A Greater Focus on Fund & Management Company Expenses in Alternative Asset Management

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Introduction

Operating Expense Ratios[1] in hedge and private equity Funds are often an area of focus for new investors, existing investors, portfolio managers and Fund regulators. Pressure on management fees, greater levels of regulation and increased investor demands for more timely and relevant reporting have all increased the cost of doing business and reduced manager margins and Fund returns. As a result, all parties are applying greater scrutiny to operating expenses across Management Companies and Funds and how these expenses are allocated. The deeper inspection of expenses in Funds of similar size and strategy has revealed important information about the manager's investment and infrastructure practices. This has facilitated improvements in the control environment, lower Management Company and Fund costs and contributed to a more robust dialogue around maximizing returns.

The Current State of Gray

Fund strategy classifications[2] enable managers and investors to compare the gross and net performance returns of Funds with similar investment strategies. However, little information has been made available to help managers and investors in similar funds compare, understand and evaluate the operating practices and expenses that impact their Management Company and Funds. A cursory inspection of Fund operating expense ratios may lead one to incorrectly conclude that lower ratios compared to Funds of similar size and strategy are "better" while higher ratios may be considered "worse." And, of course, in many cases a Fund's operating expense ratio may carry even less weight in the manager selection process when the Fund's net performance return exceeds its peers. All of these cursory observations are just that, and may lead to grossly incorrect conclusions about how efficiently a Fund is managed. More insight is needed.

In addition to the operating expenses borne by Funds, recent studies[3] indicate that the cost borne by the Management Company for non-investment functions continues to grow annually at double-digit rates. This spending ballooned to $14bn in 2012, or roughly 65 basis points on industry AUM. Similar to the lack of comparative fund expense ratio data, no comparative data existed to enable managers to assess the effectiveness and efficiency of their Management Company's operating practices. And, it is important to note that expense allocations can also vary within Funds of similar size and strategy. For example, one fund's documents can require that an expense be paid by the manager (and funded via the management fee)

[1] Operating Expense Ratios are defined as expenses paid by a Fund's limited partners excluding management, incentive, transaction and other fees paid to the manager for investment advice, interest expense and trading costs.
[2] Hedge Fund Strategy classifications are provided by firms like Hedge Fund Research & Morningstar.
[3] 2012 Hedge Fund Business Expense Survey, "Industry-Wide Benchmarks for Managing Hedge Fund Organizations," Citi Prime Finance

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while in another Fund its documents allow the same expense to be paid from its net assets. This lack of comparative data and natural differences created by different allocations all contribute to today's current state of gray.

Clarity is Slowly Emerging

The growth of infrastructure expenses across Management Companies and Funds and the potential for different expense allocations suggests that the manager, investor and regulator needs to take a more holistic, end-to-end view of total operating expenses to fully understand the total cost of supporting the business, regardless of which entity pays. Some managers have begun to do this and are using data available from Convergence to benchmark their operations and develop plans to drive continuous improvement.

In Table 1 Convergence research points to 7 key areas and a variety of "causal factors" within them that can help explain why Management Company and Fund operating expenses can differ across managers of similar size and strategy. It can also help to demonstrate how these types of differences may often be misinterpreted:

Table 1:

Aspect of the Manager's Business Practice that can Influence a Fund's Expense Ratio	Fund Expense Ratios Above/Below Benchmarks Key Drivers & Factors
1. Non-Investment Infrastructure	- Process maturity and standardization, internal scale and the use of technology
	- Investment in control environment and monitoring of service providers
2. Investment Process	- Complexity of the fund assets traded and trading strategies
	- Trading volume, counterparties, use of leverage and liquidity constraints
3. 3rd Party Service Providers	- Number of Administrators, Prime Brokers, Custodians and Technology providers
	- Pricing power based on relationship with providers
	- Amount of work that can be outsourced to third party service providers
4. Fund Documents	- Expense language in fund documents and vintage of funds
5. Expense Policies	- Specific policies and procedures and governance of fund expenses
6. Investor Requirements	- Frequency, content and complexity of investor reporting
7. Company Culture	- Expectations governing quality and reputational risk
	- Expectations on availability and accessibility of infrastructure staff

Convergence conducted independent research on 175 of the largest 200 Hedge Fund Managers[4] and identified significant differences in the number of infrastructure staff supporting similar levels of AUM across all strategies cited. The reasons for such differences raise important questions that when answered may help managers improve efficiency and reduce Fund and Management Company expense.

Table 2 shows the infrastructure headcount (referred to as non-Investment Professionals-NIP) for hedge fund debt managers grouped by AUM levels. Note the significant differences between the minimum, maximum and mean for the three headcount benchmarks for debt managers in the 10-25bn of AUM size group. The magnitude of these differences suggests there are significant opportunities to understand what drives these differences and apply that knowledge to potentially improve efficiency and reduce the costs in their Management Companies. Compare this to debt managers with greater than 25bn in AUM. The

[4] Hedge Fund Alert , April 17, 2013, "Top 200 Hedge Fund Managers"

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differences between the min/max/mean are much smaller suggesting a business process maturity level that creates more similarities among this group than all others.

Table 2: Convergence Headcount Profile for the Top 200 Hedge Fund Debt Managers

		Total FTE	IP	NIP	FTE/BNAUM	NIP/BN	NIP/IP
All Debt Managers	Min	12	6	6	0.57	0.26	0.45
All Debt Managers	Max	626	230	396	34.25	22.16	4.78
All Debt Managers	Mean	102	40	61	7.70	4.46	1.46
>25bn	Min	349	132	217	5.56	3.34	1.51
10-25bn	**Min**	**12**	**6**	**6**	**0.57**	**0.26**	**0.86**
5-10bn	Min	14	7	6	2.11	0.97	0.45
0-5bn	Min	31	12	17	6.76	4.14	0.55
>25bn	Max	634	253	396	9.34	5.81	1.72
10-25bn	**Max**	**246**	**91**	**155**	**14.52**	**9.81**	**4.78**
5-10bn	Max	156	50	106	20.36	13.83	2.12
0-5bn	Max	170	60	110	34.25	22.16	1.83
>25bn	Mean	536	205	331	7.70	4.78	1.62
10-25bn	**Mean**	**96**	**37**	**59**	**6.11**	**3.75**	**1.67**
5-10bn	Mean	57	26	30	7.72	4.10	1.11
0-5bn	Mean	83	34	49	18.06	10.32	1.32

1. Total FTE refers to the number of staff reported by the manager
2. IP refers to "Investment Professional"
3. NIP refers to "non-Investment Professionals"
4. FTE/BNAUM refers to the number of total manager staff per billion of AUM
5. NIP/BN refers to the number of non-Investment Professionals per Billion of AUM
6. NIP/IP refers to the ratio of non-Investment Professionals for each Investment Professional

Operating Expenses Matter and Can Be Rationalized

Fund expense ratios[5] in Funds managed by traditional asset managers[6] have long been central to the debate and decision on whether it is better to invest with an active or passive asset manager. The passive managers argue that, over long periods of time, active managers cannot overcome the performance drag created by the compounding effect of Fund expenses. Yet, in the alternative investment world it has long been accepted that Fund operating expense ratios are so idiosyncratic to the practices of the manager and vary so widely that analyzing them creates more work than value. We believe this long held view is changing. Managers and investors want to improve their efficiency and effectiveness and can now do so with better insight with the advent of information now available through Convergence.

[5] Defined as total expenses paid for by the limited partners in a Fund.

[6] Traditional asset managers are defined as managers of public Mutual Funds and Long-Only Accounts.

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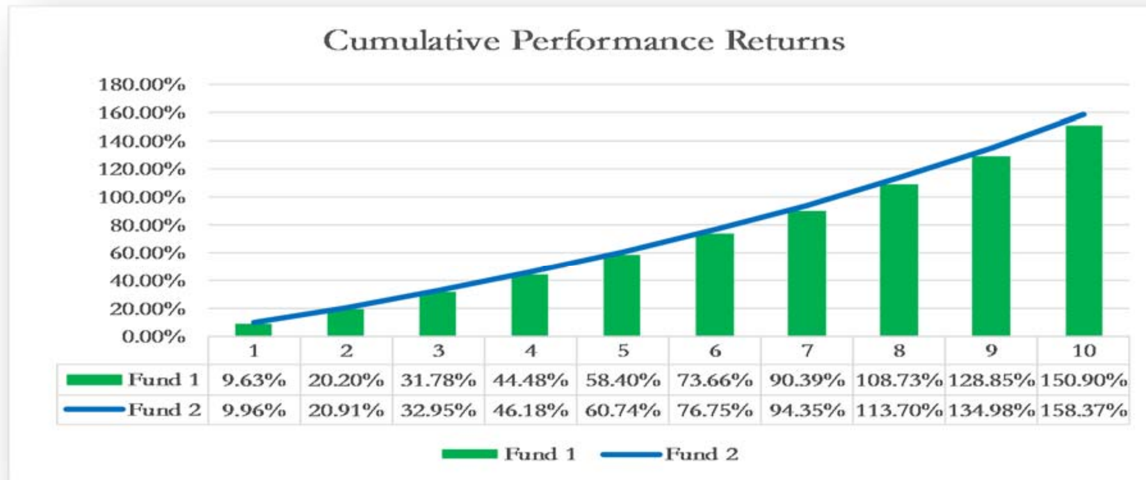
Chart 1 shows the impact of different operating expense ratios on the cumulative performance of two identical 2 & 20[7] Funds generating 15% gross annual performance returns over a 10 year investment period. In Fund 1 the Operating Expense ratio is 75 basis points on AUM while in Fund 2 it is 37.5 basis points. Fund 2 generates a return of 158.7% on the investors' investment versus 150.9% for investors in Fund 1.

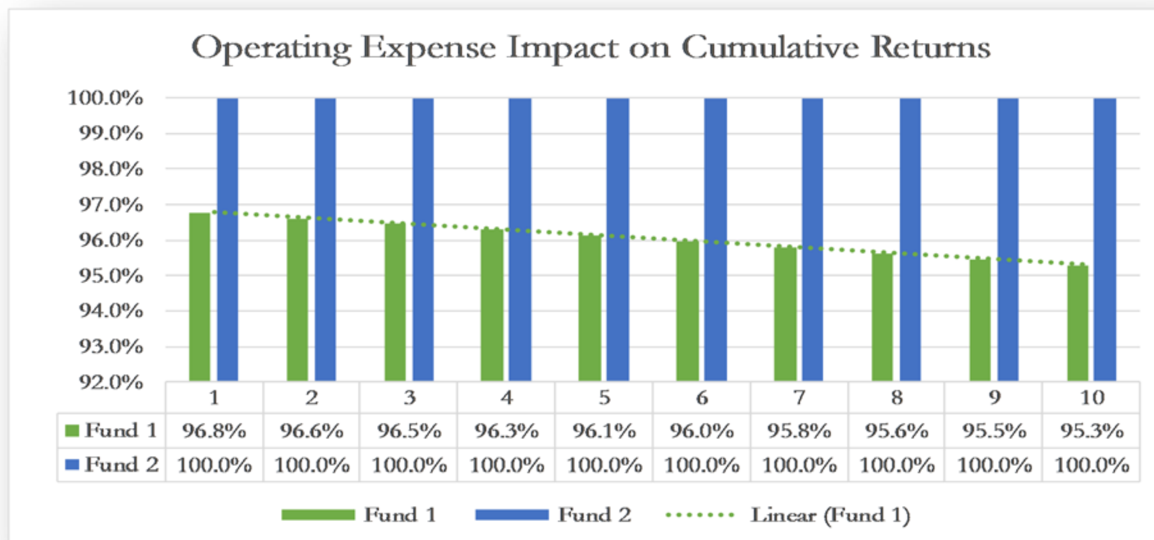
Chart 1:



	1	2	3	4	5	6	7	8	9	10
Fund 1	9.63%	20.20%	31.78%	44.48%	58.40%	73.66%	90.39%	108.73%	128.85%	150.90%
Fund 2	9.96%	20.91%	32.95%	46.18%	60.74%	76.75%	94.35%	113.70%	134.98%	158.37%

Chart 2 shows the impact on returns of different expense ratios, compounded over a 10 years. Fund 1 will only generate 95.4% of the return generated by Fund 2.[8]

Chart 2:



	1	2	3	4	5	6	7	8	9	10
Fund 1	96.8%	96.6%	96.5%	96.3%	96.1%	96.0%	95.8%	95.6%	95.5%	95.3%
Fund 2	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

[7] Refers to 2% management fee and 20% incentive fee paid to the manager
[8] The Operating Expense Impact on Cumulative Return assumes that each investor's original capital and all net returns are allowed to compound in the Fund over a 10 year period.

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Digging Deeper

The investment processes among managers with similar strategies can vary widely and these variances can account for different alphas and may also explain some of the significantly different costs across Management Companies and Funds. For example, while investment volumes of an active trading strategy can easily explain some of the additional costs, a more thoughtful examination of other investment practices can reveal equally impactful differences that drive incremental costs, and may be avoided. As an example, let's take a look at the use of ISDA agreements. ISDA agreements are set-up by managers on behalf of the Funds they manage so they can trade derivatives through various executing brokers. Assume in our example that Manager 1 believes they need many ISDA agreements to ensure liquidity and achieve best execution versus Manager 2 who believes they need fewer. The initial and ongoing cost to set-up and manage these agreements will be higher in Manager 1 than Manager 2. So the question for Manager 1 is whether the benefit of maintaining multiple ISDA agreements justifies the costs. If Manager 1 outperforms Manager 2 on a net basis then the answer may be yes. If it underperforms Manager 2, then perhaps Manager 1 should reconsider maintaining multiple ISDAs.

Benchmarking the Business Practices that Drive Expenses

Until now, it has been difficult for managers and investors to benchmark the effectiveness and efficiency of their processes versus those of competitive Funds. Many managers today benchmark themselves against prior years and are understandably pleased when they perform the same functions at a lower cost. Some managers have unsuccessfully sought data on industry "best practices" to identify how they compare to competitors and learn how they can become more efficient. Convergence benchmark data and proprietary tools and models can help managers readily compare themselves to their peers, identify opportunities to adopt best practices and reduce costs without increasing operating risks.

The Road Ahead

The operating costs for managers and investors continue to grow driven by the search for return, greater regulation and increasing investor demands for more frequent and relevant reporting. Benchmarking the practices that drive these expenses in Management Companies and Funds can provide a fresh perspective to managers trying to improve controls, lower costs and improve returns. Given the magnitude of change taking place across our industry, we suspect investors will favor managers who consistently deliver competitive gross and net performance returns, evidence best practices within their operating environment and deliver returns at a cost that is transparent and competitive to its peers.

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