THE LIFE CYCLE OF HEDGE FUNDS

INTRODUCTION

Harder, Better, Faster, Stronger.

-Daft Punk/Kanye West

While every business is different, all typically go through a five phase life cycle: Start-up, to Growth, then Expansion, Maturity, and then finally, Decline.

Few investors spend time thinking about applying that same framework to hedge funds. The life cycle of hedge funds is very similar, as no hedge fund can exist into perpetuity. Hedge funds do have expiration dates. However, as we have seen time and time again, the death of one hedge fund often results in the birth of “spin-offs” - a variety of new firms, with the cycle beginning yet again. This occurs when young investment talent leaves their predecessor firms, and have entrepreneurial aspirations to launch their own funds, underscoring the importance of understanding the history and lineage of hedge fund managers.

From our viewpoint, the life cycle of hedge funds can be divided into four phases: Start-up; Wealth Creation; Wealth Preservation; and ultimately, Decline, as shown in Figure 1 below.

We discuss each of these distinct phases in detail below and flesh out our team’s constant quest for the next undiscovered star hedge fund manager – and identifying them before they become well-known household names.

**Figure 1** Manager selection at WA emphasizes emerging managers entering their wealth creation phase.

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**PHASE I: START-UP**

You don’t get another chance. Life is no Nintendo game.

-Eminem

Nascent and hungry, newly minted hedge fund managers hanging their own shingle for the first time
have fire in their bellies and something to prove. Many of these emerging managers are compelling because they often include a star analyst from a mature hedge fund that is looking to replicate past success – but without the constraints of a large asset base. In addition, recent data confirms that these hedge funds early in their life cycle are delivering the highest returns and beating more established funds every year. A recent study of nearly 1600 hedge funds conducted by alternative assets data provider Preqin found that recently launched hedge funds (defined as hedge funds that are less than three years old) have consistently outperformed more established funds by almost 4% annually since 2012.\(^1\) This analysis confirms that the argument for identifying and investing with emerging managers is very compelling.

Figure 2 fleshes this out further, showing that annualized returns of emerging managers outperformed established managers by 3.7% and 4.6% on a three- and five-year annualized basis, respectively. This outperformance is achieved with modestly higher risk – the volatility is a mere 1.2% and 0.5% higher than for established managers during that same time period.

In addition, the annual returns shown in Figure 3 through the January 2012 to June 2019 time period also demonstrates consistent outperformance by emerging managers, outperforming established

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\(^1\) “Opportunities Investing with Early Lifecycle Hedge Funds: A Preqin & 50 South Capital Study”. Preqin. October 2019. PDF file.
managers every single year. Not only did emerging managers outperform but they also protected capital better in 2018, when markets experienced extensive losses. These observations are not intended to diminish the returns that can be realized from investing in established funds. Rather, it is to highlight that the results suggest that investors can benefit from identifying and investing in emerging managers as part of a dynamic, blended hedge fund program alongside established managers.

While an important cornerstone of any investment, it is often not just about the manager’s pedigree or their edge (in other words, what they like to identify as their “secret sauce”). It is, however, in those early years, a struggle. London-based financial services consultancy Capco’s often-cited research shows that over 50% of hedge fund failures are due to operational risk alone as opposed to investment risk.\(^2\) This was based on Capco’s study of 100 hedge fund failures over the past 20 years. Most investors focus on management, strategy, and the track record when choosing hedge funds, paying less attention to the operational side of the business.

When launching a hedge fund, few realize how difficult it will be to raise assets in a highly competitive landscape, as they need to be not only a good investor (to manage the fund), a good business manager (to manage the business), but also a good marketer (to raise assets). It requires a significant commitment from a core team of highly experienced individuals in terms of time, capital, and patience, and requires them to be well versed - not only from an investment perspective, but also from an operational perspective.

However, emerging managers often don’t have the level of assets that would afford them the ability to build a world-class, institutional-grade, operational infrastructure. Investing too early in an institutional quality infrastructure before assets materialize can reassure prospective investors but create a fundamental weakness by raising the breakeven point. On the opposite end of the spectrum, some funds rush to launch, without taking into consideration what careful steps are needed to scale their businesses accordingly as they grow. Somewhere in the middle, we have seen funds successfully grow their operations prudently alongside asset growth. It is a fine and tricky balance, and we recognize that the cost of not getting the structure right in the first place can lead to considerable pain later. As a result, in the start-up phase we often see hedge funds outsource their back office. The growth in outsourcing these functions and delegating those responsibilities to dedicated professionals in their respective fields is mainly driven by the need for money managers to focus on their core strength, which is leveraging their investment expertise.

In attracting initial capital, during the start-up phase there are often three types of investors who show up at the door. This typically includes Seeders, Fund of Hedge Funds, and Family Offices, but all for different reasons. Many hedge funds cannot launch with a large enough asset base to cover organizational expenses and be considered credible by investors. As a result, there exists an ecosystem of strategic investors who often get involved at this stage. However, there is no free lunch.

**Seeders:** Hedge Fund Seeders are exactly what they sound like – they provide early-stage capital and are instrumental in the development of emerging hedge funds. However, different from other investors a seeder’s return potential is greater than that of other investors because in exchange for its willingness to take start-up risk and make an early commitment, it receives a portion of the hedge fund’s revenue stream (a percentage of the manager’s management and performance fees). It also may establish other advantages, such as rights to future capacity, full transparency, etc. There are many groups that specialize only in hedge fund seeding activities. Seeding hedge funds is a fully mature industry. However, it is important to note that large seeders are not usually considered quality capital. This is

because seeders can abruptly redeem their capital if a fund is not quickly successful, introducing a structural weakness. In addition, managers end up trading away economics in their business to facilitate asset gathering, which could imply a lack of confidence in their own odds of success.

Fund of Hedge Funds (“FoHF”): Fund of Hedge Funds investors create a pooled fund that will invest in a variety of hedge funds. They may participate in the seeding business (as discussed above) or may assemble collections of managers focused on a particular strategy or goal. The FoHF industry has been declared dead many times, as players failed to evolve. Fund of Hedge Funds have often assembled collections of managers that are too large and dilute the successful strategies. They have also favored lower risk strategies to deliver a high Sharpe ratio, but at the expense of higher returns. Nevertheless, a FoHF structure allows nimble allocators to take some risk with emerging managers. At present, there are a select few successful FoHFs that remain, but the industry not surprisingly has contracted in the last decade.

Family Offices (“FO”): Family Offices are private wealth management firms that serve ultra-high-net-worth investors. It is an often-overlooked source of funding. As many of the underlying families are far out on the wealth distribution curve, they can employ professionals whose sole focus is to manage and preserve wealth. While some wealth is generational, others are entrepreneurs who have achieved outsized business success. As a result, Family Offices can be more innovative and forward thinking, willing to invest in early-stage managers. More importantly, Family Offices contend with taxes and therefore aim for higher returns than institutional investors. Since most of the best strategies are capacity constrained, FO recognize that you need to partner early with high potential managers in order to secure access.

At Windrose Advisors (WA), we uniquely share traits of both the Fund of Hedge Fund structure and the Family Office structure – we seek higher returns for our taxable investors, while our structure uniquely allows us to integrate emerging managers into the mix alongside established managers.

Where do we typically prefer to nail our stake into the ground? While we constantly conduct research across strategies, geographies, asset sizes and maturity levels, not surprisingly there are certain points in the cycle that we gravitate towards. Somewhere between Phase I and Phase II tends to be the optimal entry point. This is typically when a manager is not yet fully discovered by the broader investor community. The fund may still be ramping up its operational infrastructure at this point. However, after a few years in business, managers have tackled some of their start-up issues, raised assets and built their back office to a higher standard than on day one. They are often looking to close their fund to new investors in a relatively short time frame and to embark on a wealth creation phase that is often the most rewarding for their investor, and themselves.

Given our team’s experience, we often provide consultative advice to assist managers as they get up to speed and become more institutionally friendly. As can be expected, we end up turning over a lot of rocks before we find something worth pursuing. We joke that it is a lot like dating, and you have to go on a lot of dates before you finally find “the One”.

PHASE II: WEALTH CREATION

Get rich or die tryin’.

-50 Cent

After some initial growing pains, by focusing on performance and achieving a three-year track record, emerging managers are no longer considered start-ups. At this juncture, after posting three or more years of what are considered “good” returns, they survived what most institutional investors, especially consultants, consider a critical period. In our view, three years of returns is still not statistically significant, and we prefer to focus on our fundamental understanding of a strategy. Many allocators underestimate the role of luck and favorable market conditions in the early years. For example, with value investing so out of favor at present, it is highly unlikely that a new value-oriented manager built a stunning track record and attracted much interest in recent years.
Overall, however, managers who have successfully navigated this period have likely reached critical mass in terms of assets under management. The investment team generally remains focused and small. And, having achieved breakeven (in terms of being able to pay all operating expenses), they are now able to fine tune operations and invest further in developing their back-office controls. This is a mission critical element. In addition to performance, institutional quality operational infrastructure is a key component to garner interest from consultants.

Consultants are employed by institutional allocators to navigate the “opaque” world of hedge fund investing and are often dubbed “The Gatekeepers.” They advise some of the world’s most powerful allocators on where to invest their money and, as a result, for many hedge fund managers, it is a relentless quest to curry favor with consultants in order to access these valuable clients. Getting on the exclusive short lists of recommended managers is a rigorous, extensive process that is long, tedious, and challenging. It is a highly coveted prize, however, to make it past the evaluation stage onto the approved list, and into client portfolios. For the lucky few, this “stamp of approval” spurs growth in assets under management.

However, it is a double-edged sword. More often than not, recognition by consultants can trigger so much interest that it can also lead a manager to allow its asset base to grow beyond what the strategy can reasonably handle – in turn resulting in a potential degradation in performance. Large consultants (growing larger through industry consolidation) have an incentive to prioritize high capacity strategies that can be deployed across many client accounts. This “agency bias” may result in niche strategies receiving less attention, despite their attractive return potential.

As an independent advisor with a significant but manageable asset base in the context of these large allocators, WA is uniquely suited to allocate to any manager or strategy without bias to size or capacity. Even smaller allocations in absolute terms can meaningfully enhance performance for our clients.

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**PHASE III: WEALTH PRESERVATION**

Success is my idol and being broke is my rival.

-Big Sean

Several years have gone by, and the hedge fund manager is now firmly established in the market. There are no longer any operational kinks, it now has an institutional quality back office where significant time and money has been invested to pass the test of even the most discerning operational due diligence team. The investment team has expanded from not just a portfolio manager and two analysts, to a more hierarchical organizational structure, with senior analysts, junior analysts and research associates. This allows more portfolio breadth but results in the fund manager becoming more of a manager of people and less in touch with the underlying portfolio. More importantly, as managers strive to maintain their investor base, there is an increasing focus on limiting downside, mitigating volatility, and as a result, maintaining a high Sharpe Ratio.

These underlying factors typically attract endorsement by Endowments & Foundations (“E&Fs”), Pensions, and Insurance Funds who tend to favor stability and predictability because of the nature of their underlying assets and the constituents they serve. In addition, these groups do not contend with tax friction and as a result can afford to take less risk and accept a lower risk/lower return proposition. It is fair to say, that on a general basis, the group of investors that tends to dominate during the “Wealth Preservation stage” typically constitutes what we would describe as the quintessential “institutional investor sector.”

As hedge fund managers continue to grow and attract the types of institutional investors that can write very large checks, it is likely that asset size becomes a constraint and begins to level off. There is often less month to month volatility in performance as the manager endeavors to satisfy the desires of its larger investors. The larger asset base also results in hefty management fees, and performance fees matter less to the manager’s wealth, reducing the incentive to take risks and generate outsized returns.
The manager at this juncture has now amassed a personal fortune. The hunger that existed when the manager first hung his or her shingle has now evolved into a “stay rich” mentality. With growing wealth, the manager’s lifestyle can change dramatically, whether it is through the consumption of material goods or a new interest in philanthropic causes. We are constantly assessing if the managers’ time enjoying the fruits of their success will distract them from investment management.

During this phase managers may also hire young, talented apprentices and aim to groom them and transfer years of knowledge and expertise with the intention of passing on the torch. This is all in attempt to maintain continuity of the firm. This often is not a successful exercise as a manager may have difficulty retaining younger talent as they may have aspirations of their own – with a focus on higher returns or the desire to be entrepreneurial. Or, these apprentices may not possess the same talent level.

PHASE IV: DECLINE

_The future is born, put the past in a casket._

-Lil Wayne

After a while, the hedge fund manager is considered a large, well-known brand name across the investor community; it has amassed assets under management on a multi-billion dollar basis; it has established several offices globally; it has also expanded the investment and operational team meaningfully. Performance begins to disappoint as a large asset base makes deploying assets into high return opportunities increasingly difficult. Alignment begins to waver as the manager begins to focus instead on retaining assets to maintain the continuity of the firm. The fund may evolve from a simple single strategy into new areas with significant product proliferation. It may experience team departures, as younger talent who desire to be entrepreneurial or have different aspirations begin to leave and create spin-offs.

After being able to successfully preserve wealth, but unable to continue the pace of work to sustain an “edge,” the manager at this point is facing a major issue: as younger talent departs, he or she recognizes the need to create a succession plan. It is very difficult in our view to “transfer” the original manager’s edge to the next generation within the same firm. In our collective experience, there have been very few hedge fund firms that have been able to do this successfully. This creates meaningful instability in the firm that ultimately contributes to the hedge fund firm’s eventual, and slow, decline, but spurs the evolution and innovation of new talent where the cycle starts again.

AND THE CYCLE BEGINS AGAIN

_Life is a wheel of fortune and it’s my turn to spin it._

-Tupac

All hedge fund investors should maintain a keen eye on where a hedge fund manager is in its life cycle and integrate this critical element into the consideration, due diligence, and allocation of hedge fund assets. It can be a lonely road for investors who focus on the earlier parts of the life cycle, as few investors are well equipped to conduct investment and operational due diligence at this stage and integrate the risks into an investment program. This is where opportunities lie. The constant life cycle that exists amongst managers across a variety of strategies makes for a very robust pool (with fewer competitors) for our investment team to fish and uncover new investment talent for inclusion into our portfolios.

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