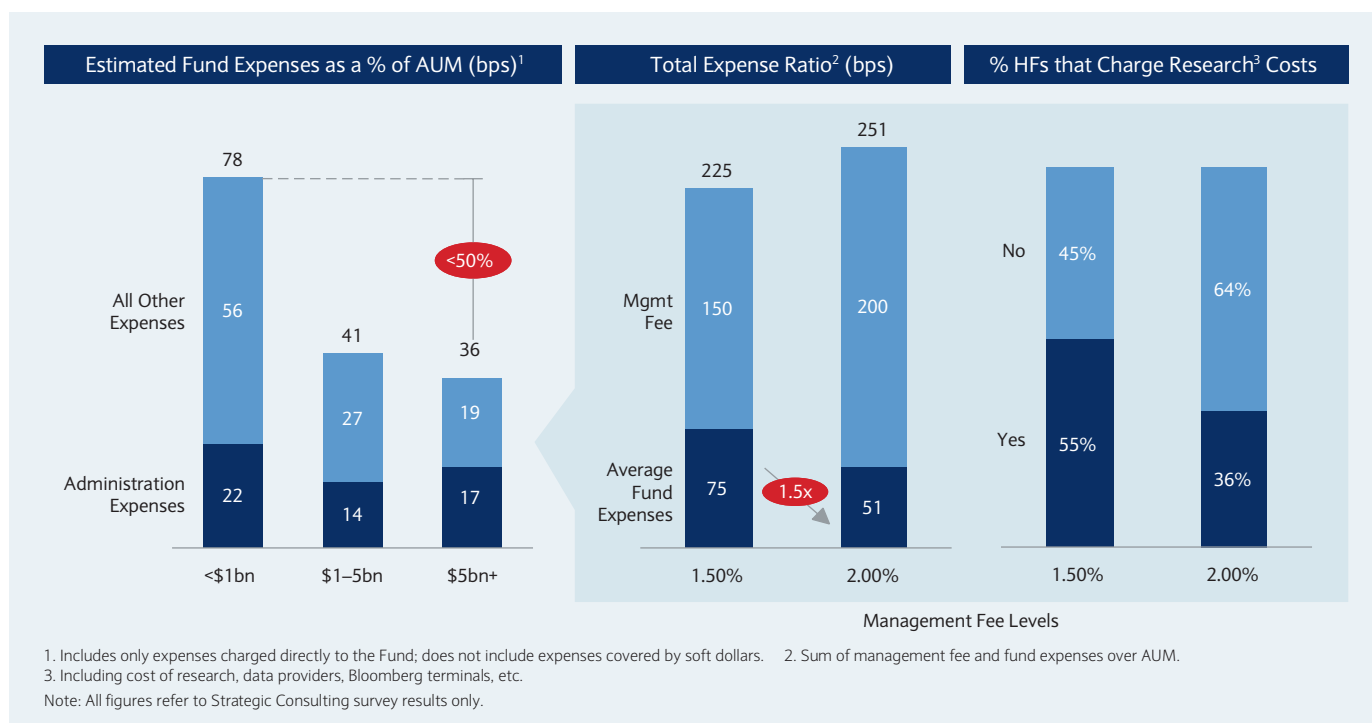
### VF. Valuation Considerations

Finally, we present here an illustrative valuation of a HF manager with \$3bn in AUM (in Figure 18). This valuation is based on:

- The average economics for a \$3bn fund – based on the data we collected and shared in this study.
- The multiple-based valuation methodology currently used to assess the enterprise value of a HF manager.

We do not want to position this illustrative valuation as anything but a back-of-the-envelope exercise to conclude our paper and bring some of the metrics we discussed together to explain how

FIGURE 17: FUND EXPENSES



they impact the valuation of a HF business, as the multiples applied to management and performance fees vary significantly by firm based on qualitative factors, e.g., stability of AUM (lock up, diversity and quality of investor base), asset flows, stability of returns, diversity of source of returns, capacity constraints, key man risk. However, this exercise does help make an important point about the importance of the quality of the business management of the manager.

The multiples we use are in line with recent transactions involving a HF manager:

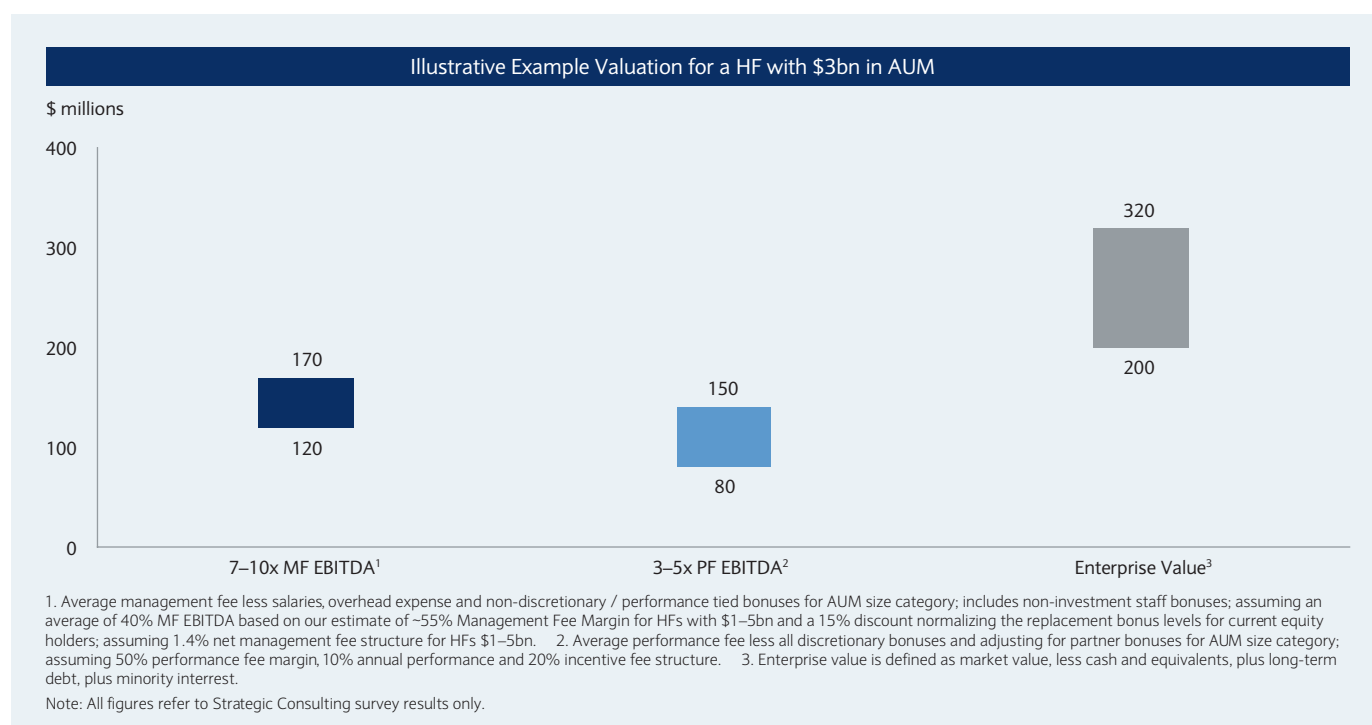
- 7–10x of management fee EBITDA (which approximates to the management fees less fixed costs).
- 3–5x of performance fee EBITDA (which approximates to performance fees less variable costs, normalized for replacement bonus levels for current equity holders).

The resulting enterprise value is \$200–320 million, which equates to 7%–11% of AUM. It is worth noting that the contribution to the enterprise value of the management fee EBITDA is higher than the contribution from the performance fee EBITDA.

## VI. CONSIDERATIONS FOR MANAGERS

- All HF managers still largely live and die by investment performance, but the quality of business management has also rapidly become a crucial variable for investors
  - Better business management may give a HF better long-term sustainability (i.e., by being able to cover essential costs and better retain key talent in flat or down performance years).
  - It may provide a level of confidence to investors (institutional investors, in particular), who want to see a high-quality business organization and infrastructure because they believe that it reduces the business risk they take on the HFs to whom they allocate.
  - Finally, enterprise value models for HFs in the normal course ascribe a ~2x higher multiple to management fee EBITDA than to the performance fee EBITDA, reinforcing the importance of running a ‘tight ship’.
- For managers below the \$1bn AUM mark, reaching scale is essential to long-term business sustainability and, to that end,
  - It may be best to keep the model simple, with as few products as possible until AUM crosses the \$1bn mark, after which point the economics of the business improve dramatically.

FIGURE 18: HF VALUATION CONSIDERATIONS



- It may be ok to consider managed accounts even though the complexity goes up a bit, but not as much as adding a completely new product.
- For managers above the \$5bn mark, two alternative paths of growth are available.
  - Following a scale model to grow AUM, potentially building either a long-only business or ‘adjacent’ products like CLOs with potentially lower fee structures, but without adding significant additional headcount.
  - Following a human capital-intensive model, i.e., adding multiple product teams, which would likely reduce efficiency (measured by the AUM / HC ratio) but would bring higher margins relative to the scale model.
- Managers need to make sure the way they pay people is consistent with where the industry is going, with retention tools like deferred compensation, profit sharing and equity in the management company already being more popular than generally assumed.
- Managers need to be pragmatic about fund expenses; while there are philosophical differences across HFs, there are broad norms around what are acceptable expenses and investors hate being ‘nickel and dimed’.
- Finally, the adage “what you can measure, you can manage” seems to be true in the HF business as well – there is significant variation in managers’ ability to track and manage key business metrics and we hope our limited analysis will spur additional thinking / action.

## VII. ACKNOWLEDGMENTS

Strategic Consulting would like to thank the Managers that participated in our interviews and surveys and made it possible for us to put this piece together. Per our promise to them, we have aggregated and presented the responses we received from them anonymously and in a way that no participant can be singled out. We want to thank them for allowing us to share this information with our clients.

## VIII. CAPITAL SOLUTIONS

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

Our integrated offering includes:

### Capital Introductions

- Maintenance of ongoing Investor dialogue to provide valuable feedback to HF Managers.
- Targeted introductions.
- 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 research, on the hedge fund industry and its participants (e.g., Hedge Fund 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, organizational efficiency.
- Acting as a HF competence center internally for Barclays Capital.

Our partners in the Asset Management Banking group provide the following additional services:

- Advice on control and minority stake M&A transactions.
- Raising strategic LP capital / advice on fund restructurings.
- Underwriting and placement of debt financings and equity offerings.







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