Survey of Hedge Fund “Success Factors”

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Ulicny

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In an industry that manages assets exceeding $1 trillion, you might think the answer to the question above would be apparent. After all, the smartest, most farsighted people in the world work in hedge funds. They must have some good ideas that have made their firms successful.

But do they know for sure?

Does anybody know yet what makes a great hedge fund, aside from strong performance?

As three professionals[1] who specialize in providing advice and services to hedge funds, we decided to find out. Despite our experience in the industry, we weren't sure what key success factors separate the enduring hedge funds from the mediocre also-rans. More important, we weren't sure that hedge funds themselves had a clear grasp of these elusive factors.

That's why we conducted an informal survey of leading hedge funds, the results of which are summarized in this report. We are sharing these findings, plus some of our own interpretations, in the hope that they will help your firm become even more successful and sustainable through market ups and downs. *We firmly believe that the survey results have directional value in helping senior managers of hedge funds make strategic decisions.*

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[1]Kathy Freeman Godfrey of Kathy Freeman Company; Russell Parker, CIMA of RPM Consulting LLC; and Jeanie Ulicny of Ulicny Communications, Inc., are like-minded souls who serve the hedge fund industry. We believe that the more we know about hedge fund success factors, individually and collectively, the better we will be able to help hedge fund clients achieve optimum results apart from portfolio performance. In this survey, we did not attempt to evaluate how important performance, in relation to other factors, is for success. We focused on defining the "other factors" that can make a difference.

Dimensions of the Survey

We distributed a questionnaire to a number of hedge funds with diverse characteristics, ranging in size from $25 million to nearly $6 billion in assets under management. Respondents ranged from firms with one team/strategy to a firm with 11 teams managing 21 different strategies. Most major categories of hedge fund styles (long/short, multi-strategy, FOHFs, convertible bond) were included. In terms of longevity, firms ranged from two to 18 years old. Employee head counts ranged from three to 150.

Our Interpretation: Obviously, we couldn't survey the whole industry. So we surveyed a cross-section of so-far-successful firms representing many different types of companies. Within this diverse range we hoped to find a few practical ideas about common success factors.

1. Why Clients Invest

The survey asked participants to list the top three reasons why they think clients invest with them. Predictably, "performance" was by far the most common answer. Behind performance, many factors were mentioned, but with no clear pattern. Hedge fund success seems to be based on a string of *intangible values* that vary from firm, to firm including: reputation, integrity, trust, experience, pedigree of the principals, relationships and philosophy. Several firms said clients are attracted to their unique investment characteristics, including a doctrine of risk, double-hull protection, macroeconomic beliefs, qualitative infrastructure, or low correlation with other hedge funds. Very few firms mentioned specific "hard" non-investment strengths or capabilities—e.g., recruiting of talent, technology platforms and client relationship management programs.

Our Interpretation: Successful hedge funds tend to develop a self-perpetuating mantra that simultaneously describes who they are and why they are successful. Performance is the "hard stuff" they produce, and everything else tends to be somewhat soft, warm and fuzzy. For even the most successful hedge funds, it's not easy to see other tangible strengths (or gaps) objectively. Perhaps in some firms, the mantra of intangible values clouds vision and planning.

2. How Business Is Won

In a very competitive industry, successful firms must do something well (aside from performance) to attract clients. But what? In most cases, the answer seems to be: "Whatever worked to build the firm in the first place…and why change what's working?" In several cases, the firm's principals developed the initial client base in a given industry or based on their philosophies, prospect networks or marketing channels. Since the original approach has continued to bring in assets, most hedge funds surveyed see little reason to change.

Representative Responses:

"One of our first clients is a political commentator on the radio. He's very well connected and respected, and his contacts have given us strategic advantages."

"Our legacy clients have stayed with us since the firm began. They are people who understand and appreciate what we do."

"Our firm was founded with one client and then that client's family members. We have continued to service these clients and build rapport with them on both personal and investment levels. We and our clients have similar views on long-term strategies."

Our Interpretation: For a dynamic "new economy" industry, most hedge funds seem somewhat inertia driven in evaluating new client acquisition strategies. In contrast, declining "smokestack industry" companies (e.g., General Motors) may have relatively more motivation to innovate or change marketing strategies, in part because their old customers are leaving and they see better opportunities in other segments.

Some hedge funds have become victims of consistent investor demand. Perhaps they should get a little more "smokestack" in their outlooks, because the hedge fund industry may not always have the investor demand that greatly exceeds supply.

3. Effective Marketing Approaches and Resources

"Networking" was the only effective marketing approach mentioned favorably by a number of the firms we surveyed, but the definition of this term varies widely. To some firms, it means seeking referrals from existing clients, while to others it means employing techniques such as speaking engagements, hiring a PR firm or participating in manager databases. Survey participants showed little enthusiasm for marketing through capital introduction firms or attending conferences.

While some larger firms have hired dedicated sales professionals, the responsibilities of such people can be somewhat clerical—e.g., setting up personal appointments or conference calls with portfolio managers. In general, successful hedge funds seem to demand less productivity and accountability from sales professionals than most other industries do.

AUM goals have proved almost meaningless as motivators for dedicated salespeople because most successful firms have far exceeded their goals through referrals, additional client investments and performance. Sales presentation materials are important at almost all firms, but they aren't viewed as a differentiator or major success factor.

Representative Responses:

"We engaged a PR firm that helped to position us as experts in distressed situations. We also conducted a three-part educational series for an association of credit managers."

"We don't do PR or speak to the press. We're very conservative."

"We market through word of mouth with existing clients and some brokers with whom we have worked."

"We are in the unusual position of never having proactively marketed ourselves. Our clients have always been referred."

Our Interpretation: We also asked survey participants what part of their total expenses they spend on marketing, and their answers demonstrated no consistency or clear pattern. Responses ranged from 20% of total firm expenses down to zero. The more successful some firms get, the less they spend on marketing. This can create vulnerabilities because there is no sales momentum to pick up the slack during any period of weak investment performance.

4. Client Communications and Transparency

Most funds send clients a monthly performance summary with manager commentary, and some add statistical analysis and performance attribution. Only a small minority of firms do more—e.g., blast e-mails, newsletters, periodic investor meetings. A surprising number of firms said that they are hearing more investor requests for transparency, but few offer daily or weekly portfolio details yet. Some firms still believe that there is no benefit in providing clients more than bare-minimum communications or any level of portfolio transparency.

Representative Responses:

"We're state of the art with transparency, including monthly client reports, material profits and losses, sector analysis, spreads and correlations."

"We are trying to produce more transparency. I've been talking about it for six years. Demand for transparency will increase across the industry."

"There isn't much demand for transparency among high-net-worth investors. The demand is from institutional clients."

"We show clients our daily performance on our Web site."

"Transparency is not to our benefit. Our clients know what they need to know."

Our Interpretation: The transparency debate is more about supply and demand than some hedge funds realize. If the firms needed more clients and assets, and those clients demanded more transparency, this issue would become more important. Farsighted firms already see this potential and are anticipating it ahead of the curve.

5. New Products, New Markets

How do hedge funds launch new products or tap into new markets? Survey answers lack any kind of consensus or success pattern. Some firms plan "event-like" new-product launches, while others just "spread the word" among existing clients and contacts. Few firms seemed to have a disciplined process for evaluating and implementing new products/markets systematically. While some funds have outsourced marketing to specialists, none mentioned permanent or assignment-specific relationships with new business development consultants. Very few firms have a dedicated staff professional charged with developing new business initiatives.

Representative Responses:

"We launched a new gold strategy about three years ago because we believed it would have strong performance. But we have made no attempt to market it."

"Our best tool for new-product development is our existing customer database. It tells us who to contact and what they want, based on prior sales."

"We have not yet added a second product, but I think we will soon. It will be different than our existing product as a result of demand."

"Although we have brought a variety of new strategies to market, we have no formal process for doing so."

Our Interpretation: Most hedge funds don't have a strategy for developing new products or markets through a systematic planning process. They don't have a committee of senior people that meets periodically to explore new possibilities systematically. New concepts seem to be driven by a combination of opportunity and serendipity.

6. Employee Retention Strategies

This is one area in which hedge funds are focused on building a strong infrastructure based on clear objectives. Talent is recognized as the major asset of hedge fund management firms, and almost all firms surveyed have programs for retaining, promoting and rewarding talent. Equity, bonuses, profit-sharing and "paths to partnership" were mentioned by many participants. Several firms also mentioned cross-training programs that help employees learn skills outside their main areas of expertise. However, in the smallest firms, cross-training is not so important, because many employees automatically wear many hats.

Representative Responses:

"All of our employees have equity. We don't need cross-training in other functional areas because we all do everything."

"We have created a tier of 'directors' for our (non-partner) key people, and they are steered onto that track. In addition to regular bonuses, they can earn supplemental bonuses at the end of the year."

"We emphasize cross-training in other functional areas of the firm, skills development, "promotability," equity participation and profit-sharing."

"Our principal wants to build a lasting organization. He wants farmers—people who are used to working together. The hunters are gone."

Our Interpretation: Hedge funds are the ultimate entrepreneurial culture. They thrive on incentives and don't mind sharing them with key employees. As firms grow larger, we have to wonder if the incentives will trickle down to rank-and-file employees, who also are important to retain and promote. Also, when hedge funds become acquired by larger entities or public companies, will the freedom to use incentives continue?

On the whole, this is one area of "hard strengths" in which hedge funds seem to be in pretty good shape.

7. Business Goals for the Next Five Years

Client Mix: A basic dilemma is whether to move in a more institutional and upscale direction, or to become more "retail." Several firms mentioned a desire to expand FOHF business or to expand offshore and European clients.

Representative Responses:

"We are trying to understand European investors and domestic pension plans."

"We are always interested in talking to potential clients who understand our focus and concentration. We've turned away hundreds of millions of dollars because we won't change how we manage money."

"We would rather deal with the more sophisticated investors. Our vision is to take the market upstream so we don't have to educate investors."

New Distribution Channels: A variety of channels were mentioned, with none very dominant. They included third-party marketers, RIAs, wirehouses, regional brokerages, independent broker-dealers and family offices. New distribution channels are not a compelling need in general.

Staffing and Company Structure/Ownerships Issues—Most survey participants have fairly modest goals for staff expansion, but a greater number want to expand firm ownership or profit-sharing arrangements. There is little motivation to grow substantially larger firms in terms of head count and infrastructure. Growth through outsourcing has some appeal.

Our Interpretation: For being such successful enterprises in a dynamic industry, hedge funds tend to have fairly modest long-term business-building goals. In general, hedge fund leaders tend to think and plan ahead incrementally (about what we can accomplish today and tomorrow), rather than starting with long-term goals and working backward. Whether visionary leadership (apart from performance) can build larger, more successful firms remains to be seen.

8. Acquisitions, Strategic Partners and Exit Plans

About half of the firms surveyed indicated an interest in making acquisitions or forming strategic alliances, but increased AUM was rarely the motivation. A more common motivator was the potential to add expertise in an attractive investment strategy or research area. Exit strategies aren't even on the radar screen of most successful hedge fund partners, perhaps because the partners believe their growth and success will continue for many years, they are currently satisfied with their work and they have a desire to remain independent and entrepreneurial.

Our Interpretation: It seems that the hedge fund industry is not looking at itself in the same way in which it shrewdly analyzes investments. As investors, hedge funds are great at putting on hedges against unexpected or outlier events. But few hedge fund principals have contemplated how their own businesses could be affected by any sharp turns in global economies, taxes, regulations, public attitudes or client needs.

In Conclusion

While this survey was, admittedly, informal, it has confirmed several of our hunches about hedge fund strengths and weaknesses. Hedge funds are the cutting-edge entrepreneurial firms in the U.S. economy, and investment performance drives everything from new client acquisitions to staff bonuses. It is as if these firms and their partners are convinced that strong performance will lead to great wealth (regardless of other factors), while weak performance will inevitably lead to demise.

What may be missing in this equation, we think, are some basic hedges. Could it be possible for a firm to weather a period of weak performance because it has strong infrastructure and client communication channels? What if financial markets shift dramatically or Congress throws hedge funds a tax curveball?

The survey also confirmed that most hedge fund executives believe performance is the dominant differentiator that sets them apart from competitors—even when performance is favorably influenced by positive industry dynamics and market conditions. *In our opinion, this belief creates vulnerability to a potentially damaging loss of business momentum if industry performance or market conditions deteriorate, even for a brief time.* The vulnerability may be increased by the absence of marketing efforts to generate new business (beyond referrals) or cross-sell new strategies to existing investors.

If hedge funds are at one extreme end of today's economy, a smokestack company like General Motors is perhaps at the other end. The executives at GM have no clue about how many cars they will sell at what profit in 2008, and this data really is their equivalent of "performance." However, in GM's perilous state, they must work creatively on building a strong company capable of surviving and even thriving *regardless of performance*. With their backs to the wall, these executives can't afford to be either optimistic or pessimistic. They just have to do all the business-building things right, with foresight, planning and execution.

In general, we think hedge fund principals tend to be a bit overconfident about their investment research/management skills and confidence-challenged in almost all other business-building areas. Perhaps this pattern is symbolized by the cutting-edge trading consoles where they work, with a clear window on every market and data source imaginable. Where is the comparable console for monitoring the business strategy of the firm itself, and for making the equivalent of timely "trades" that will help the firm anticipate and respond to changes?

Unlike executives at GM, hedge fund executives don't feel any kind of "back to the wall" pressure to build businesses with foresight and planning. But will they soon, or one day, feel such pressure? Perhaps the best way to start answering that question is to ask another: *What would sustain the growth of a successful hedge fund firm in the absence of superior performance?*

We think that for each firm surveyed, a soul-searching process aimed at answering that question could be valuable—and put the firm in the best position to respond to changes that are as inevitable as they are unpredictable.

Ulicny, Inc., serves the financial services industry exclusively, helping top investment managers acquire, retain and develop assets through effective communications. With their solid understanding of institutional and high-net-worth investors, Ulicny's professionals create sales presentations, Web sites, brochures and other marketing materials that focus the discussion on investment.

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