

FEBRUARY 2011

## The Business of Running a Hedge Fund

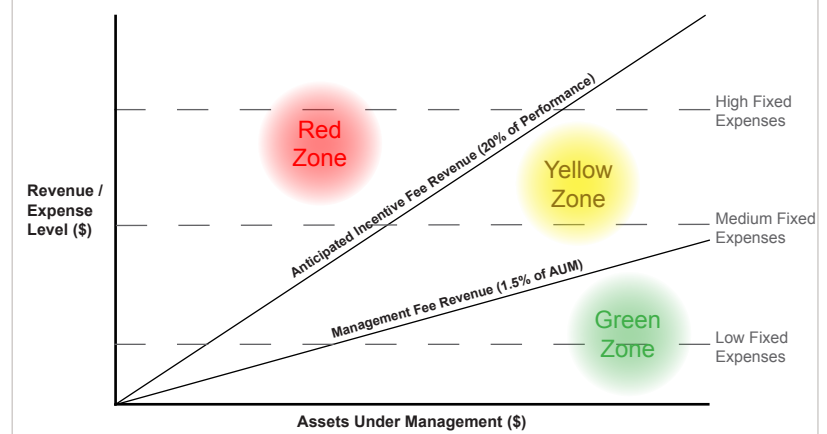
*Best Practices for Getting to the “Green Zone”*

### Executive Summary

2010 was a transformative year for the hedge fund industry and served as a strong reminder that managing money is not the same as running a business. The significant number of small, mid-size and large fund closures already in 2011 provides continuing evidence of the material, multifaceted challenges facing operators of hedge fund businesses. Managers who understand the distinction between managing money and running a business and who execute both effectively are best positioned to maintain a sustainable and prosperous business – to achieve not only investment alpha, but also enterprise alpha.

This paper examines the hedge fund business model and is based on our observations and numerous conversations with hedge fund managers, investors and industry experts. Our goal is to share the best practices we have witnessed among “green zone” hedge funds that are well positioned for sustainability across a variety of economic and market conditions.

### In the Zone: Three Types of Hedge Fund Operating Models



**M**ost hedge fund managers would agree: given the broader market environment and the specific challenges facing the industry, 2010 was a difficult year. In fact, the past few years have tested the industry in unprecedented ways. The industry, by and large, has passed that test, and there are a wealth of excellent funds operating today that are poised for growth.

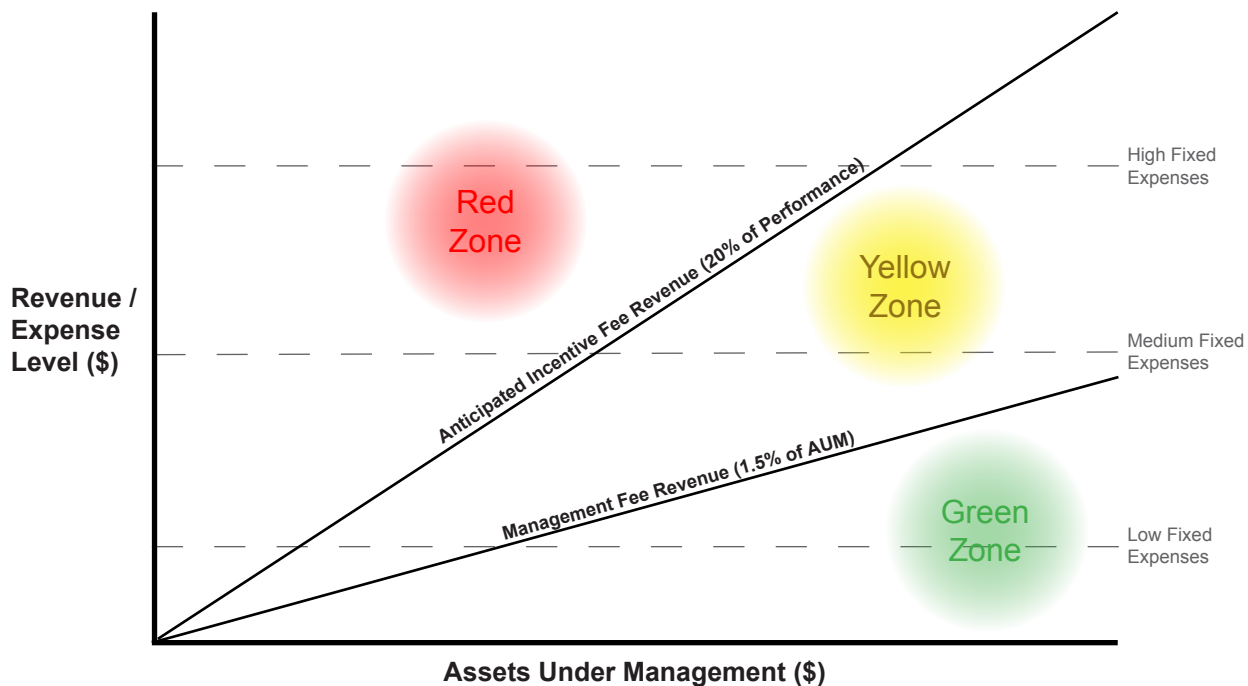
Managers are more focused than ever on designing their business models to thrive under a wide range of market scenarios. While performance and AUM growth are still important levers in the hedge fund business model, they are no longer foregone conclusions and are not wholly controlled by the hedge fund manager. Expenses are the only lever the manager can reliably control.

While there is no one-size-fits-all business model for hedge funds, there are several consistent elements and best practices we have witnessed among well-managed funds with staying power.

As a starting point, the diagram below highlights the basic revenue and expense scenarios that describe three types of hedge fund operating models: red zone, yellow zone and green zone. A

### IN THE ZONE: THREE TYPES OF HEDGE FUND OPERATING MODELS

The two most important levers for a hedge fund's basic business model are its fees and its fixed expenses. The green zone below represents funds that keep their fixed expenses lower than their management fee revenue. Such funds have a margin of safety built into their model and can withstand difficult market environments. Yellow zone funds, which spend more than their management fee but less than their realistic performance fee expectations, require some degree of positive performance revenue to stay profitable. Funds in the red zone may be forced to take drastic, unplanned actions during soft-performing years.



fund operating in the red zone is dependent on outsized performance to cover its expenses; a fund in the yellow zone requires minimal performance; and a green zone fund can sustain itself when its performance is lower than expected, nonexistent or even negative. Funds that structure their business model to operate in the green zone are better positioned to navigate through downturns and therefore have higher survival rates over the long term.

The remainder of this paper examines hedge fund revenue inputs, expenses and business model considerations. We discuss the importance of identifying a fund's breakeven point (i.e., the point at which revenues cover expenses) and seek to isolate several practices that have helped funds operate in, or closer to, the green zone.

### **THE BIG FIVE HEDGE FUND EXPENSES**

Where do hedge funds allocate most of their spending? The answer to that question also explains where funds can find opportunities to lower their expenses.

1. People and HR
2. Office space
3. Technology
4. Manual processes
5. Third-party providers (e.g., order management systems, risk, aggregation, analytics for investors, allocation tools)

## **THE HEDGE FUND REVENUE MIX**

Hedge funds have two revenue inputs: the management fee, which is a fixed percentage of assets under management (AUM), and the performance fee, which is a percentage of positive performance. Incentive fees are what lure the most talented financial professionals to join the hedge fund industry, and they offer tremendous upside. It's the management fee, however, that keeps people alive in this industry. While tempting, it is risky to build a business around the hope of large incentive fees rather than the guarantee of management fees.

To better understand the relationship of these revenue inputs, consider some basic scenarios. Based on a 1.5% management fee and 20% incentive fee,<sup>1</sup> a fund with no returns is

<sup>1</sup> For consistency, this paper uses the "1.5 and 20" fee structure throughout.

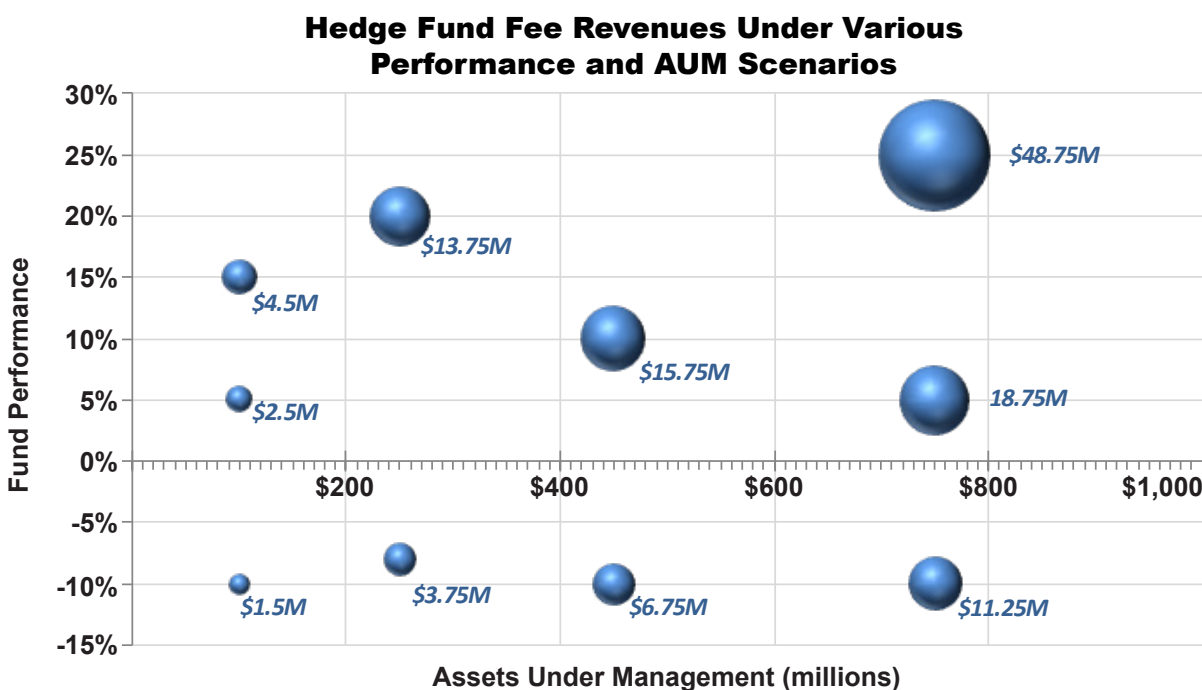
100% dependant on its management fee. A fund with gross returns of 5% gets 60% of its revenue from management fees. In order to derive more than 50% of its revenues from performance fees, a fund needs to generate returns of at least 7.5%. Refer to the chart below for a map of hedge fund revenues based on a variety of asset and performance levels.

Putting some real numbers around this provides more color. A fund with \$200 million in AUM and zero or negative performance would generate revenue of \$3 million. A return of 5% bumps the total revenue up to \$5 million. With a 7.5% return, the fund's revenues are \$6 million: \$3 million from the management fee and \$3 million from the performance fee. Beyond the 7.5% performance mark, the incentive fee becomes the primary revenue contributor.

The performance fee effect is what makes the hedge fund model so appealing and unique. Whereas traditional asset management models derive revenues almost exclusively based on assets, a hedge fund's revenues include performance incentives, thereby better aligning the interests of the manager and the investor. If the \$200 million AUM fund mentioned above delivers a 25% return, the manager's revenue is \$13 million – more than double what the manager would receive for a

## THE AUM / PERFORMANCE MAP

What level of assets does a fund require to support its expenses? Where does performance need to be? The chart below depicts both sides of the revenue map: AUM and performance, including negative performance.



very healthy 7.5% return. By comparison, a similarly sized mutual fund would earn roughly \$3 million in management fees. This distinction drives our industry. (The chart on page 8 provides an additional visual of how performance fees contribute to the revenue mix.)

Looking more closely at the revenue inputs, two clear concepts emerge regarding the hedge fund business model. First, because hedge funds can be opportunistic with how they invest, both the manager and investor stand to benefit tremendously when the manager performs well. Second, there is only one consistently reliable revenue input for funds: the management fee. Not surprisingly, the managers we work with who are most sustainability-minded think of their revenues in terms of their management fee alone.

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In fact, we recommend that a conservative place to start with the hedge fund business model is to base revenue expectations on management fees alone. This provides both the fund and its investors with a margin of safety. Even during periods of low or no returns, a conservatively modeled fund can sustain, adapt and emerge.

## DETERMINING THE BREAK-EVEN POINT

When companies calculate their breakeven points, they often come at it from the perspective of how much revenue they require to cover their expenses: “If we don’t sell \$2 million worth of widgets this year, we’ll face a shortfall and we’ll need to downsize.” Similarly, a hedge fund manager may ask: “What level of assets and performance do I need to cover my expenses?”

However, the hedge fund business model allows for a different approach. Since hedge funds have a fixed revenue stream – their management fee – and since they know their current level of AUM, they can work out their breakeven point from the other direction: “What level of expenses can I support with my fixed revenue?” Referring to the business model graphic on page 2, a fund can approach its breakeven point by pegging its expenses to the point on the graph where its management fee intersects with its AUM level.

The \$200 million AUM fund described earlier could therefore base its annual revenue projections around its \$3 million management fee (i.e., 1.5% of AUM) and set its expense caps accordingly. During a strong-performing year the fund will run with a surplus which, like other businesses, it can use for capital expenditures, incentive bonuses, cash reserves and so forth.

A start-up fund can apply the same principal based on realistic AUM assumptions. (For most funds, “realistic” start-up capital consists of investments by partners, friends and family.) A fund with \$20 million in start-up capital and a 1.5 and 20 arrangement could base its expense considerations on \$300,000 of annual fixed revenue – a considerably lower amount than in the previous example.

It’s also important for managers of start-up funds to understand the numerous expenses associated with operating a hedge fund. As an example, many funds – like the \$20 million fund described above – cannot afford a non-bundled third-party vendor’s order management system (OMS), risk management product, aggregation service, trade allocation module and attribution tools. Once a fund understands its expenses, it can determine exactly the asset level and performance combination necessary to cover those expenses and have an adequate profit.

For a prospective start-up fund, this analysis will determine whether the business plan is realistic or needs refinement before it launches (i.e., either the fund will need to raise more launch capital or lower its fixed expenses). For an established fund, this analysis determines whether it is operating in the red, yellow or green zone.

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## GETTING TO THE GREEN ZONE

It’s important to understand why some funds target operating in the green zone, and why other funds may intentionally operate in the yellow or red zones. The green zone calculus is simple: when a fund maintains fixed expenses that are lower than its fixed revenues, it operates with a margin of safety. In a green zone fund, both the fund and its investors have a reasonable cushion to ride out difficult periods of low or no performance, and the fund operates with less business risk.

In other cases, a manager may wish to operate in the yellow or even red zone, relying on performance to cover any expenses that are above and beyond its fixed revenue. This is particularly true among start-up hedge funds, which – like other start-up companies – require initial investments and operate with a higher burn rate. Additionally, any fund that is significantly building out its infrastructure may operate with higher relative fixed expenses, even if just for a short period of time.

We advocate that both new and established funds constantly work toward getting to the green zone. This is key to managing a sustainable fund.

Distinct from raising AUM, delivering strong performance or changing the management fee structure, the only lever that managers have complete control over is fixed expenses. Using this lever and reducing expenses will enable funds to get to the green zone. Looking at the breakeven analysis from a different perspective, reducing fixed expenses has a multiplier effect on the level of assets required for a fund to break even.

For instance, based on the pure management fee model described above, a fund with a 1.5% management fee and fixed expenses of \$600,000 would break even at \$40 million in AUM. By decreasing fixed expenses by \$60,000, or 10%, the fund's breakeven AUM drops by \$4 million to \$36 million. Stated differently, \$15,000 in fixed expenses equates to \$1 million in AUM.

In some cases, reducing fixed expenses may mean cutting excess and non-core spending across the board – including measures such as reducing headcount, taking smaller space and cutting budgets by a prescribed percentage in each area. Sometimes such draconian measures are necessary – e.g., for a prospective start-up fund which is budgeting \$25,000 in expenses per million dollars of AUM, or for a fund whose AUM has decreased significantly. Very often, however, funds can get closer to the green zone by shifting some of their expenses from fixed to variable and by moving the burden of expenses to the shoulders of a third-party service provider.

Like many businesses, hedge funds have to make difficult decisions about which tasks they should perform in-house and which they should outsource. Third-party service providers are available to do nearly all of a fund's activities outside of making investment decisions. Our observation is that funds typically prefer to do as much of their work in-house as is possible. As a result, they tend to build up significant fixed costs.

Some hedge funds are concerned that reliance on a third-party will increase risk or lead to an operational or compliance failure. Many emerging managers come from larger funds and have therefore never developed relationships – or negotiated contracts – with third-party vendors. They believe that

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if they don't do it themselves in-house it won't get done correctly. This may have been correct in the past with certain functions, like fund administration, but that's no longer the case today.

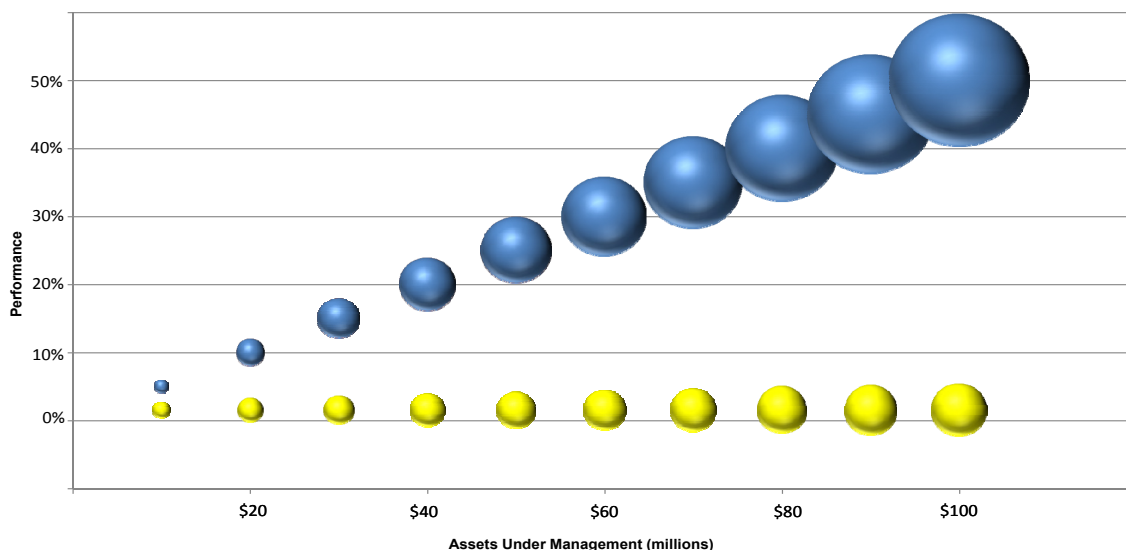
Hedge funds rely on the economies of scale available through third-party providers all the time. They don't borrow stock directly; they leverage the scale of their prime broker. They don't issue commercial paper directly to finance long positions; they leverage the banks. Similar opportunities exist across a wide range of fund activities, from trading and technology, to human resource support, to risk management and reporting.

By moving the burden of high-expense activities from their own P&L to a service provider, hedge funds can reduce their fixed expenses. The resulting model is leaner and more effective, and it can be scaled up or down with greater ease depending on the fund's performance, assets and business needs. As a fund grows, for instance, it may require more back office support, but if the fund's growth levels off, some of that support will no longer be necessary.

By leveraging third-party providers, the fund stays nimble and is able to ramp up its productivity without adding significant new recurring expenses in the form of compensation, space, technology and so forth.

### THE HEDGE FUND MODEL AT WORK: PERFORMANCE FEE VS. MANAGEMENT FEE GROWTH

As a fund increases its assets, its management fee income (yellow) steadily ramps up. When performance fees (blue) are included, the revenue growth can be remarkable. The performance fee growth line is a simple representation of the inherent power of the hedge fund model and helps explain why talented investment managers gravitate toward hedge funds.





In this way, outsourcing not only affects expenses, it also gives funds added adaptability. One of the hallmarks of funds that have successfully navigated difficult periods is that they were positioned for the negative environment before it happened, and they were able to adapt quickly to their new reality.

## CONCLUSION

The hedge fund industry has literally reshaped the investment landscape for talented managers and for qualified investors – not only because hedge funds provide greater flexibility in investment decisions, but also because of the business model itself, which aligns managers and investors and provides excellent incentives for strong performance. In the post-crisis environment, managers are increasingly focused not only on their investment performance, but also on their business models. Whereas pre-crisis the top hedge funds were dedicated to performance alpha, post-crisis the top funds also seek enterprise alpha.<sup>M</sup>

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