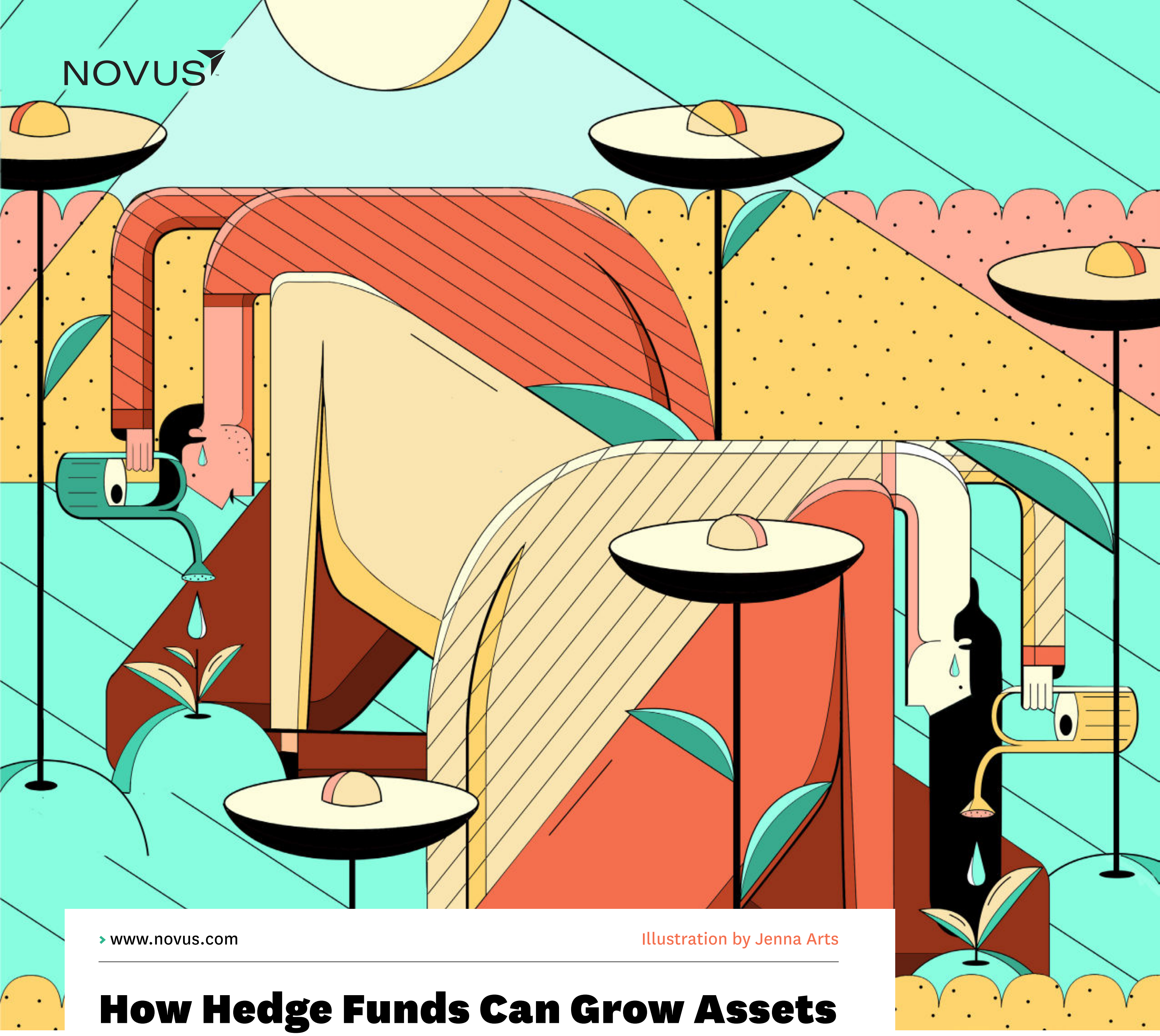

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Illustration by Jenna Arts

How Hedge Funds Can Grow Assets in Today's Tough Environment

By Stan Altshuller

According to feedback from our readers, today's greatest challenge facing hedge funds is growth, and for some managers it's even more fundamental: simply staying in business.

For multiple reasons, most hedge fund managers find the current environment extremely difficult for raising capital. From conversations with clients on both sides of the equation (asset owners and managers), we've found four main obstacles to growing assets. Let's dissect each one and explore ways to overcome these hurdles.

Overcome Performance Headwinds

First, the elephant in the room: Hedge funds haven't kept up with the broad markets and have lower alpha and higher beta today than twenty years ago. The last eight years were especially challenging, even on a risk-adjusted basis. Below, two charts show the alpha and correlation of the HFRI Equity Hedge Index to the S&P 500 on a five-year rolling basis.

learn why they hired hedge funds in the first place. Tune into their needs in that first meeting in order to learn about them and get a second meeting.

Zero in on allocators whose goals line up nicely with your strategy, and don't spend much time with the others. For instance, if the prospect's goal is to diversify their predominantly equity holdings, and you're an equity manager, their

FIG 1 - ROLLING ALPHA/CORRELATION - 5Y (S&P 500)

Source: HFR, Standard and Poors.

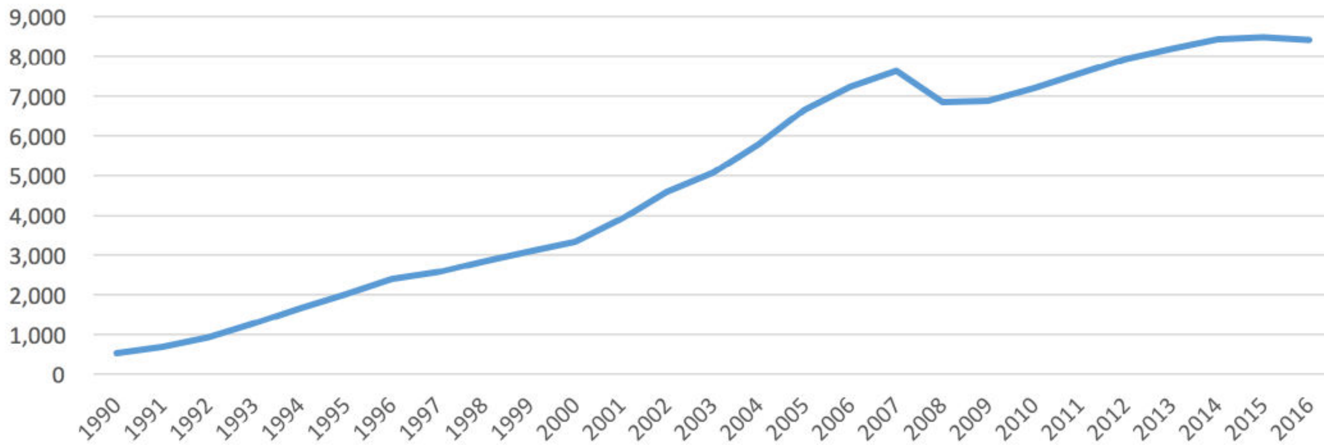
Even if you've performed well in the past, there's no doubt the industry's backdrop looms over your prospects. When large allocators divest from hedge funds, this is usually why. Unfortunately, by divesting from the entire segment, allocators lose good managers along with the mediocre. However, not everyone is divesting, despite what headlines would have you believe. Dispersion of returns between best- and worst-performing hedge funds is still very wide. Some of our allocator clients are in fact increasing their investment to hedged strategies, judging the bull cycle long in the tooth.

We humbly propose that to win business today, you must listen to your prospects and

business isn't worth your while. If, on the other hand, you're a relative-value credit manager with low correlation to the prospect's book, you can bypass the return side of the conversation and focus on reducing risk for the client.

Understanding the investor is key, and they'll appreciate your time spent considering their needs. You'll become a partner in finding a good solution, versus someone simply selling a product. This changes the tone of the meeting and differentiates you from those who pitch regardless of fit.

FIG 2 - NUMBER OF GLOBAL HEDGE FUNDS



Source: HFR

Differentiate Yourself Among Record Number of Hedge Funds

Large allocators are inundated with managers pitching their funds through email, phone calls, and events. The total number of hedge funds in operation has tripled in twenty years, and there are a record number of managers to keep track of and many more opening shop at a rapid pace. How do you differentiate your offering from the thousands of others competing for the same investment dollars? Our hedge fund clients who've achieved this goal usually follow the below steps in presenting their firm to prospects.

- Build a compelling narrative—simplify your message, and clearly communicate why your business exists. You're telling a story, not listing off facts from a bio.
- Show, don't tell—add color to your narrative with one or two illustrations that reinforce your main point.
- Don't try to do too much—assume the prospects will only remember one thing from your presentation. What do you want it to be?
- Focus on repeatable skill—investors want you to perform on their dollar. Show them how you'll do that in one clear slide.
- Demonstrate that you invest in your process and improve over time—investors are more sophisticated and in tune with the changing economic landscape than ever. More effective presentations make it clear that the manager has built an adaptive machine vs. a static investment process at the mercy of shifting winds.

Beat the Size Bias

Most new capital is allocated to the biggest managers. Investors, especially larger ones, want institutional processes in place, and many managers simply won't get there. If you're a smaller manager, weed out the prospects where this is a nonstarter, and focus your efforts on those that can be swayed. Then, examine the reasons investors wind up going to the brand names.

In reality, most allocators are conflicted regarding asset size. They understand the benefits of investing in smaller managers—namely, they have higher performance (on average), their incentives are more aligned, and they more often offer favorable terms like liquidity, transparency, and fees. But from what we've seen, these benefits don't help the smaller manager raise capital because of the higher risk associated with smaller managers.

Investors are drawn to larger managers mostly to avoid this risk. Will your business operations be able to handle growth? What about your investment process? Will it survive a change in market regime? Do you have a plan to adopt if you raised capital? How "institutionalized" is your business from the investment process to operations and providers? The best you can do is make the investors comfortable on these fronts and move on.

However, there's another, more difficult to address reason investors go with larger managers. There's safety in numbers, and large managers guarantee many peers by the investor's side. Although investors rarely state that outright, we believe it accounts for some of the discrepancy between interest and actual investor cash flow.

Turn Negative Perception on its Head

There's a sense among the broad investment community that hedge fund managers operate under an air of mystery and don't justify their fees. You can see it in the media, the commentary sections of news stories, and even coming from some hedge fund managers themselves.

To combat this perception, treat your investors like partners. Show them flexibility on fees in exchange for a longer lock-up or some other trade-off that's less important to them. Investors want to feel that the manager is working with them to come to a common solution. Display your aligned interests by investing a significant portion of your own capital into the fund. This is a big one with many investors, and a show-stopper for some.

Another important attribute is transparency. Investing is an act of trust, and trust works both ways. If you don't trust an investor to properly handle the details to your portfolio, why should they trust you with their capital? Our allocator clients want to feel like their managers are truly their partners. This can be a great source of differentiation, since four out of five managers don't provide position-level transparency to their investors.

As partners, investors want to know that you have their best interests in mind. This means giving them a call when things don't go as planned, not only to inform them of good news. When an analyst leaves, or when there is a bout of unexpected volatility in a fund, reaching out first goes a long way. Especially in this tough environment.

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