The Evolving Hedge Fund Landscape:

Capital Flows, Hot/Not Strategies, Succession Planning, Business Infrastructure

Thursday, September 15, 2011

At a recent gathering hosted by the **Russell Reynolds Associates Hedge Fund Team,** Dean Barr, Managing Partner of Foundation Capital Partners and former Head of Citigroup Hedge Fund Investments, led an interactive discussion on the evolving hedge fund landscape. Key individuals from several major hedge funds were present, representing the senior leadership, investment management, distribution & marketing, and human capital functions of these firms.

Numerous topics were discussed, including capital flows, in-and out-of-favor strategies, succession planning, and business infrastructure. Our key takeaways from the discussion included:

1. **Hedge funds are enjoying massive capital inflows** as investors continue to move money away from global fixed income, and from heavily regulated institutions (i.e. banks).
2. **The competition for talent has never been fiercer.** Alternative funds (both PE and HF) looking for senior investment talent are increasingly targeting competitors as the migration of sell-side proprietary traders has largely played itself out.
3. **Succession planning issues have reached a critical level.** Tenured founders need to pass the baton on to the next generation. However successful money managers aren't always the best people managers.

Increased Global Regulation

- **Hedge Funds stand to gain from proposed regulation** as business moves from the heavily regulated banking industry into Hedge Funds and other less regulated providers.
- Many Hedge Funds are considering moving to non-U.S. jurisdictions with less regulation around operational issues and compensation structures. The response by regulators and investors, yet to be seen, could prove negative for the industry.

Russell Reynolds Associates: We have received requests from the larger hedge funds for regulatory talent and believe this trend to continue in anticipation of future reform.

Capital Flows

- **Global Hedge Fund AUM is expected to reach $2.25 trillion by the end of 2011**. Flows are increasing 10-15% annually with no signs of a slowdown. In this low-interest-rate environment, Hedge Fund growth has been fueled by institutions increasing their alternatives exposures away from traditional strategies, most notably global fixed income portfolios.
- Larger, established firms have benefited the most. **90% of flows went to managers with over $5 billion in AUM**.
- Hedge Funds are looking for long-term capital and strategic partners who share their vision. However, headwinds prevail, including the global market crises, stresses on the industry, structural illiquidity and fund redemptions.
- **Institutional investors (pensions, endowments, foundations and wealth managers) are taking longer to conduct their due diligence (**often over six months), prompting the demand for top tier operational experts who can interface effectively with investors.

Russell Reynolds Associates: The demand for distribution and investor relations talent continues to dominate our recruiting work for hedge funds globally. Individuals with established institutional client relationships are central to this trend. We are also seeing a need for operational talent who are effective in client-facing situations, as noted above.

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Hedge Fund Seeding

- **Hedge Fund seeding is back.** Nearly 300 Hedge funds were launched in 1Q11, a launch rate of 3.3%, as total industry assets exceeded $2 trillion for the first time in history. Even so, the mortality rate for new funds remains high at 40%. While risk appetite increases, the rate of failure remains high.
- The largest firms, with the best operational infrastructures, are dominating flows and charging the highest fees, enabling them to diversify, scale and attract top talent in the industry.

Russell Reynolds Associates: Hedge Funds need business and people managers, not just money managers.

Succession Planning

- Founders of the largest hedge funds are at a crossroads, faced with the decision to either wind down the fund or build a brand with a lasting legacy. **The top 50 firms have been in business for an average of 22 years. The average age of the founders of the top 50 funds is 54.**
- Hedge fund managers do not do a good job of proactively identifying and developing the next generation of leaders. Looking outside for new talent is difficult so many firms focus on compensation as a primary recruiting tool, creating an unsustainable arms race based on pay.
- New regulations, evolving economics and shifting client demands (for more transparency, more time for due diligence and new investment strategies) require a different set of competencies for the success of tomorrow's leaders.
- Given the years and years of hard work that have gone into the success of these funds– not to mention the tremendous value they've created for employees and investors – it's critical that the owner/founder think more carefully about succession. It is no longer about the money, but about their legacy.

Russell Reynolds Associates: Hiring top leaders in the industry and planning for the future is more critical now than ever for founders who want to build enduring businesses.

Returns, Expectations and Popular Strategies

- August 2011 was a pivotal month for Hedge Fund performance and will be critical in determining asset flows moving forward. The largest managers have the ability to diversify their strategies and continue to outperform long-only managers.
- Institutional investors are increasing their allocations to macro, event driven, emerging market and fundamental long/short equity strategies. CTAs and Credit Strategies are also in demand.

Russell Reynolds Associates: Need for CIOs/PMs/Analysts mirrors these popular strategies, particularly anything related to emerging markets, as well as credit and global macro capabilities.

Russell Reynolds was pleased to welcome industry friends from the following organizations: Bridgewater, Och Ziff, BlueMountain, JP Morgan Asset Management, Solus, Oak Hill, York, Atlantic, PineBridge, Glenwood, Fortress, Goldman Sachs, Viking, Knight Capital, D.E. Shaw, BlackRock, KKR, Moore Capital, Credit Suisse, Marathon, Deutsche Asset Management, Avenue, Onex Credit Partners, and Angelo Gordon.