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The life cycle of hedge fund managers

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Introduction

The life cycle of hedge fund organizations is one of the most important, and least analyzed, dimensions of investing in hedge funds. With over a decade of institutional history, the industry now has been established long enough to learn that hedge funds, like many other businesses, experience forces of growth and decay that create a finite life cycle far more defined than in traditional money management. Yet hedge fund investors, especially recent entrants into the business, largely ignore the existence of a life cycle. Newer, mostly institutional, investors have elected to tilt their hedge fund portfolios in favor of established brand name hedge funds, not realizing that many of those organizations may already have experienced their best and brightest days. I believe that catching a hedge fund firm in the sweet spot of its life cycle is one of the most important dimensions an investor needs to achieve outstanding results.

My thesis is that people and organizations change, especially when exposed to an increase in personal fortune. For an available reference to support this thesis, look no further than the text in your hands. This is the third edition of this book. The last edition, printed in 1999, contained articles from approximately 49 contributing authors roughly evenly divided between hedge fund managers, investors and service providers. Approximately half of those authors have had one or another significant changes, some positive but most negative, in their businesses, including:

- Key management turnover;
- Retirement;
- Business spinouts;
- The sale or merger of the firm;
- Internal management disputes (legal and otherwise);
- Large losses; and
- Business closing and/or business exit.

While all of the authors are outstanding individuals, many have experienced great changes in their organizations that might or might not be in the best interest of their investors.[1] I believe this underscores the need for understanding the dynamics of the hedge fund organization life cycle.

Interestingly, the focus of many due diligence efforts has recently shifted to protect against fraud. Frauds are difficult to avoid. If a person wants to defraud you or the fund, they will invent ways that even the savviest investor will not be able to prevent. Investors now frequently perform background checks on the principals of hedge fund firms. While a noble pursuit, its premise (that people and behavior do not change) is indeed faulty. Few recognize that the most important analysis in hedge funds is not to avoid the fraud but to analyze the changes in successful organizations. While frauds make headlines, much more money was lost in brand name hedge funds such as Julian Robertson's Tiger Fund or Long Term Capital Management than was lost in frauds such as Michael Berger's Manhattan Fund.

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[1] This, of course, is no reflection on the editor of the book, who has invited me to contribute not only to the previous edition but also to this one!

Wealth management begets wealth creation (for the manager)

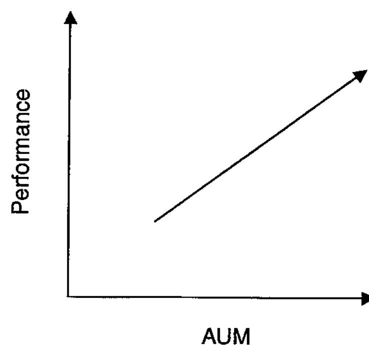
Before we examine the life cycle of the hedge fund manager, we should examine the ultimate, and often unspoken, goal of most managers. The money management business is a great source of wealth creation for money managers (and sometimes for clients as well.) Further, the largest wealth created by legends in the business has come from selling their businesses, rather than from growing their portfolio. For evidence, try to calculate how much more money the likes of Claude Rosenberg, Michael Price and Sir John Templeton made by selling their investment management companies at a multiple with how much they made in their personal accounts as investors before the sale of the firm.

If we assume that most legendary money managers are intelligent folk, we conclude that they know where to make their real fortune. The only question that remains is: can business valuation multiples be applied to the hedge fund business? To answer this question, one needs to know the primary differences between hedge fund management and traditional money management:

1. Hedge fund styles are generally capacity constrained. This is the first and most important rule that is often overlooked.

The standard formulas to value a traditional money management business are always related to assets under management (the so-called scalability of the asset management fees). The value of an asset management firm is a function of assets under management (AUM) and performance (which probably but not necessarily is a condition to greater AUM).

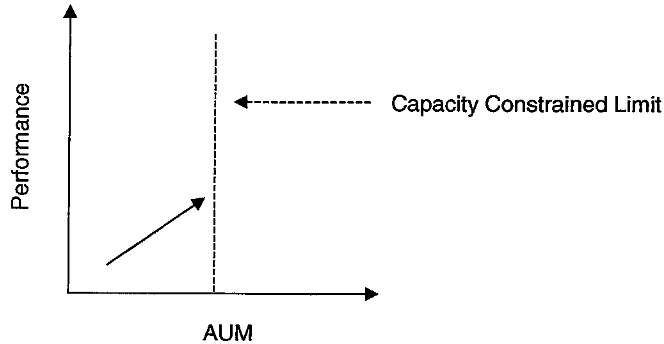
Value of Traditional Asset Management Firm



We all want our managers to be successful, but not at the expense of performance. Unfortunately, another rule of successful hedge fund investing, that size is the enemy of performance, conflicts with the ability of an asset management firm to achieve a high business valuation.

Since most hedge fund styles are capacity constrained, the value of the hedge fund firm is constrained as well.

Value of Hedge Fund Asset Management Firm



It is very important to know if a sale of the business is an objective lurking deep in the mind of your manager. An obsession with building a scalable hedge fund business might add more uncertainty about future performance, given that most hedge fund strategies are not scalable. The unfortunate consequence of the asset gathering mentality is the creation of a capital bloated hedge fund, lacking the focus and edge that created the historically attractive risk/return.

2. Hedge Funds fees, which are performance related, are higher than traditional money management fees. A hedge fund manager can make an excellent living without selling his management firm.

Even if the objective of a money manager is not to sell the firm, the inherent high fee structure of hedge funds can create an unstable environment for the hedge fund manager. A well-known observer of the asset management business, Byron Wien of Morgan Stanley Asset Management, observed the following:

> Unlike some others, I do not think we are in a hedge fund bubble that is going to end in disaster. I expect a number of new and old funds to close down, but the concept will endure. What is becoming apparent to me, however, is that the basic structure of an individual hedge fund may be unstable and that is something important for investors to think about. The case for instability starts with the fact that the two largest and best-known funds have changed structure dramatically. Tiger Management effectively closed down and returned investors' money, while Soros Management changed its focus from aggressive macro management to an endowment orientation and most of the outside investors took back their money. Both of these funds had outstanding records over a longer time but ran into a difficult two-year period. Size was blamed for some of the trouble; both had reached around $20 billion[2].

As is underscored by Byron Wien, hedge funds can destabilize as they succeed and grow. Before exploring the reason why, the math of the hedge fund business must be discussed.

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[2] Byron Wien, *The Inherent Instability of Hedge Funds*, Morgan Stanley Equity Research, April 29, 2002, Page 1.

Math of the hedge fund business

Hedge funds have historically charged '1-and-20' fees (that is, a one percent asset management fee and a 20 percent performance fee. In the early days of the business, hedge funds managed $50 to $200 million and were regarded as niche boutiques, earning sufficient fees to cover the costs of the business and provide a good living to the money managers.

Annual Revenues of a Hypothetical Hedge Fund Business (in dollars)

Performance (gross rate of return)	AUM (millions of dollars)					
	100	200	500	1000	5000	8000
15%	$4,000,000	$8,000,000	$20,000,000	$40,000,000	$200,000,000	$320,000,000
20%	$5,000,000	$10,000,000	$25,000,000	$50,000,000	$250,000,000	$400,000,000
25%	$6,000,000	$12,000,000	$30,000,000	$60,000,000	$300,000,000	$480,000,000
30%	$7,000,000	$14,000,000	$35,000,000	$70,000,000	$350,000,000	$560,000,000

As can be seen above, if a hedge fund manages $100-$200 million, the firm revenues in a year can range from $4-$14 million depending on performance. This was once considered to be a successful business model. I still consider it to be one of the great wealth creation businesses but the growth of the industry and ambitions of hedge fund managers have redefined the meaning of success and pushed asset growth to new heights. However, if assets under management grow to the range of $500 million to $8 billion, business revenues move to eight digits (10's of millions) from seven digits (millions). This is an important shift.

Tarrant's rule of eight digits

Having invested money on behalf of Forbes 400 families, institutions and foundations, and having been involved in the creation and direction of several business enterprises, I have come to the conclusion that things change whenever more than $10 million in perceived gains or losses are generated in an organization. I guess in a certain respect, eight digits are considered to be real money and thus creates real concern.

When eight digit losses occur, someone will lose a job. Management assigns responsibility to an unsuspecting person since obviously no one will take credit for losses. While this may be obvious, the more interesting analysis occurs when an eight digit figure is positive and attributed to a success.

While failures and losses are orphaned, successes and profits have many fathers. Unfortunately, in business there is no DNA testing that can determine the true father of the success, so it is left to the interpretation of contracts (employment and otherwise) and the creativity of the claimant and/or their lawyers to determine the rights to the fruits of success.

Why does this relate to the hedge fund business? It does so because the success and profits we are talking about are significant to the balance sheet of an individual. An 8-digit sum is large enough to affect the personal wealth of most individuals. An eight-digit sum, if not shared with the talent in the firm that created that sum, will drive out entrepreneurial talent.

Therefore, I believe it is important to understand how the hedge fund business evolves in relation to the wealth of its principals. It is my premise that people and organizations change when the wealth of those involved changes. It is, therefore, useful to develop a new dimensional analysis for hedge fund

managers, given the profitability of the business and the relevant cause and effect of wealth on the individual and the organization.

The five phases in the life cycle of the hedge fund management firm

Phase 1: Entrepreneurial

The first phase is the initial 18 months after the start of a hedge fund business. The hedge fund manager has probably left another hedge fund organization, a mutual fund, a Wall Street trading desk or a securities firm as a sell-side analyst. In a successful firm in this phase, the principals have invested significant capital relative to their net worth and probably have raised money from early investors. The money manager/entrepreneur is highly motivated for financial and personal achievement reasons. The critical issue an investor in the hedge fund must understand, after being convinced that the team is potentially a good money manager, is whether the entrepreneurial firm has sufficient and stable capital to survive the following few years regardless of the market environment. It is important to know the source of the capital and its stability during this period.

Start-up risks, such as operational and back office issues, were much more of a concern to me in the early days of hedge funds than they are today. With outsourced resources available at their fingertips, a hedge fund can acquire seed capital, outsourced administrative services, compliance, trading, marketing, and risk analysis. Few of these outsourced resources were available a few years ago. Today the manager can spend his time focused on value creation skills, that of money management.

Phase 2: Wealth Creation

Fortunately, during the wealth creation phase the objectives of the investor and the manager are usually aligned. The hedge fund manager is focused on the primary investment process from which he derives a competitive advantage. Through this focus the manager has the chance to generate returns and create wealth for the investors and the principals of the firm. Many consider the period between the first year and fifth year to be the best years to invest with hedge fund managers.

According to a study prepared by Cross Border Capital[3]:

- Young funds outperform seasoned funds after adjustments for the risk of failure;
- The youngest decile beats the oldest by 970 basis points per annum; and
- Investors should buy funds in their first three years of existence.

In addition, Byron Wien observes:

> Our hedge fund group at Morgan Stanley Asset Management determined that large funds lag medium-sized funds across the board. Young funds tend to do better than mature ones.[4]

I agree with these observations and have built a business investing with focused hedge managers that are disciplined enough to restrict their asset size, especially during the wealth creation phase. Most good money managers are disciplined, however, one of the most important disciplines is not to be lured by the siren song of the asset gathering business.

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[3] Cross Border Capital, *Absolute Return Fund Research*, April 2001.

[4] Wien, Page 2.

Phase 3: Wealth enjoyment

After four to five years of managing a successful hedge fund (or perhaps sooner with a very successful fund), the hedge fund manager accumulates enough wealth that his lifestyle can change dramatically. Outstanding managers may earn tens or hundreds of millions of dollars cumulatively in five years. For an investor to think that this wealth effect will not have a dramatic effect on the manager, his lifestyle, family and organization is naïve. One of the first lessons I learned when I studied economics is that money is not static. It moves and wants to move into things like houses, cars, airplanes, art, golf courses, private islands, hunting estates and more. Taken to the extreme, the time enjoying the fruits of success can cause a drag on the manager's focus.

On the other hand, some managers are more ascetic and philanthropic. For those people, money moves to noble causes in the form of private foundations and charitable activities. What can be a great benefit to society, however, can still be a distraction away from money management.

While we applaud the manager for his success and his contribution to society as a producer, consumer and philanthropist, I believe the manager should honestly assess his continued devotion to investment management as his life changes. Hedge fund investment management is more than a full-time job, and the manager and its investors should be aware of the distractions of wealth. If a manager does feel strongly about philanthropic endeavors, it might make more sense for the manager to continue to focus on his business and reduce and/or contribute his fees to the charity. An increasing number of managers (including our firm) have chosen this path and have generated millions of dollars of benefits to non-profit organizations. In that way, the manager can focus on the value added skills that created past performance, and the philanthropic cause can directly benefit from fee reduction or sharing. If there is a considerable time commitment for the philanthropic endeavors, the manager may want to consider shifting his focus, retiring as a money manager and devoting his time to charitable activities. Increasingly, we see hedge fund managers that recognize the need to manage this time commitment by funding professional non-profit management teams to execute the manager's philanthropic vision, while allowing the manager to continue to focus the majority of his time on investment management.

Phase 4: Wealth preservation

Now the manager has amassed a personal fortune. His 'get rich' mentality has been replaced by a 'stay rich' mentality, which in turn can overtake his investment style. Hedge fund managers are paid well to take smart risks. Once a manager has amassed a fortune by any measurement, he has an inclination to reduce risk significantly. When this occurs, the expected return characteristics can drop significantly based on the manager's reduced risk profile. This might or might not fit the client's objectives.

Due to his compressed time schedule, the manager might hire young protégés and attempt to transfer years of knowledge, expertise and judgment to the individuals who are pre-Phase I in their wealth development. The hedge fund instability that Byron Wien identified begins when the manager has difficultly retaining younger talent, who might have higher return needs and/or entrepreneurial aspirations.

Phase 5: Wealth succession and/or distribution

Once the manager has successfully preserved wealth, he must think about larger concerns than his own needs. After a few younger analysts leave the firm, the hedge fund manager recognizes a need to create a succession plan. Though he created the firm on the basis of his investment judgment, the manager attempts to codify the investment process so that the informational 'DNA' of his edge can be passed on to the next generation within the firm. Unfortunately, few hedge fund firms have been able to capture the founding hedge fund manager's judgment into an institutionalized process. As a result, the prospective results are unlikely to resemble the past.

Sustaining an edge in the hedge fund business is grueling. If the manager is not willing to continue the pace of work, that was required in the earlier phases, then he must pass the baton to a new generation of associates and partners. At this moment, the potential for a serious degradation in the firm occurs. If the best talent within the firm is not part of the founder's wealth succession and/or distribution plan, then the firm's instability increases. Some sure signs of instability include:

1. Discussion of the potential sale of the firm to any entity other than employees.
2. Farming out money to managers to absorb excess capital and to generate portfolio ideas.
3. New product proliferation and discussions of extending the firms brand to unrelated investment areas.
4. Sponsoring new external hedge funds or spinouts from within the firm, creating an incentive problem when trying to keep the talent internally: top talent will want to spinout, while the remaining talent left behind the firm might be second rate.
5. Transferring ownership of the firm to family members who have not proven their investment prowess.

Once the hedge fund manager 'farms out' money or 'spins out' internal groups, he enters a different business. The firm begins to look more like a fund of funds or a hedge fund incubator. The manager may have discovered a way to protect his revenue stream but an investor cannot know if he has the right skills to manage other people's money (let alone his own) in this fashion.

Conclusion

Hedge fund investors should recognize the life cycle of the hedge manager and incorporate that dimension into the allocation of their hedge fund assets. Just as institutions learned over the last years to first shift assets from bonds to stocks and then to separate small cap and large cap stocks within that allocation, so, too, may institutional investors begin to allocate capital to both the large brand name hedge funds and to smaller, emerging hedge fund managers in an effort to diversify the portfolio across the phases of the life cycle.

Sophisticated hedge fund investors will not favorably receive those hedge fund managers that are 'asset gatherers'. I only ask these managers to read two books written by Al Reis: 'The 22 Immutable Laws of Branding' and 'Focus – The Future of Your Company Depends on It'. These books were given to me by one of the most focused and longest standing members of the hedge fund community. He believes, and I agree, that all investors should read these books. For the brand name hedge fund managers that want to extend their brand into new forms of investment management, I would refer you to Al Ries' '10th Law of Branding: The Law of Extensions', which states 'the easiest way to destroy a brand is to put its name on everything'.[5] In 'Focus – The Future of Your Company Depends on It', Al Ries underscores that most successful firms focus on their competitive advantage and do not dilute their focus into new areas outside their circle of competence.[6]

Some of the greatest investment masters have retired with full knowledge about the issues outlined in this chapter. If you analyze what some of the great, retired hedge fund managers have done with their own personal fortunes, you will discover that the early investors in emerging hedge fund managers were many of the legendary names of the investment business. If investing with emerging managers is good enough for these seasoned veterans, institutions should not be far behind with a similar strategy. Most of these sophisticated investors know (perhaps first hand) the inside secret of the hedge fund

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[5]Al Ries and Laura Ries, *The 22 Immutable Laws of Branding*, "The Law of Extensions." New York: HarperCollins Publishers, 2002. Page 49.

[6]Al Ries. *Focus-The Future of Your Company Depends on It*, New York: Harper Collins Publishers, 1996.

business--there has never been a successful hedge fund that has managed more than $8 billion over a sustained period.

As a result, due diligence should incorporate the stage of the life cycle of the hedge fund management firm, and an investment portfolio should be constructed with this added perspective in mind.