



September 2001

Fund of hedge funds— Rethinking resource requirements.

- **Funds of hedge funds (FOHFs) oversee about \$100 billion.** The majority of the current global demand is from affluent individuals—less than 25% is from institutions. Over 70% of FOHF assets are managed for American investors, 15% for pan-European, and 10% for Japanese.
- **Demand will remain strong, but are there natural limits?** Investors will show continued interest in FOHFs, buoyed by the broader mainstreaming of alternative investments. This secular shift of money, however, will suppress returns if market inefficiencies become more fully arbitrated, thus potentially dampening future demand. Many strategies may already be reaching such capacity constraints.
- **The market for FOHFs is maturing rapidly.** To date, the professional standards for investment process, marketing, and client service are still in a developmental stage. As traditional investors gain more experience with FOHFs and as additional sophisticated clients (e.g. institutional investors) enter the market, these standards will be raised significantly.
- **The industry will likely enter a phase of consolidation.** Over the next few years, the FOHF business will become significantly more resource intensive. Large investments are required in client service, risk management systems, and the due diligence and monitoring of managers. The scale required to support these activities is increasing.
- **Established firms are best positioned for success.** Significant advantage goes to firms that are already developing an advanced infrastructure and performance record. Scale requirements, coupled with a scarcity of experienced FOHF professionals, may make gaining substantial market share difficult for future entrants. Going forward, larger financial institutions will likely approach this market through acquisition or alliance.

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CQA specializes in providing merchant banking and strategic advisory services exclusively to the investment management industry. CQA delivers value to its clients and partners through a unique combination of deep industry knowledge and experience, solutions-oriented thought leadership, and a proven ability to create change within organizations.

1. Introduction

This paper describes the current global fund of hedge funds (FOHF) market, and the factors that we believe will drive future success for providers. (A fund of hedge funds is an investment vehicle that allocates money to multiple underlying hedge fund managers.) Casey, Quirk & Acito (CQA) bases its conclusions upon its own research and an extensive series of interviews conducted in the Spring of 2001. Exhibit 1 describes our survey.

In summarizing the current environment, we are struck by the many parallels with the Internet phenomena in the late 1990s that apply to both hedge funds and fund of hedge funds:

- They are creating a buzz that goes beyond the investment management industry, driving cocktail party chatter with an aura of swash-buckling enterprise
- They are attracting some of the best and the brightest individuals, many of whom are leaving top firms to join start-ups
- Many, if not most, have been founded quickly, some with unproven talent
- Traditional businesses are scrambling: they are devoting significant resources to understanding how they too can participate, hoping to simultaneously stem the outflow of talent, meet client demands, and boost their own bottom line

Looking forward, we believe an Internet concept from the same period is appropriate: the rapid capture of market share and the development of scale are the keys to success and survival. We believe that elements of this advice are correct for the FOHF market: the resource requirements to be a successful FOHF manager are increasing substantially and, as a result, the market will likely consolidate over the next three to five years; hence the title of our report, *Rethinking resource requirements*.

Exhibit 1 : CQA survey methodology

To support our research of the fund of hedge funds industry, CQA conducted over seventy interviews. Participants included senior executives of:

- **Corporate and public pension plans**
- **Endowments and foundations**
- **Insurance firms**
- **Institutional investment consultants**
- **High net worth intermediaries (including private banks and brokerage firms)**
- **Prime brokerage operations**
- **Hedge fund managers**
- **Fund of hedge funds managers**

Participants were selected to fairly represent the market trends in the United States, Europe, and Japan. Our sample is not random or complete: we focused our interviews on individuals with a developed perspective on the FOHF industry. Interpretation of some of the statistics presented in this document should consider this sample bias.

Our interviews focused on three primary themes:

- **How strong is current and emerging demand?**
- **How is the competitive landscape changing?**
- **What are the keys to future success?**

Interviews were conducted in the late Spring of 2001.

Our comparison to the Internet is not meant to be pejorative. In fact, we are bullish on the FOHF business (and the entire alternative investment spectrum): hedge funds are an important asset class and, done well, FOHFs are an appropriate consideration for most high net worth and institutional investors in spite of their fees. However, the competitive environment is intensifying and will require a more developed business model than is typically employed today. FOHF providers must appreciate what many Internet pioneers did not: access to capital and relationships are not sufficient for success. For FOHFs, advanced manufacturing skills (including disciplined manager selection and portfolio construction processes, as well as sophisticated

risk management capabilities) must be coupled with excellent marketing and client service.

Our thoughts are organized in three primary chapters.

- First, we size the FOHF market, describing the current demand and the prospects for growth in each of three primary geographies (America, Europe, and Japan) and by two market segments (high net worth individuals and institutions).
- Second, we discuss how the FOHF market is rapidly evolving and what capabilities will be required for future success. We argue that competitive pressures will result in the leading FOHF managers becoming “complete firms”.*
- Finally, we predict that the FOHF market will consolidate over the next several years. The resources required to be a leading FOHF manager necessitate greater scale to be financially viable. We discuss the implications for acquisitions and alliances.

**For a full description of the complete firm, please see the report Success in Investment Management: Building and Managing the Complete Firm co-published by Casey, Quirk & Acito and Merrill Lynch in Spring 2000.*

2. Market size and growth

This chapter addresses three primary questions: What is the size of the global FOHF market? How does demand differ by market segment? What are the prospects for continued growth?

CURRENT MARKET SIZE

As shown in Exhibit 2, we estimate the size of the global FOHF market to be between \$90 billion and \$100 billion in assets under management. As such, the FOHFs account for more than 20% of the assets invested in hedge funds (estimated to be about \$450 billion). Over 70% of FOHF assets are managed for American investors, 15% for pan-European, and 10% for Japanese. The primary source is affluent individuals—less than 25% of these assets currently come from institutions.

Currently, the U.S. high net worth segment is the largest in the world, accounting for over half of all FOHF investments. Wealthy individuals have long been interested in hedge funds for sound asset allocation reasons, as well as the cachet derived from their absolute return orientation, their secrecy, and lack of regulation. Over the last few years, which have included several hedge fund meltdowns and the NASDAQ sell-off, greater interest in capital preservation has increased demand for FOHFs. In addition to diversification, wealthy individuals are drawn to FOHFs to gain access to managers otherwise closed to new and smaller investors.

To date, the American high net worth FOHF market has been relationship-driven and fragmented. By relationship driven, we mean that most individuals have sourced their FOHF provider through personal recommendations and acquaintances, not through a sophisticated assessment process. For many years, this resulted in demand being served by a large number of fragmented and small

Exhibit 2 : Estimated global fund of hedge funds market size (July 2001)

Buyer segment		United States		Europe		Japan and Asia	
		HF's	FOHF's	HF's	FOHF's	HF's	FOHF's
Institutional market	Corporate pensions	35	6				
	Public pensions	28	5				
	Endowments/ foundations	21	5	10	2		
	Insurance companies	5	1				
High net worth		261	50	68	13		
Totals		350	67	78	15	22	10

SOURCE: Casey, Quirk & Acito

HF's = Hedge funds FOHF's = Funds of hedge funds

providers. Recently, several of the private client groups within larger banks and broker dealers have gained considerable assets under management using their own proprietary products. Still, supply remains relatively fragmented because of the nature of relationship management in the high net worth sector.

Gaining access to a broad high net worth audience will remain difficult for FOHF managers who are not associated with private client groups, at least in the near-term. Given the potential economic benefits, larger financial services firms are currently choosing to develop FOHF capabilities on their own rather than partnering with a third-party. As their internal manager teams are just evolving their skill set, these firms are relying on the fact that clients are not sophisticated enough to discern differences in quality.

There may exist some opportunities for forming strategic partnerships with smaller intermediaries or those serving slightly less affluent market segments. Smaller private banks and broker dealers may more readily recognize their inexperience and inability to construct quality products and be more attracted to outsourcing FOHF management.

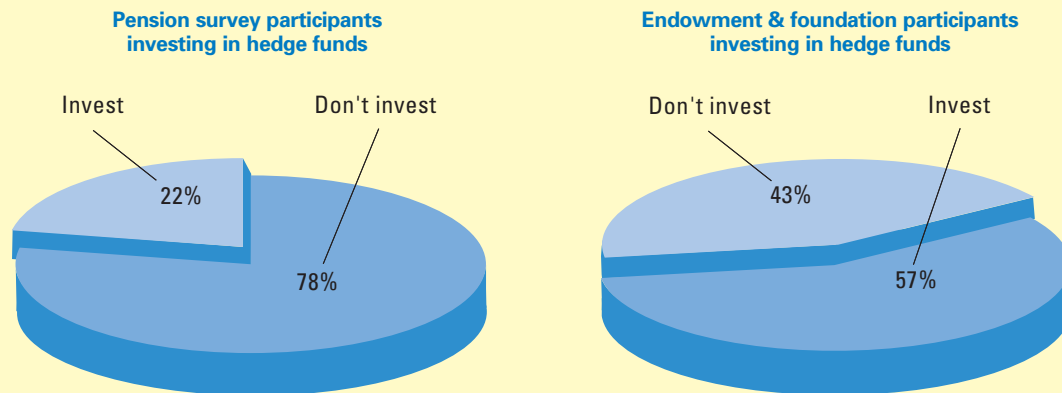
Unfortunately, serving these "smaller-ticket" markets in a cost-effective manner is challenging, especially after factoring in distribution fee stacking.

The U.S. institutional investor market is the second largest market segment with over \$15 billion in FOHF's. The pension, endowment and foundation, and insurance segments are considered individually.

Substantial media attention has been given to corporate and public pension plans' interest in hedge funds (e.g., Calpers and General Motors). Similarly, many FOHF business plans have been built on the promise of "suppose pension funds allocated just 1 percent of their assets to FOHF's...". Given the sophistication of these pension plans, many observers are surprised that the current demand for FOHF's is small in an absolute sense (about \$10 billion) and minute relative to overall assets of over \$5 trillion. Just how real is pension fund demand?

Among pension plans, we conclude that there has been more talk than action. As shown in Exhibit 3, just over 20% of the plans we surveyed (a sample biased towards larger and more sophisticated plans) currently invest in hedge

Exhibit 3: Institutional interest in hedge funds



SOURCE: Casey, Quirk & Acito FOHF market survey

funds. Many plans are still in the process of investigating hedge funds as an asset class or are only beginning to make the investment case to their investment committees.

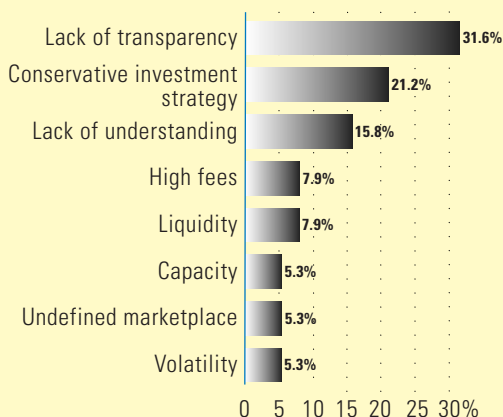
Pension plan demand for hedge funds is also very inconsistent. Over 75% of the surveyed plans without current allocations to hedge funds are not even considering future allocations. Among pension funds, there remains a significant reluctance to invest in hedge funds, despite interest in other alternative investments like private equity. This “fear factor” has several reasonable causes. Many pension fund directors feel there is a large amount of professional risk in possibly being associated with “the next Long Term Capital Management”—certainly not enough to balance the modest diversification benefits of a small allocation to hedge funds. Also, many hedge funds or FOHFs cannot meet plans’ standards for investment process. Finally, most plans lack the resources to credibly address this asset class. (Exhibit 4 summarizes pension plans’ concerns about hedge funds.)

As will be discussed in the next section, we believe that an emerging FOHF opportunity exists with institutional

investors, but tapping it will require a non-traditional business model. Keys to success must include a well-structured, transparent, and perceived repeatable investment process—well beyond the standards prevailing among most FOHFs today. Also, a well-resourced client service and marketing capabilities must be employed to work in a consultative manner with plan sponsors to help them fully understand the asset class.

Clear distribution channels to the institutional market are far from defined, making marketing efforts more opportunistic than systematic. Providers are currently using a variety of methods to reach buyers, including word-of-mouth, industry contacts, and references. Traditional systematic marketing to institutions has not been significantly used to date. (Over the last two years, as institutional assets have begun to flow into the hedge fund market, only a little over \$1 billion of demand appeared in traditional searches, leaving the remaining distribution to other approaches.) Few buyers indicated that investment process and skill are the best ways to gain broad-based

Exhibit 4 : **Primary investor concerns about investing in hedge funds**



SOURCE: Casey, Quirk & Acito FOHF market survey

NOTE: Includes both investors currently investing in hedge funds and those who do not.

recognition; rather, contacts, references, and networking seem to be the most prevalent methods of establishing a reputation.

The greatest FOHF opportunity will likely be with larger pension plans. While some plans believe they have the resources to directly make hedge funds investments most pension plans will recognize their inexperience and partner with a leading FOHF manager. Systematically serving the mid-sized pension plan market in a cost-effective way will be difficult, with access via consultants being the primary systematic channel.

In contrast to the pension market, endowments and foundations show a well-established culture and use for hedge funds. Over half of the endowments and foundations in our survey were already clients. This segment includes several prominent universities that have committed over 20% of their endowments to hedge funds. Typically, an investment committee that includes individuals with a sophisticated knowledge of capital markets drives the significant use of hedge funds.

For FOHFs, the endowment and foundation market is competitive. Several entities have chosen to develop the specialized resources to assess and monitor hedge funds and, therefore, to make direct investments. At a minimum, their sophistication makes endowments and foundations skeptical of the additional layer of fees introduced by FOHFs. Mid-sized endowments remain attractive new business development targets for FOHFs so long as their percentage allocations for hedge funds remains high.

Some large insurance companies are showing initial interest and appreciation for fund of hedge funds. Large insurance firms typically have a familiarity with hedge fund products. In addition, the fund of hedge funds is appealing to insurance firms because they often have neither the resources nor expertise to effectively construct and monitor a portfolio of individual managers. Yet, much like the

It is easy to overestimate institutional demand for FOHFs.

pension funds, even the largest firms are still simply investing with a “toe in the water” approach. Firms are placing small allocations using assets from their fund surpluses.

Though large firms are showing interest, the overall insurance market still displays an aversion to hedge fund investing. Insurance companies are typically highly conservative investors. Investment committees are still uncomfortable with the perceived risks involved; and hence, are not willing to put serious allocations into this asset class. Another factor is their industry’s regulation of equity-like investments.

The European and U.K. institutional markets have lately been showing an overall increased interest in alternative investments. This market, though smaller and generally less sophisticated than its U.S. counterpart, shares many of the same characteristics as a buyer segment. Therefore, though the market holds an opportunity for FOHFs, on an absolute basis, demand will remain moderate at best and highly fragmented between countries. Accessing this market will demand a broad-based marketing effort, including extensive education, while accounting for language and distance challenges and individual country demands.

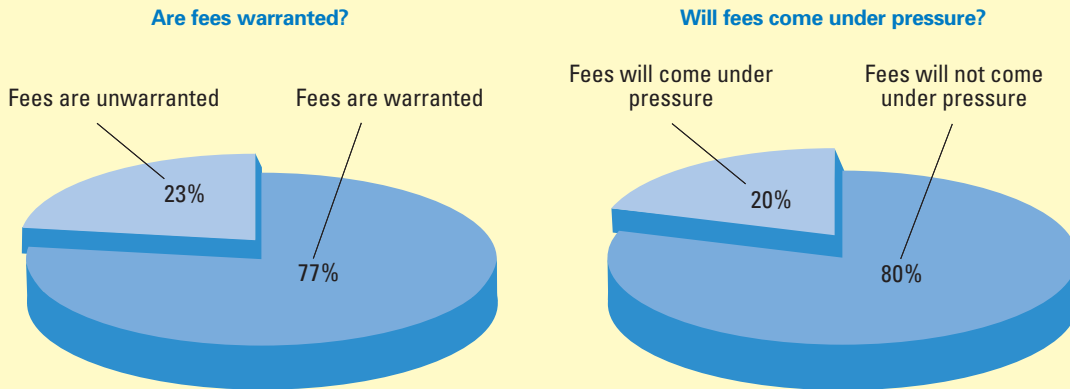
The European and U.K. high net worth market (estimated to be \$13 billion) is currently very limited to potential entrants, perhaps even to a greater extent than in the U.S. The largest private banks dominate the market, most have created some form of proprietary FOHF to offer to their clients. The strength of relationships and the private bank brand name are enough to satisfy clients without necessarily providing highest quality products. Partnerships are still rare, as banks find the strength of their relationships creates an immense barrier to independent fund of hedge funds providers. This may change as clients become more sophisticated and capacity is reached in proprietary products.

The Japanese market is a very interesting segment in terms of buyer demand and opportunity for FOHF providers. Demand for hedge funds is currently split between two major groups. Pension plans are showing little or no interest in hedge fund products. There is still a high aversion to any sort of risky investments, real or perceived. Many funds still lack the sophistication to fully appreciate the benefits of alternative investments, including hedge funds. This aversion to FOHF products may change if they are ultimately viewed as fixed income-like investments.

On the other hand, banks, brokers, and insurance companies are showing interest in hedge funds. These institutions are recognizing that the risk characteristics of hedge fund products, particularly the fund of hedge funds structure fit the demands of their risk-averse client base. Currently, investors are placing very little emphasis on returns, rather they are far more concerned with managers' ability to deliver the promised risk characteristics, with an emphasis on capital preservation.

Despite this interest in FOHFs, there are several considerable barriers to entry in this market. First, Japanese investors have perhaps the world's highest requirements in terms of client service. As an example, to become comfortable with hedge fund investing, these institutional investors require a high level of transparency that only few FOHFs can provide. Second, issues of distance and language will add further costs and complications. Third, access to the market is highly dependent on strategic partnerships, many of which are already firmly established. Access to buyers is controlled by a handful of key players (e.g. trust banks and securities firms) with whom partnerships will be difficult to build. Partnership fee structures favor key players so heavily that they erase a substantial component of the economic profits for FOHF managers. (Some arrangements are reported to take a majority of the management fee and 50% of the carry.) Fourth, there has been a strong historical pattern of turning over relationships, thus putting the FOHF at risk with its underlying managers. FOHF providers who are currently successful in Japan have invested several years of relationship building.

Exhibit 5: Investors' perceptions of fee structures



SOURCE: Casey, Quirk & Acito FOHF market survey

PROSPECTS FOR FUTURE GROWTH

At least three compelling reasons lead us to believe that hedge fund demand will continue to grow steadily and that FOHFs will match and likely exceed this pace:

- Alternative investments are becoming mainstream. While difficult to define exactly, we believe that alternative investments are characterized by low correlation to traditional market indices, an absolute-return orientation, often including less liquid securities, and a carried interest in performance. Such strategies are becoming increasingly popular as investors adopt more core-and-satellite asset allocation; hedge funds and FOHFs are well-suited to this investing paradigm.
- The return environment. The recent poor performance of both traditional equity and fixed income markets (and the prospect of a continued lower return environment) highlights the appeal of absolute return and risk-controlled strategies.

- The fund of funds structure is sensible. As the market becomes more sophisticated about hedge fund investing, it is likely to be more aware of its challenges. Investors will appreciate the specialized skills offered by FOHFs, including due diligence, portfolio construction, and risk management.

Considering each of these factors, it is reasonable to believe that the FOHF market can generate annual growth rates of 20% for the next two to three years, barring any market or hedge fund catastrophe. Clearly, this rate may be higher in Europe and Japan where the current base of assets under management is low. After this period, growth rates may decrease significantly as capacity constraints reduce aggregate demand and net returns.

Growth is not likely to come at the cost of management fees. Our survey finds that nearly 80% of FOHF investors believed their fees were warranted and were unlikely to come under pressure in the near future. (Exhibit 5 presents these statistics.) We believe fees will remain steady because, despite growth in the FOHF market, demand will continue to outpace high quality hedge fund capacity.

LIMITS TO GROWTH

How big can the hedge fund market get? We have seen projections of \$1.5 trillion or more in hedge funds within the next five to ten years. This projection is easy to generate using combinations of market appreciation, a shift in percentage of institutional investor allocations, and continued growth of the high net worth sector.

We are not persuaded to agree with these growth numbers. The continued flood of money will have two important effects. First, it may suppress returns as market inefficiencies become more fully exploited. Many investment strategies appear to be already reaching such capacity constraints. Second, the market will likely contain greater risks because managers will be tempted to boost their leverage to maintain target returns, and lower quality managers will continue to enter the market due to the low barriers of entry. Reduced returns and increased risk will potentially dampen future demand.

Continued growth will also affect FOHF managers. To maintain their own returns while continuing to increase capacity, FOHFs must increasingly expand their coverage of managers. As illustrated in Exhibit 6, we call this the “T-effect.” (Its depiction resembles an architect’s t-square or inverted letter “T”.) Within each investment strategy, to gain additional capacity, FOHFs must increase the number of firms they assess and monitor. Finding quality capacity will become increasingly challenging. To preserve returns and find capacity, FOHF managers will also be compelled to review a broader range of investment strategies.

To FOHF managers, these changes are both a blessing and a curse. As the hedge fund market becomes more complex, the value added by FOHF providers will be more evident. The challenge is that FOHF providers will need greater resources, both for manager selection and risk management. The resulting changes in FOHF business models are addressed in the next chapter.

3. A maturing market

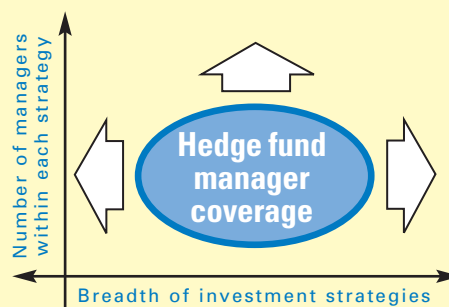
The previous chapter described two important trends influencing the FOHF industry: clients (both retail and institutional) are becoming increasingly sophisticated about hedge fund investing, which in turn is becoming more demanding (the T-effect). The confluence of these trends will drive a rapid maturation of the industry. This chapter describes this transition and the resultant successful business model.

CURRENT STATE

To date, the client demands placed upon FOHF managers have been relatively minimal. For example, very little formal marketing has been required to secure clients as referrals and existing financial services relationships have dominated new business development. (Exhibit 7 describes what our survey participants believe to be the primary sources of FOHF new business.) Also, client service activities are fairly minimal, with the majority of client interaction handled by the intermediating broker or sales person.

There has also been relatively little demand for FOHF managers to have a rigorous investment process. To illustrate which elements of investment process have been valued, it is helpful to consider the FOHF value chain, illustrated in Exhibit 8. From an investment standpoint, five primary FOHF activities deliver value.

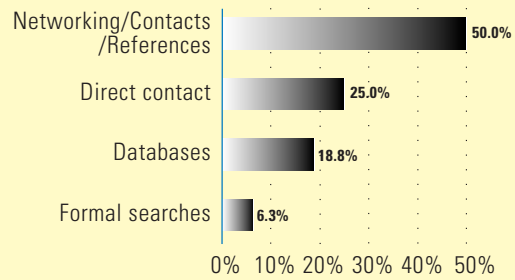
Exhibit 6: The “T-effect”



SOURCE: Casey, Quirk & Acito

- **Sourcing/screening:** This activity involves identifying a relatively focused list of qualified hedge funds from the total universe of some 6,000 managers. Leading FOHF managers must have a disciplined process for sourcing and screening new investment ideas. This activity requires extensive industry contacts, and a well resourced research effort just to process all of the opportunities. As a reference, consider that the typical institutional consulting firm meets with approximately one thousand firms per year.
- **Due diligence:** This process involves conducting in-depth analysis of hedge fund managers identified in the screening process. During this step, FOHF managers must evaluate all aspects of the individual firms, including the effectiveness of strategy, strength of investment process, soundness of operations, quality of investment professionals, and durability of business management.
- **Placement:** This step speaks directly to the ability of fund of hedge funds managers to place capital with desirable managers. As a manager’s capacity is often limited, buyers see value in FOHFs that can offer access to funds that might be otherwise unavailable to them.
- **Portfolio construction:** Portfolio construction involves actively balancing the FOHF portfolio to meet client requirements in terms of expected return and risk exposure. Done well, this results in diversification and, pos-

Exhibit 7: Primary method of sourcing fund of funds managers



SOURCE: Casey, Quirk & Acito FOHF market survey

sibly, increased alpha by utilizing various investment strategies.

- **Ongoing monitoring:** The part of the investment process entails providing risk control and monitoring of all underlying managers in the fund. FOHF managers must ensure that managers are staying within their product goals, strategies, and most importantly, skill sets.

To date, much of the perceived value of FOHF managers has been with sourcing/screening and with placement. That is to say, investors have counted on FOHF managers to identify and place money with attractive managers. Portfolio management has meant little more than diversification and monitoring little more than qualitative ongoing feedback.

Exhibit 8: Fund of hedge funds value chain



To summarize, in view of limited marketing and client service capabilities and underdeveloped investment processes, the current FOHF industry can fairly be described as “immature.” Confidence in the FOHF manager has been driven as much by persona and perceived professionalism as by demonstrated technical capabilities. In many regards, the FOHF market has the characteristics of the long-only money management industry in the 1970s and early 1980s.

With relatively unsophisticated clients, this business model has persisted. It has also been profitable because the resources that are required to support these activities have been fairly minimal.

THE COMPLETE FOHF

A new FOHF business model has been emerging over the last few years that will evolve into prominence. The strength of this model is that it fits all the criteria of a “complete” firm: balanced excellence in investment manu-

The complete FOHF will require broad and deep resources.

facturing, distribution, including both marketing and client service, and business management. (For a full description of the complete firm, please see Casey, Quirk & Acito’s June 2000 report *Success in Investment Management: Building and Managing the Complete Firm*.) Some may prefer to call it the “institutionalization of FOHFs” because the professional standards more directly apply to the institutional segments; these standards, however, are applicable to and will ultimately be demanded by the high net worth market as well.

With regard to investment process, complete FOHFs have equally robust processes for portfolio construction

and risk management as they do for identifying good managers and placing assets. In particular, risk management is emerging as the most distinguishing capability for sophisticated FOHF clients. Leading risk management capabilities have begun to include daily security-level analysis of each individual manager and the aggregate position of the entire FOHF. This analysis includes not only an integration of leading risk management packages but also proprietary modeling and data collection. To support the transparency required for superior risk management, extensive use of separate accounts is becoming essential.

With regard to distribution, FOHFs are beginning to recognize the need to dedicate resources to these specialized activities. Penetration of the emerging institutional demand for hedge funds will require FOHF managers to work extensively with and provide ongoing education to a sponsor’s investment professionals. Supporting alliances with high net worth distributors will also require such intensive interaction. Complete FOHF firms will transform themselves from opportunistic networkers to systematic marketers.

The future resource requirements of the complete FOHF are therefore significant. With regard to investment process, specialized teams must be dedicated to both the ongoing monitoring of investments and to manager evaluation. The scope of both activities will continue to expand, as the T-effect requires attention to an ever-increasing number of managers and investment strategies. Marketing and client service will each require dedicated resources. To effectively compete, it will not be uncommon for complete FOHFs to have fifty or more employees—a substantial increase from today’s staffing levels.

4. Future consolidation

We predict that the future belongs to complete FOHFs, both in the institutional and retail markets. What will turn the market in their favor? What will the resultant market structure look like?

FORCES DRIVING CONSOLIDATION

Three primary factors should drive demand towards complete FOHFs and away from under-resourced managers.

- **Increased sophistication.** As institutional investors become more involved with the hedge fund asset class, they will be significantly more inclined to work with complete FOHFs. The more fully resourced FOHFs will be better able to meet the professional and process standards of this client segment. High net worth investors will also soon discern between the quality of FOHFs. Most very affluent individuals have financial services relationships with more than one institution. Enterprising bankers will soon learn to differentiate their firm's depth of resources from those of weaker competitors.
- **Capacity constraints.** Given capacity limits in their underlying hedge funds, FOHFs must have extensive reach to effectively place the continued flow of assets. Only complete FOHFs will have the resources to address the T-effect, covering an increasing breadth of strategies and larger number of hedge funds.
- **Superior performance.** To capture market share, the complete FOHFs ultimately must generate results for their clients. Here, they have at least three advantages. First, greater resources devoted to manager screening and due diligence will likely increase the average quality of the managers in their portfolio. Second, advanced

portfolio construction capabilities can deliver not only absolute returns, but also excellent risk-adjusted performance and reduced correlation with traditional market indices. We believe that these two portfolio characteristics will receive greater attention in future. Finally, over the longer-run, investment in risk management technology will significantly reduce the probability that a manager will be exposed to severe performance events.

SCALE AND MARKET SHARE

Clearly, if leading FOHFs require substantially more people and bigger investments in technology, the minimum number of assets under management to be financially viable will be substantially higher than it is today. Rough estimates are that this minimum threshold for complete FOHFs may be over \$1 billion, relative to the \$50 million to \$200 million required for simpler FOHF business models. If one factors in salary escalation (a likely scenario given the scarcity of investment professionals with FOHF experience) and any reduction in average fees, this break-even point rises even higher.

Over the next several years, we would expect to see the global league tables dominated fifteen to twenty leading FOHF providers. These managers are likely to oversee between \$4 billion and \$8 billion in assets under management. Given the current market size and projected growth, this group is likely to have over 60 percent market share—greater consolidation than exists today. To reach this point, these large players must capture the lion's share of new money flowing to FOHFs.

This consolidation has significant implications for would-be market entrants. Starting with little or no FOHF operations today, it will be very difficult to organically build a complete FOHF capability. Therefore, financial services firms without current capabilities but with substantial FOHF aspirations must entertain either an acquisition or

strategic alliance. The past year has seen several FOHF purchases (e.g., Ivy, Tremont) and more are likely to follow. To date, alliances have been difficult to structure, either due to fee-sharing issues or to would-be distributors developing an interest to build a FOHF capability on their own. Going forward, the scale requirements of a complete FOHF should make alliances more likely, perhaps using partial equity ownership to align interests.

As a final clarification, we do not believe that more modest FOHF business models will not be successful. Quite the opposite, smaller firms can be quite profitable for their principals. However, these more modest firms will be

Acquisitions of or alliances with FOHFs will increase.

under enormous competitive pressure from the larger FOHFs. They will face questions about the depth of their resources and vulnerability to loss of one or two key individuals. Success will hinge upon either outstanding performance or an intensely loyal set of client relationships.

CANDIDATES FOR SUCCESS

Who are the FOHFs most likely to achieve complete firm status and capture significant market share?

Several existing independent FOHFs are likely to make the cut. Many of these firms have already accumulated substantial scale in personnel and in assets under management. Their business plans anticipate the need for more “institutional” quality investment processes. In addition, the ability to offer key employees an equity stake in the company stabilizes the franchise and attracts scarce experienced professionals. The primary challenge to these firms is building a strong distribution capability, one that can work in a consultative manner with clients.

Probable candidates are also to be found among the largest global financial services organizations. Many have already created reasonably substantial FOHF operations. These organizations have several inherent advantages (of varying importance), including:

- Extensive high net worth and institutional investor relationships
- Prime brokerage activities, a good source of hedge fund market intelligence, including identification of new managers
- Brand recognition, to partially comfort reluctant investors in this asset class
- Capital to invest in building FOHF capabilities and seeding new funds
- Advanced risk management skills, which can be imported from capital markets divisions
- Global reach in many of the above capabilities

These larger financial services firms, however, face two significant hurdles. First, as with many new initiatives, will a FOHF capability get the managerial attention required to support its growth and drive synergies with the broader organization? Second, attracting and keeping leading talent without a direct equity stake in the FOHF business may be difficult. This second factor puts the larger financial services firms at a disadvantage to independent FOHFs.

Industry players facing greater challenges in becoming part of the FOHF leadership include:

- **Institutional investment consultants.** The consulting community's existing relationships, particularly with pension plans, provide them with an outstanding opportunity to educate and guide major market segments in hedge fund investing. However, unless consultants are capable of building a strong investment platform and are willing to adopt market standards for pricing (including incentive fees) they will not be able to retain the talent necessary for success.
- **Traditional money managers.** Like consultants, "long-only" managers have an existing base of relationships that can be potentially be leveraged to introduce hedge funds and FOHFs. However, the skills required to run FOHFs are currently not resident in most traditional money management firms. These skills are difficult to build organically, leaving acquisition (e.g., Oppenheimer Funds—Tremont) as the more viable strategy.
- **Smaller financial services firms.** Regional brokers and smaller private banks are unlikely to internally generate the asset flows required to back a complete FOHF capability. These firms, however, may be attractive alliance partners.

5. Conclusion

As an asset class, hedge funds (along with other alternative investments) will continue to be attractive to both high net worth individuals and, increasingly, to institutions. Given the potential challenges with hedge fund investing (such as decreasing returns, and larger numbers of marginal quality managers) FOHFs make for an appropriate vehicle for both of these segments. These challenges will require more robust FOHF investment processes. In addition, gaining market share will require marketing and client

Assets will consolidate with complete FOHFs.

service capabilities focused on educating clients, not just selling to them. Enhancing both the distribution and manufacturing elements of FOHF management will require significantly more resources than are currently employed. As a result, assets under management will consolidate with complete FOHF providers, though smaller quality firms can also build very profitable businesses.



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