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Whitepaper

The Anatomy of a Hedge Fund

Hedge Fund Fees and Expenses Explained.

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DID YOU KNOW

Hedge Funds Offer Diversification

Hedge funds are typically characterized by their flexibility and ability to employ a wide range of investment strategies. Unlike traditional mutual funds, which are often bound by regulatory restrictions on how they can invest, hedge funds have more freedom to pursue various strategies to generate returns. Some common hedge fund strategies include long-short equity, global macro, event-driven, and quantitative trading.

Deconstructing the Business of Hedge Funds

Many bright, well-educated young professionals dream of breaking into the hedge fund industry. This is often driven by expectations of compensation, the glamorous media portrayal in shows like *Billions*, or the desire to work in a field that competes at the highest level on a global scale. Many that want to break into the industry know very little about the mechanics of the business. In this piece, we'll deconstruct the business of hedge funds.

Fee Structures - How Hedge Funds Make Money

The first step is to better understand how hedge funds make money: a combination of fees paid on assets under management, as well as fees paid on performance. The former is industry practice across asset management. Go to a mom-and-pop retirement advisor, and you will often find a fee structure that's tied to the assets they are stewarding on behalf of their clients. Just like the mom and pop, hedge funds need to raise assets to grow their business. While their clients differ due to regulatory restrictions (the so called 'Qualified Purchaser' rule), hedge funds really differ through a performance incentive.

This is revenue tied to the performance of the fund. The idea is to drive an incentive for outperformance and to solidify alignment between the principal (the qualified investor which often takes the form of an endowment, foundation, or pension), and its agent (the fund). Pay for performance pushes the hedge fund to deliver superior results. This is a key differentiator with other fund managers such as mutual funds. Hedge funds are designed to provide asymmetric return profiles, geared towards alpha versus now commoditized and near-free beta.

The classic fee structure for a hedge fund is 2% of assets under management paid per annum as a base-level management fee and 20% of the profits generated, paid as an incentive fee. Sounds simple enough. How did this come about? From what we can tell, rather serendipitously. This fee structure has its roots dating back to one of the first fundamental long/short equity funds, AW Jones. As a lesson in the importance of initial conditions, that fee structure held for quite some time!

1.35%

DECLINE IN HEDGE FUND
MANAGEMENT FEES

16%

DECLINE IN HEDGE FUND
INCENTIVE FEES

DID YOU KNOW

HF Fees Are Declining

Over the past decade, average hedge fund fees have declined by to an estimated 1.35% management fee and 16% incentive fee. These are the lowest levels since the 2008 financial crisis.

Not Quite Two and Twenty

That's not to say there haven't been changes with fees, or that all hedge funds charge 2 and 20. Some hedge funds charge more than that, either in base fees, or in performance. There is understandably a supply and demand dynamic in the market for purchasing hedge fund services, especially when a strategy is capacity constrained and has a track record of exceptional performance. However, in the last decade or so, there has been a trend toward fee compression. 2 and 20 has turned into something closer to 1.5 and 15. Prominent allocators have called for an entire rethink of the fee model (e.g., the 1 or 30 promoted by Albourne, a consultant, and Teacher Retirement System of Texas, a prominent pension). In a follow-on piece, we'll decompose fee trends and fees across strategies with greater fidelity.

Nuances in Fees

Fees within a fund can differ, often segregated by share classes. Just as mutual funds may have different share classes (e.g., share class A vs I) with different fee structures, hedge funds often do the same. Share classes often differ on the dimension of "lockup" (e.g., a 1-year commitment of capital vs a 2-year commitment). Finally, certain institutional allocators with heft often negotiate what is called a "side letter" agreement, where they carve out special considerations regarding liquidity, fees, and transparency. Those often come with either a hefty capital commitment or come part and parcel with winning a venerable allocator. Such allocators' commitments allow the fund to signal to the marketplace (often discreetly) the quality of their investor base.

Just as differing share classes come with different fee levels, performance fees are not all the same. Some come with conditions that shift the favorability either in the direction of the limited partner (LP) or the general partner (GP). These conditions address certain principal /agent issues that arise with performance fees. For one, allocators have become sensitive to "heads I win / tails you lose" dynamics associated with hedge fund fees.

\$3.25T

THE SIZE OF THE GLOBAL
HEDGE FUND INDUSTRY IS
NEARLY AS OF 2023

Clawbacks and The Like

For example, if a fund generates superlative performance by engaging in a risky strategy, collecting an outsized performance fee in a single year, allocators want to ensure that those fees earned can't be squirreled away if that risk strategy leads to poor performance in the following year. This often happens when market condition sours or if the strategy falls out of favor. As a result, performance fees can be tied to clawback provisions, which mean that incentive fees paid out in Year 1 are subject to reversal if the fund suffers in Year 2. While claw backs aren't universal, the concept of a high water mark is far more prevalent, where individual shares or tranches of capital pay differing amounts of performance fees given that their time series of returns may differ depending on when their capital commitments were made.

Take a fund that returns +10% in period 1, -10% in period 2, and +10% in period 3. A day-one investor will have a different 'high water mark', associated with their starting level of capital, than a period 2 investor, and so on. As such, the high water mark is calculated for each investor. And so, performance fees can vary depending on the investor and the timing of their investment.

It's important to note that a period of challenging performance for a fund can put a substantial percentage of the assets under management below its high water mark. This puts strain on the operating business, as many funds pay out staff bonuses as a direct function of performance fees. This was a notable problem after the global financial crisis, where many funds faced exogenous shocks which stressed performance, leading to business instability with retaining talented staff. This can hamper a fund's ability to profit from dislocations during an ensuing recovery. Fund managers need to be cautious, balancing the need to compensate staff that drive alpha generation, with the stability of the business.

Basic Budgeting

Let's take an example of a long/short equity Fund X with \$500 million of assets under management. This is a pretty healthy asset level for the strategy, generating ~\$7.5 million above the line revenue simply from the base management fee (remember: 1.5 and 15 is the new 2 and 20!). Inclusive of cash management revenues which have become more meaningful as of late, this revenue stream can support the full function of the investment team.

For posterity, let's assume there is one CIO with the name on the door, a lieutenant portfolio manager, and 2 analysts. For operations there is a combined CFO/COO/CCO, for trading/execution a junior trader. Let's also assume a risk officer, and a junior data analyst focused on alternative data processing / minor data science. Finally, a business development professional and two people serving as administrative staff. Let's peg an average base-salary of \$250,000 per person across this organization of ~10 individuals. Factoring in benefits and taxes, salaried compensation can run about \$3-4 million for a typical organization of this size.

Then there is office space. Let's assume this firm is based in midtown Manhattan, probably paying anywhere from \$75 (value) to \$120+ (prestige) per square foot for office space. Funds want a presentable conference room, a location amenable to the various staff members that may live in various suburbs, as well as a "Class A" office environment for these elite workers. Let's assume the square footage requirement is between 3,000 – 5,000 square feet. Then there is commensurate insurance, technology, administrative, janitorial, and miscellaneous expenses. Let's put all of this at close to \$750,000 per year, on a multi-year contract.

Technology and data are becoming a meaningful driver of expense for all funds. For a fundamental firm, let's peg a Bloomberg for each investment, trading, and risk professional, an administrator for the onshore and offshore funds, an order management system (OMS) / portfolio management system to ensure compliant trade execution and risk governance, and some form of risk or attribution analytical software. Next, there are alternative data sources, expert intelligence interviews or databases, risk factor models, data rooms, and outsourced consultants.

Let's peg this at \$1 million in total, the lion's share going to the administrator, a requisite in today's modern institutional ecosystem. This firm also engages in travel for scuttlebutt research and has ancillary expenses around servicing clients. It also subscribes to two institutional research offerings. Let's generously peg that at \$250,000. Legal counsel maintains a retainer and may be involved to varying degrees depending on the type of strategy or needs of a firm. Most firms that work with institutional clients will also have outsourced compliance consulting to ensure they are dotting their compliance i's and crossing their t's. Let's also peg this at \$250,000 per year. This puts our total expenses at \$5 – 6 million. This leaves some wiggle room for bonuses – which often drives far more of the percentage of compensation for investment professionals – but not a whole lot given compensation expectations for elite knowledge workers!

Nuances in Budgeting

There is some nuance with certain expense line items. Not all expenses are borne solely through the revenue generated by management fees. Expenses that would otherwise be paid for brokerage related services can be “soft dollar.” This is a practice where brokerage commissions pay for some ancillary services provided by trading counter-parties. This includes investment research, certain technologies, and market data access.

Here’s how it works: Let’s assume Fund X trades anywhere from 5-10 million shares per year. In addition, let’s assume their average long and short exposure is 120 / 80 for the year, meaning they are accessing on average \$100 million of portfolio margin and \$80 million of short borrow.

Expenses associated with this portfolio activity could be simply routed to lowest cost counter-parties. In actuality, it is often selectively chosen across counter-parties that provide access to ancillary services (as mentioned above), in exchange for winning that business. Given there is a “perceived” conflict associated with this, the activity is disclosed by the General Partner to Limited Partners.

The “conflict” isn’t straightforward, as the ancillary benefits aims to drive a more performative fund, with the goal of deliver superior returns for the LPs. Funds, just follow different jurisdictional rules, specifically in Europe given a regulation called MIFID.



Navigating the Ups and Downs

Let’s assume our Fund X has a 10% return in a particular calendar year. That \$50 million of profit entitles it to \$7.5 million in incentive fees (15% of profits). Setting aside the risk management around clawbacks, that money can be used to pay bonuses to investment professionals that drove that profit, as well as retaining the earnings into the General Partnership.

The real challenge for funds before they achieve significant scale is managing the ratio between stable revenues, expenses which maintain competitive edge, and the inevitable variability of incentive income.

Revenues are never airtight unless the firm has unusually long lock-ups, so there is a delicate balancing act between managing expenses, retaining talent that erstwhile can command high salaries, while delivering performance, which makes the entire machine hum!

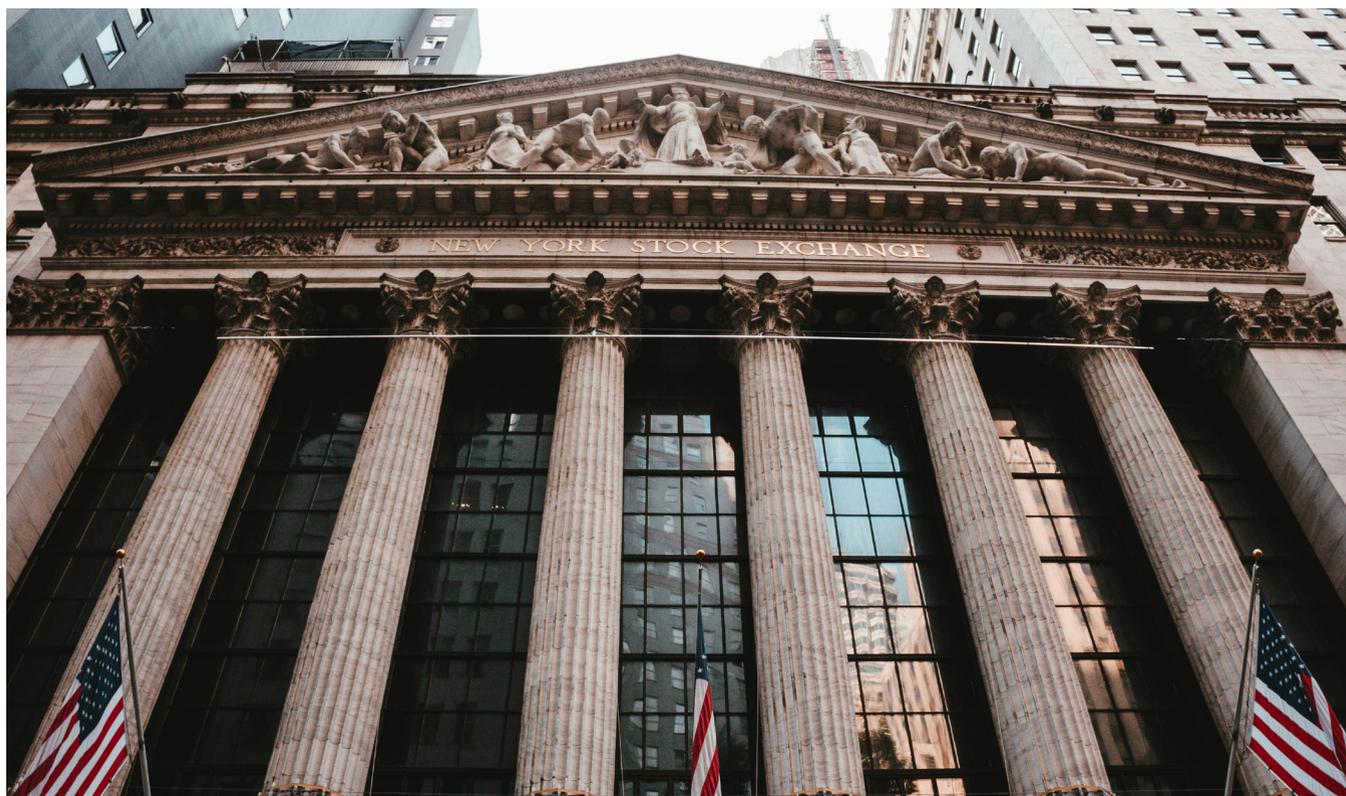
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Conclusion

The business of hedge funds is a balancing act: maintaining strong relationships with LPs that reinforce the capital base, developing a performance-oriented investment team with the necessary resources to deliver results, and structuring expenses in such a way that balances resilience with the reality of market pressures. This can be a hard balancing act, but the best fund managers find a way of balancing strong client relationships with relentless focus on performance.

Some of the world's best analysts use Daloopa models to help them get up to speed on companies quicker, with cleaner and more auditable data. We are a common "expense" within the business architecture of fund management. While our business focus isn't on the inner mechanics of hedge funds, our goal is to be partners with the analyst community as they get acclimated to the mysterious world of hedge funds. In future reports, we'll tackle the nuances across different strategies, regulatory requirements attached to SEC regulated private partnerships, as well as tips for breaking into the industry. Stay tuned!



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