



## The Extra Mile

Partnerships between Hedge Funds and Investors

June 2014



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# I. Foreword on behalf of AIMA

I am delighted to introduce, on behalf of the AIMA<sup>1</sup> Investor Steering Committee, our new paper, 'The Extra Mile: Partnerships between Hedge Funds and Investors', written in conjunction with Barclays Capital Solutions. The paper is based on a survey of major hedge fund investors and hedge fund managers with a combined \$2.2 trillion in assets.

The publication of this paper comes at an important time in the evolution of the hedge fund industry globally. Amid the ongoing process of institutionalization (a theme that we first addressed in AIMA's *Roadmap to Hedge Funds* in 2008), institutional investors are actively pursuing a more direct engagement with the underlying hedge funds in which they are invested.

This paper explores the changing relationships between hedge fund managers and investors. What we have found is that investors are increasingly striking up partnerships with hedge funds. These partnerships take many forms, including the sharing of knowledge on expertise and risk management, the building of more customized products, co-investment solutions, product seeding and equity investment. As the title of the paper implies, both parties are properly investing in these relationships – they are going the extra mile – and, in doing so, are achieving significant benefits for both sides.

I would like to express our sincerest gratitude to Barclays for collaborating with the AIMA Investor Steering Committee ('ISC') on this project. I would also like to thank AIMA on behalf of the ISC for their continued commitment to investor engagement, which is so widespread today<sup>2</sup>. The ISC has been responsible for a number of publications in recent years including *Beyond 60/40: the evolving role of hedge funds in institutional investor portfolios*<sup>3</sup>, the *Roadmap to Hedge Funds*<sup>4</sup>, the world's first educational guide for institutional investors in hedge funds, and the *Guide to Institutional Investors' Views and Preferences*<sup>5</sup>, which discusses a variety of important operational and organizational issues. A final word of thanks is due to my fellow investors for devoting so much of their time to this initiative.

I hope that you enjoy this paper and find it to be as useful a reference tool as those earlier ISC publications.

Michelle McGregor-Smith  
Chair, AIMA Investor Steering Committee  
Chief Executive, British Airways Pension Investment Management Ltd

1. The Alternative Investment Management Association

2. AIMA would like to also highlight the work of the Hedge Fund Standards Board. Its mission is to promote the hedge fund standards through bringing investors and managers together to determine how the industry works, and to improve the hedge fund standards and to ensure they are applicable internationally. Its Investor Chapter was formed in 2010 and includes pension funds, endowments, sovereign wealth funds, private banks and funds of funds.

3. <http://www.aima.org/download.cfm/docid/77A589A0-3BEA-4559-B0F0EE38CF21B1CF>

4. <http://www.aima.org/en/education/aimas-roadmap-to-hedge-funds.cfm>

5. <http://www.aima.org/download.cfm/docid/CF822EF3-CB7A-4B13-81A7949E4C97C0AA>

## II. Study overview

As the hedge fund ('HF') industry evolves and becomes increasingly institutional, many hedge funds are reorienting their business models, away from the idea of selling a fixed product offering, and instead toward the principle of becoming partners, using their expertise to deliver solutions for investors. In this piece, undertaken in conjunction with the AIMA Investor Steering Committee, we explore the development of this new trend, looking at the rationale for the development of these partnerships, what they consist of, and how managers looking to get involved in partnerships should think about them.

The main areas we address in this piece are the following:

### 1. Partnership rationale

- What have been the factors driving recent growing interest in partnerships?
- What are the benefits to HF managers and investors in forming partnerships?

### 2. Elements of partnerships

- What are the typical elements of partnerships between HFs and investors?
- What defines each element, and how do they work?
- How prevalent are these elements relative to each other?

### 3. Attributes of partners

- What criteria do investors use to select HF managers as partners?
- Are HFs of a certain size / strategy more attractive?
- Are fee concessions essential in the context of partnerships?

### 4. Key considerations for HFs

- How should HF managers think about partnerships in the context of their strategy? Are certain types of partnerships more or less attractive?
- How should HFs select investors to target for building partnerships?
- What lessons can HFs learn from FoHFs?

### Methodology

With these areas in mind, Barclays Strategic Consulting team tapped three sources to gather the required information for the study:

#### 1. Investors

- A total of 30 investors were surveyed, including a number of members of AIMA's Investor Steering Committee.
- These investors manage over \$2tn of overall AUM and over \$260bn of AUM invested in HFs.

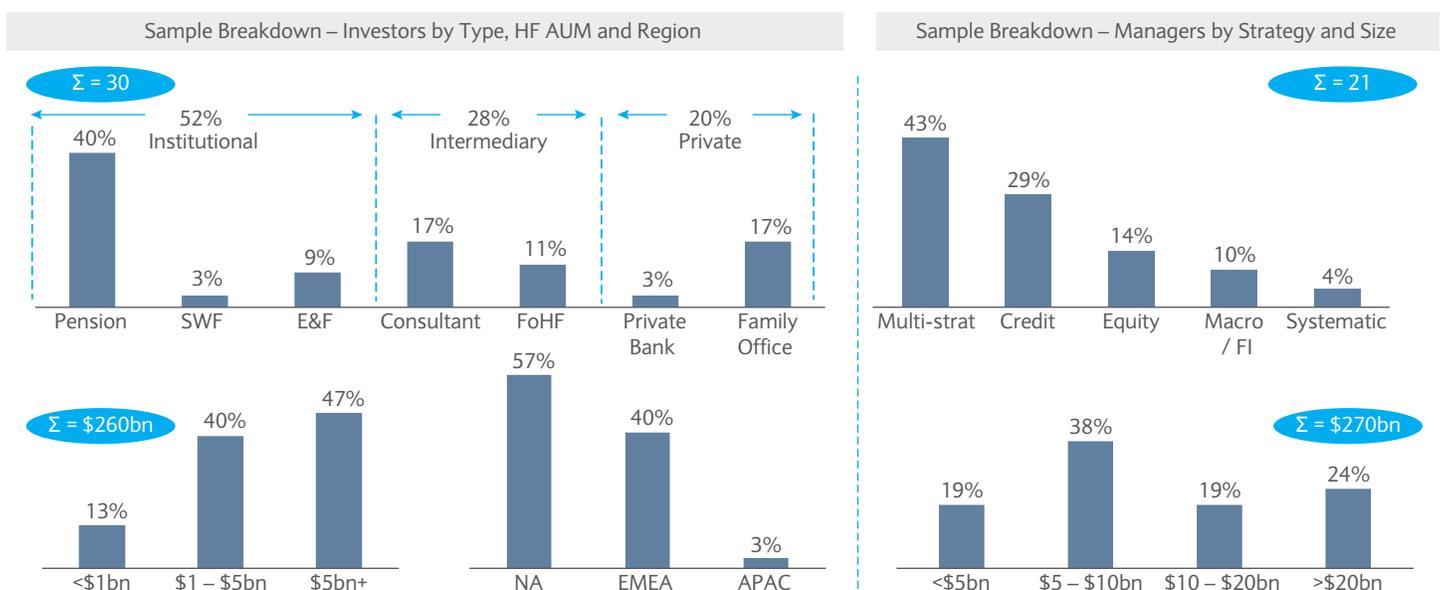
#### 2. Managers

- Interviewed 21 managers, including several that have been at the forefront of developing the concept of partnership with investors.
- Focused on established managers, across a range of strategies / sizes.

#### 3. HF industry databases: over 10,000 data points analyzed from HFR, BarclayHedge, and HFN.

Figure 1 depicts the distribution of the participants interviewed, by type (for investors), strategy (for managers), geography and level of AUM.

FIGURE 1



Source: Barclays Strategic Consulting Analysis

### III. Executive summary

The following are high level takeaways from the study:

#### Partnership rationale

- Partnerships present significant benefits for investors and managers alike.
- HF investors have become increasingly sophisticated in their view of their HF investments, looking at HFs as a way to tailor the risk-return of their entire portfolio and, simultaneously, they have concentrated their HF portfolios to a smaller number of managers. As such, they are looking to have fewer but more meaningful relationships with HFs to obtain the following benefits:
  1. **Access to HF expertise/skills:** Partner investors can leverage HFs' knowledge and expertise.
  2. **Customization:** Partner investors can work with HFs to develop customized solutions for their investment needs.
  3. **Increased understanding:** Partner investors are likely to have greater knowledge and understanding of the managers they are partnered with.
  4. **Value for money:** Partner investors say they can obtain more value from their HF investments, often for the same or sometimes lower fees.
- Managers have five main reasons for forming partnerships with investors:
  1. **'Stickier' tickets:** Partner investors are more likely to be loyal investors and allocations to partner HFs are generally for the longer term.
  2. **New product development:** Partner investors can help launch new products by providing seed capital or being early investors.
  3. **Cross-selling opportunities:** Partner investors may be more open to investing in the manager's other products.
  4. **Knowledge sharing:** HFs can learn from investors – e.g., a pension fund partner can be helpful in showing HFs how to interact with pensions and to cater better to their needs.
  5. **Investor references:** Investors can act as a positive reference to fellow investors.

#### Elements of partnership

- Investors and managers cite six key elements they value in partnerships: highly responsive and proactive client service, knowledge sharing, customization, co-investments, product seeding and equity stakes
- A highly responsive and proactive client service is a prerequisite to form a partnership with HFs, but partnerships have to be based on much more than that.
- Knowledge sharing comes in different flavors, each having different cost and scalability characteristics, as well as appeal to investors. No matter what form such knowledge sharing takes, the objective of HF managers is to demonstrate to investors they are the 'go-to' on their specific areas of expertise.

- Customization is often at the core of what partnership is for most HF investors. As investors are becoming more sophisticated, they are utilizing customized mandates to tailor their investments and risk exposures to suit their own preferences.
- Co-investments are an important way in which HFs and investors partner on opportunistic investments, many of which do not fit neatly into a commingled fund vehicle.
- Equity stakes represent a full alignment of interest and allow investors to share in the economics of HF management companies; however, they also present drawbacks and therefore only a few investors and managers choose to take this route.

#### Attributes of partners

- Investors care about both the right set of capabilities as well as the right attitude toward investors in the HF managers they decide to partner with.
- In terms of capabilities, larger HF firms with broad strategies are most often described as good partners, although smaller managers with narrower strategies also have a role to play and are indeed preferred by some investors.
- Investors typically value HFs which are 'solutions-oriented' and transparent above all else when they have to choose a partner.
- Investors are divided as to whether fee concessions are a necessary part of partnership, with half stating they are an integral part of what partnerships are and the remainder saying that partnerships are not about fees.

#### Key considerations for HFs

- HFs' strategy-related characteristics have a role to play in determining the types of partnerships that make the most sense for them.
- Partnerships require time and effort, so HF managers must choose the investors they partner with carefully. Choice is a function of the size of an investor and their appetite for various elements of partnership.
- HFs can learn from the successful funds of hedge funds (FoHFs) that have reoriented themselves from being product-oriented businesses toward a solutions-based model.
- Some HF managers have made the decision not to seek partnerships for a variety of reasons, suggesting that this too could be a viable strategy in the right circumstances.

### IV. Rationale for partnerships

Of the investors in our sample, 68% said they had at least one partnership with an HF manager which transcended the traditional LP relationship. At the same time, 75% of the managers surveyed said they had investors which they considered partners. To put this current interest in partnerships into context, we first explain the basic rationale for partnerships, from the perspective of HF investors and managers, and the factors that have driven current interest in partnerships as a concept.

## Rationale for investors

As institutional investors have gained experience with HFs, they have started to reevaluate the way that they work with them. In particular, the current trend is to move away from treating HFs as mere products into which to invest a limited part of their portfolio for diversification reasons, toward instead viewing them as means to access opportunities and tailor the risk-return profile of their entire portfolio. This process is well documented in the AIMA Investor Steering Committee's May 2013 paper, *Beyond 60/40*.

At the same time, HF investors have been concentrating their portfolios – they now look to have fewer but more meaningful relationships with a few HF managers, and expect these managers to help them come up with creative solutions for their investment needs.

In short, investors are obtaining the following benefits:

1. **Access to HF expertise/skills:** Partner investors can leverage the knowledge of the HF to make better investment decisions. We discuss the different ways in which this occurs in the next section.
2. **Customization:** Partner investors can work with HFs to develop customized solutions for their investment needs.
3. **Increased understanding:** Partner investors are likely to have greater knowledge of the managers they are partnered with, which can help with their understanding of the investment process. This can give them greater comfort in times of market stress.
4. **Value for money:** Partner investors say they can obtain more value from their HF investments, often for the same or sometimes lower fees.

## Rationale for HF managers

As institutional investors' share of industry assets continues to rise (see Figure 2), a majority of HFs have been focusing their

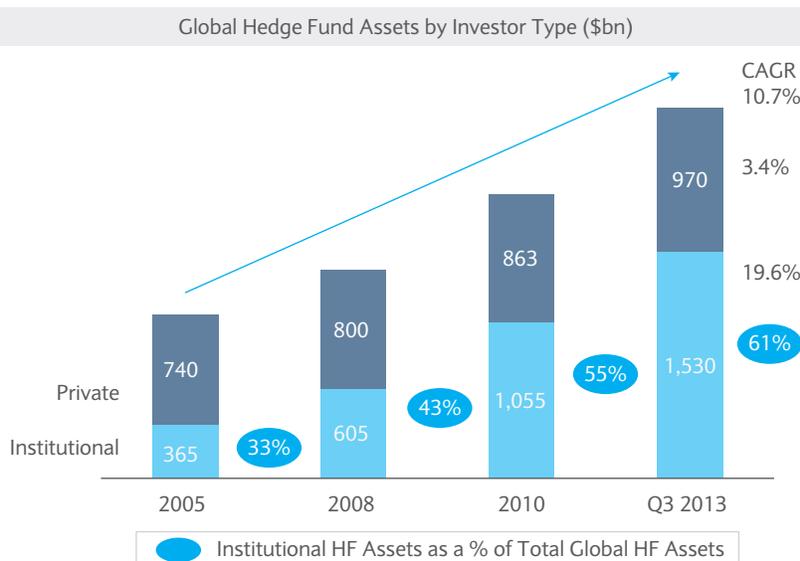
6. Barclays Strategic Consulting Report 'Till Performance Do Us Part', January 2013

asset raising efforts on them (~70%).<sup>6</sup> Institutional investors have some common characteristics: they write larger tickets, they tend to have more concentrated HF portfolios, and they tend to be quite resource-constrained; moreover, many have developed a more sophisticated view of the role HFs should play in their overall portfolio. These characteristics make them natural candidates for partnership, and, as such, represent one of the reasons behind the growth of these relationships.

HF managers, for their part, are interested in building partnerships with their investors that transcend the normal LP relationship for the following key reasons:

1. **'Stickier' tickets:** Our survey finds that partner investors are more likely to be loyal investors, and allocations to partner HFs are generally for the longer term. HF managers are better able to offset the vicissitudes of their month-to-month returns and build more stable relationships with their investors. Figure 3 helps to put this in context. It shows that there is a correlation between performance and net flows, but there are also other factors at work. For example, some HFs in the lowest-performing quartile over the preceding three years recorded net inflows in 2013, while some of the best-performing HFs reported net outflows. This suggests that investor loyalty is not always driven purely by performance.
2. **Product development:** Investor partners can help with the launch of new products by providing seed capital or being early investors.
3. **Cross-selling opportunities:** Partner investors may be more open to investing in the manager's other products.
4. **Knowledge sharing:** HFs can learn from investors – e.g., a pension fund partner can be helpful in showing HFs how to interact with pensions and to cater better to their needs.
5. **References:** Partner investors often act as a positive reference to fellow investors.

FIGURE 2



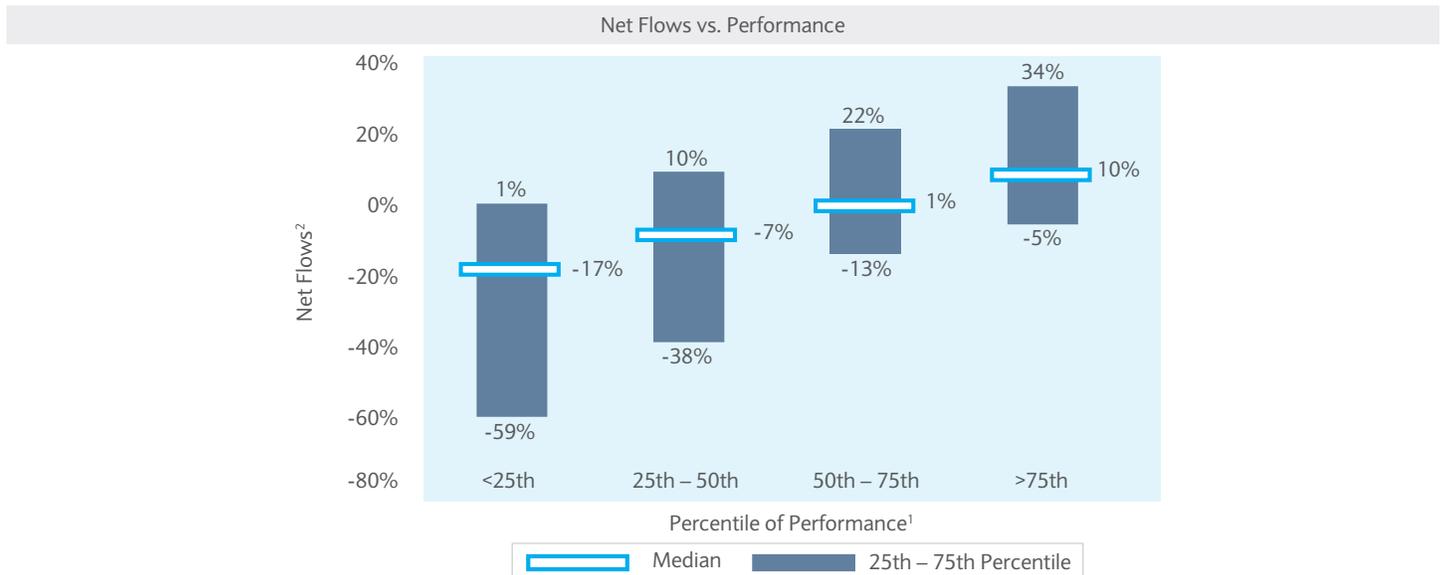
Source: Hedge Fund Research, The Bank of New York Mellon, Casey Quirk Analysis and Barclays Strategic Consulting Analysis

All this is particularly important given that, as Figure 4 shows, net flows into the HF industry are smaller as a proportion of total industry AUM than in the pre-crisis years. This points to a more mature industry, one in which the growth of an HF is largely dependent on its ability to take market share from competitors rather than being able to ride the wave of overall industry growth. In this context, anything that an HF can do to offer a differentiated proposition for investors can be hugely important for growth.

## V. Elements of partnership

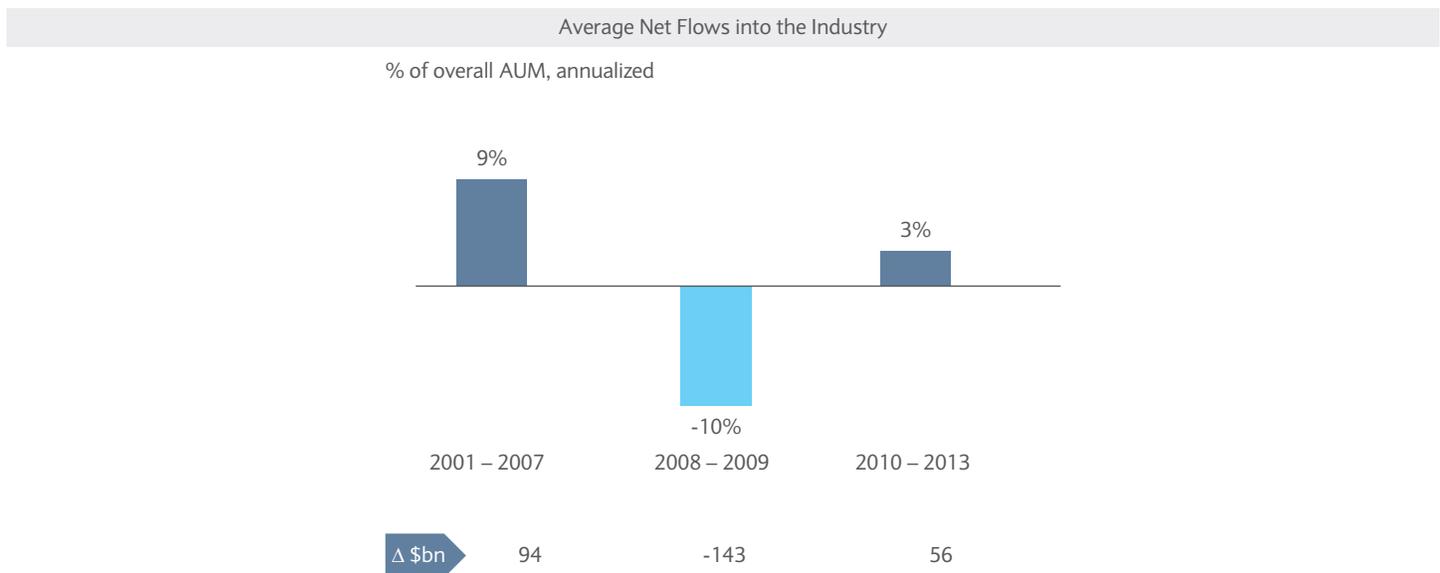
In Figure 5 we lay out the components of partnerships and their incidence as investors described them to us. For the 68% of investors in our sample who said they had at least one partnership with an HF manager, proactive client service and knowledge sharing were the most commonly cited elements of partnerships. These were cited by around three-quarters of investors. Next most common were customization and co-investments. Equity stakes and product seeding were cited by fewer investors in our survey.

FIGURE 3



Source: Hedge Fund Research, BarclayHedge, Barclays Strategic Consulting Analysis; 1. Performance quartile determined using a combination of two metrics (return, Sharpe ratio) across two horizons (3yr, 1yr); 2. As a percentage of EOY 2013 AUM

FIGURE 4



Source: Barclays Strategic Consulting Report 'Making it Big' June, 2013; Hedge Fund Research

There was some variation between types of investors, moreover: whereas institutions and family offices appeared to value knowledge sharing above all else in partnership, funds of hedge funds (FoHF) and investment consultants were most interested in customization. This reflects the differing expertise and approaches to HF investments of these organizations. FoHFs and consultants are much more likely to feel they have sufficient expertise in-house and not value knowledge sharing as a result, whereas the intellectual capital and expertise of HFs is likely to be valued by institutions and family offices. Equally, consultants and FoHFs are more likely to value customization as a tool that allows them to provide a differentiated offering to their own clients.

### Proactive client service

At the core of partnership is a level of client service that goes above and beyond the traditional perception of HF marketing and investor relations. HFs wanting to be partners need to have client service professionals that are capable of delivering the firm's expertise and solutions for its clients. Investors describing the client service attributes of partner HFs tended to see them as having two core qualities. The first is a great knowledge of the firm's strategy and an ability to talk in detail about performance, positioning, and to field queries related to the portfolio without having to refer investors directly to the investment team in most cases. The second key attribute is the ability to listen and understand the needs of the investors themselves, often extending beyond simply their HF investments, to their wider portfolio. The best client service is able to synthesize these two attributes: by understanding the firm's expertise and the investors' needs, they are able to help ensure that the firm delivers solutions to clients' problems and thus position the HF as a partner.

### Knowledge sharing

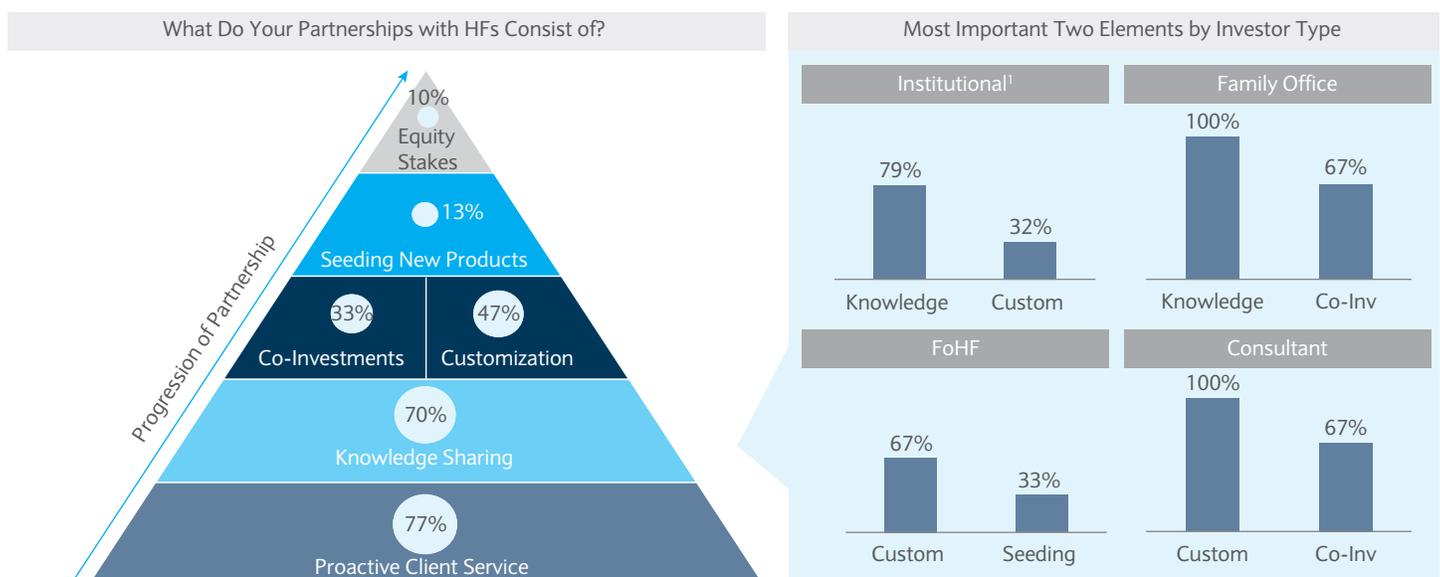
Knowledge sharing is a crucial element of partnership – it allows HFs a way to establish their expertise with investors and influence their thinking while providing added value. As one investor put it,

“If you give investors good content, you will be able to shape their thoughts, to make them think the way you think, and that helps get clients close to you, understand you, and stick with you in bad times. It is very powerful.”

Managers and investors we interviewed gave us some concrete examples of knowledge sharing. These can be bucketed in four different categories (the incidence of each category in the answers in our sample is in parentheses):

1. **General content / research / analysis.** (83%) This is the simplest form of knowledge sharing, involving the creation of proprietary content to share with clients and prospects. The principle is straightforward and one that banks have long relied on as part of their sales process within the capital markets. It has the advantage of being relatively low-cost to produce and eminently scalable – but in itself may not be a great differentiator.
2. **Access to PMs / analysts.** (73%) Giving investors access to investment professionals can be very powerful – it is highly valued by some, who use their conversations with a group of individuals perceived as some of the most knowledgeable in the markets to shape their own investment approach. As a \$20bn Pension told us, “Access to senior investment professionals is very important to us. Conversations with individuals who look at the market every day help us in all aspects of our portfolio, not just the HF portion.” At the same time, HFs need to be careful in how they manage this: giving investors unfettered access to investment professionals can be a distraction and a drain on their resources. It is also inherently non-scalable, so HFs must decide which investors they are able to offer it to. Indeed, for these reasons, many investors actually prefer to speak to a high-quality client service professional rather than take the time of PMs, whom they would rather see being focused on the more important job of managing money day to day.

FIGURE 5



Source: Barclays Strategic Consulting Analysis; 1. Institutional includes pensions, endowments and foundations, banks and sovereign wealth funds

3. **Customized research / analysis.** (47%) This is one step further on from general content, which allows an HF to differentiate itself better and increase the value it delivers to its most important investors and prospects. Given the lower scalability of these pieces (although they may later be rolled out to other clients if possible), the value placed on them by investors will be higher – as will the cost.
4. **Commitment of resources.** (17%) This last element can mean many different things, but ultimately refers to any instance in which an HF may use its unique resources in order to benefit a client or prospect. Some examples include:
  - A manager inviting an investor to attend their internal training program that they give to their employees
  - An equity manager taking an investor with them on a trip through Europe to meet with companies’ management
  - A manager having an investor spend several days sitting with them on the desk to understand their process

### Customization

As HF investors become increasingly sophisticated, a recent trend has been the growing interest in customized mandates. In the Barclays Strategic Consulting report ‘Waiting to Exhale’, published earlier this year, of the 220 HF investors surveyed, over half said that they planned to grow allocations via customized mandates in 2014. This compares with only 6% of the same investors which did indeed allocate via customized mandates during 2013 (See Figure 6). Historically, investors preferred managed accounts / fund of ones for the better transparency and control over their assets, and mitigation of co-investor risk. Sophisticated investors today like customized mandates for all the above reasons, and also because they can tailor the investment mandate and the risk guidelines much more narrowly to suit their own.

From the HF point of view, there are in essence two ways of offering customization. The most basic form of customization is

offering certain elements of a single existing product in a format that suits an investor’s needs – for example, a manager offering their hedging book as a stand-alone tail-risk strategy for an investor. Another form of customized product, typically offered by multi-strategy managers, offers customized exposure to their existing underlying strategies, which may be dynamic and adjustable according to an investor’s needs. Managers looking to offer customized solutions should focus on what format makes most sense given their business model.

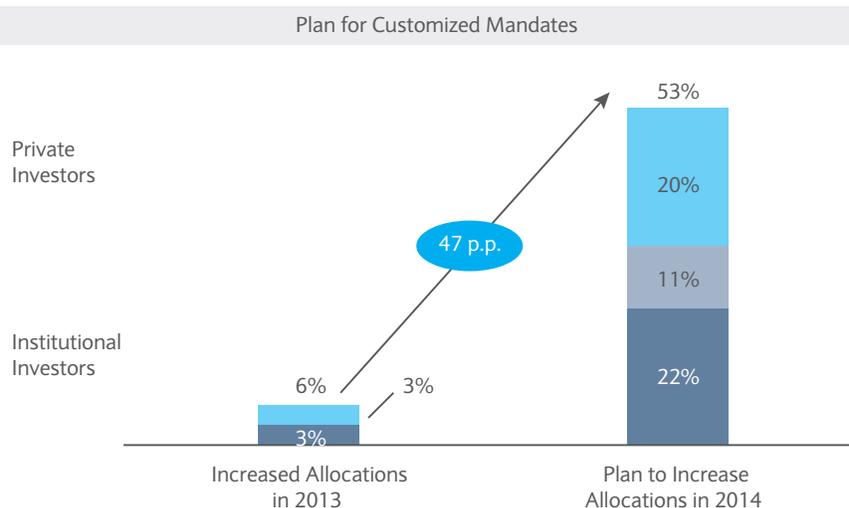
### Co-investments

Co-investments offer a way for HFs and investors to partner on opportunistic investments that often don’t fit into commingled fund vehicles. Originally, they were developed in the context of private equity (PE), and, as Figure 7 shows, 66% of investors surveyed by Preqin received better returns on their co-investments than on their PE investments. Post-2008, investors in HFs sought shorter liquidity terms and, as a result, co-investments, which tend to have a longer time horizon, were not particularly popular. However, as investors have become more comfortable with longer investment horizons, they have started looking at co-investment opportunities in other areas of their portfolio, including with HFs.

For HFs, the typical motivation for launching these vehicles is fourfold:

1. **Capacity / concentration.** HFs typically have concentration or liquidity limits and co-investments provide them with a vehicle to go beyond these limits
2. **Partnership / goodwill.** HFs are able to retain investors and build goodwill with them; often investors will allocate to a flagship commingled vehicle with an eye toward getting access to co-investment opportunities
3. **Building a track record.** HFs who have one type of expertise might use co-investments as a tool to build a track record in products where they do not appear to have any current expertise

FIGURE 6



Source: Barclays Strategic Consulting Analysis; Barclays Strategic Consulting Study ‘Waiting to Exhale’, January 2014

4. **Building an edge.** Not all HFs offer co-investment opportunities and managers can differentiate themselves by bringing interesting ideas to investors

Typical opportunities these days could be both in longer-lock equity strategies (e.g., activist) or credit-oriented strategies. The investment vehicles set up to capture this opportunity are either drawdown-type structures or managed account / separate fund structures, generally with a 2 – 3+ year lockup period.

However, co-investments will only be suitable for investors and managers of a certain profile, so both HFs and investors looking to explore this space need to ensure that they have the capabilities

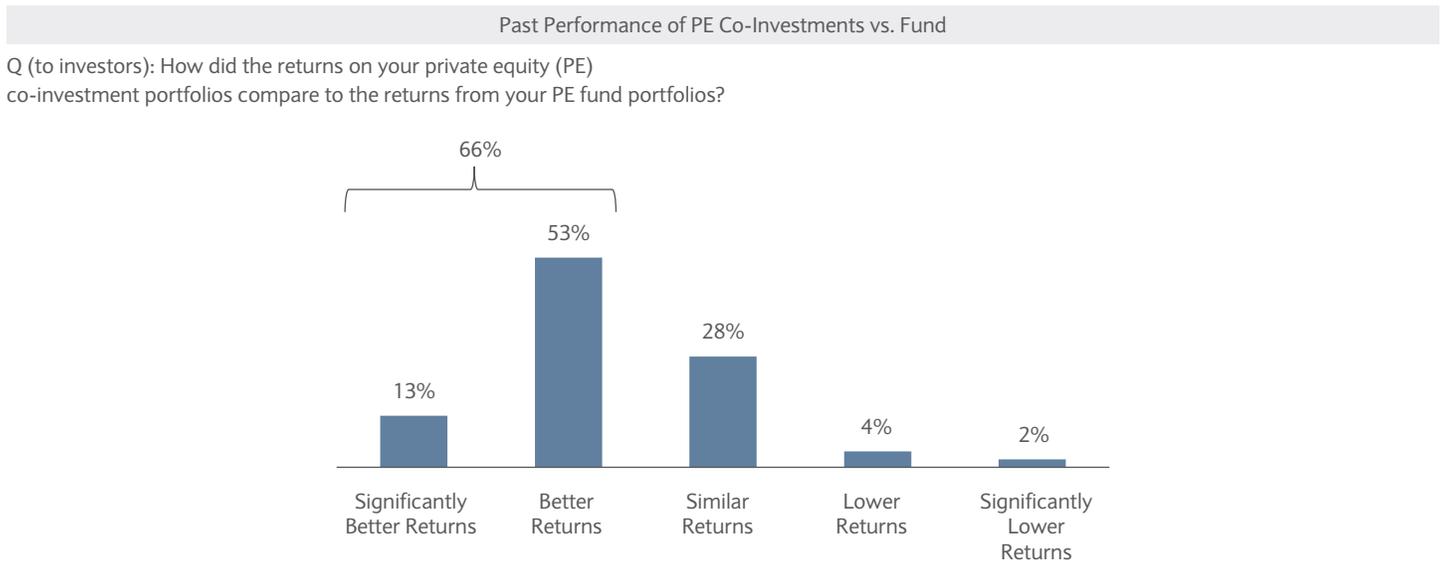
and appetite to do what is required of these opportunities, as set out in Figure 8.

### Equity stakes

Equity stakes are perhaps the truest form of partnerships – in the strictest sense of the word. With an equity stake, the interests of the manager and the investor are fully aligned.

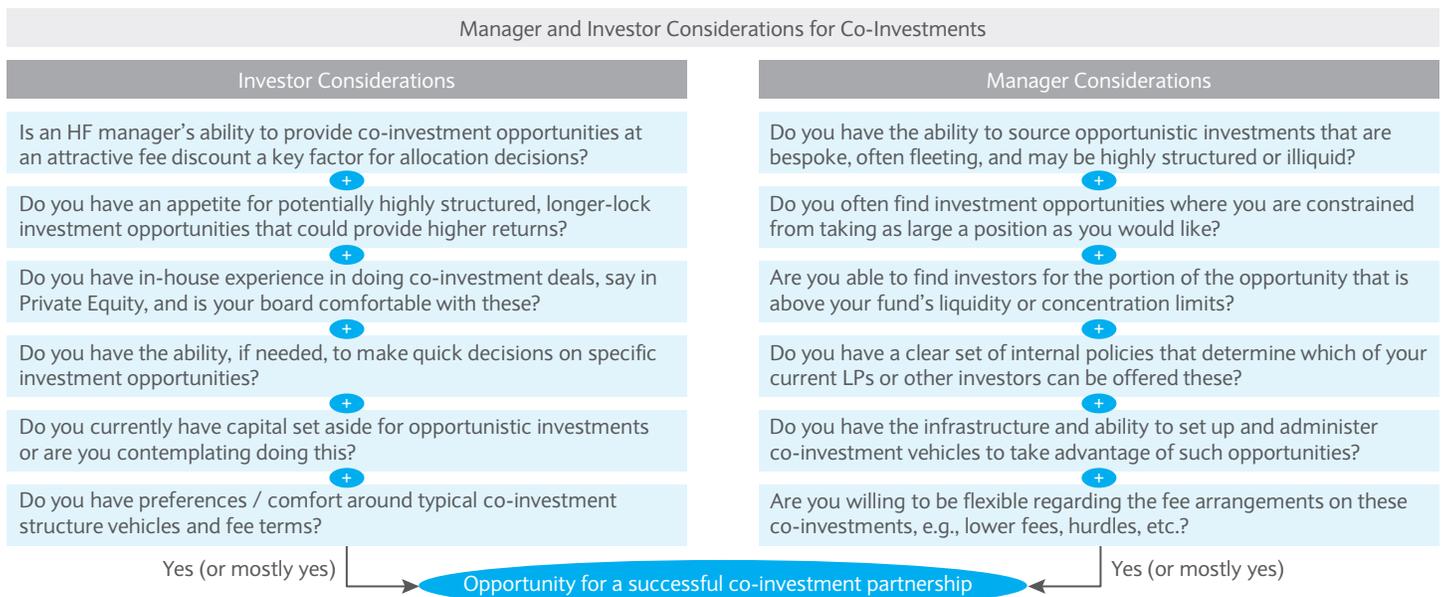
As a general rule, assuming an HF has moderately strong performance, and is able to grow AUM over time, buying an equity stake in the GP on top of making an LP investment will likely return better economics than having an LP investment alone.

FIGURE 7



Source: Preqin Special Report: LP Appetite for Private Equity Co-Investments, 2012; Hedgefundlawreport, Pensions and Investments

FIGURE 8



Source: Barclays Strategic Consulting Analysis

Furthermore, beyond the straightforward economics and alignment of interest, buying an equity stake in an HF can potentially help an investor by gaining greater access to the investment talent within the manager.

Equity stakes are not without their downsides, however. For a start, they introduce an element of cognitive bias: an investor's judgment of relative performance of an HF may be impaired by equity ownership, which in turn may affect redemption decisions. Then, in buying a stake in an HF, investors are essentially betting on the longevity of the firm, which is always uncertain – as with any business. Owning an equity stake increases an investor's exposure to business risk and key man risk.

## VI. Attributes of partners

Given the elements discussed above and what they require from HFs and investors, there are certain attributes of HFs that make them better suited to entering into various forms of partnership. Here we explore some of the key attributes necessary for partnership.

For HFs to make good partners, very broadly speaking, there are two criteria that investors typically measure them by: 'capability set' and 'attitude'. The *capability set* of an HF is a measure of the ability of the manager to deliver what the investor requires from a good partner under one roof. The *attitude* is a measure of how focused the manager is on providing a specific solution to an investor's needs, rather than just being set on the belief in the "one product fits all" approach.

### Size and strategy

The first determinants of the capability set will likely be the size and strategy of a manager. There is some correlation between the size of HFs and their desirability as partners. As shown in Figure 9, 58% of the managers cited as partners by the investors we spoke

to have >\$10bn AUM. This is unsurprising, given that the largest managers are likely to have the resources to be able to dedicate to delivering partnerships.

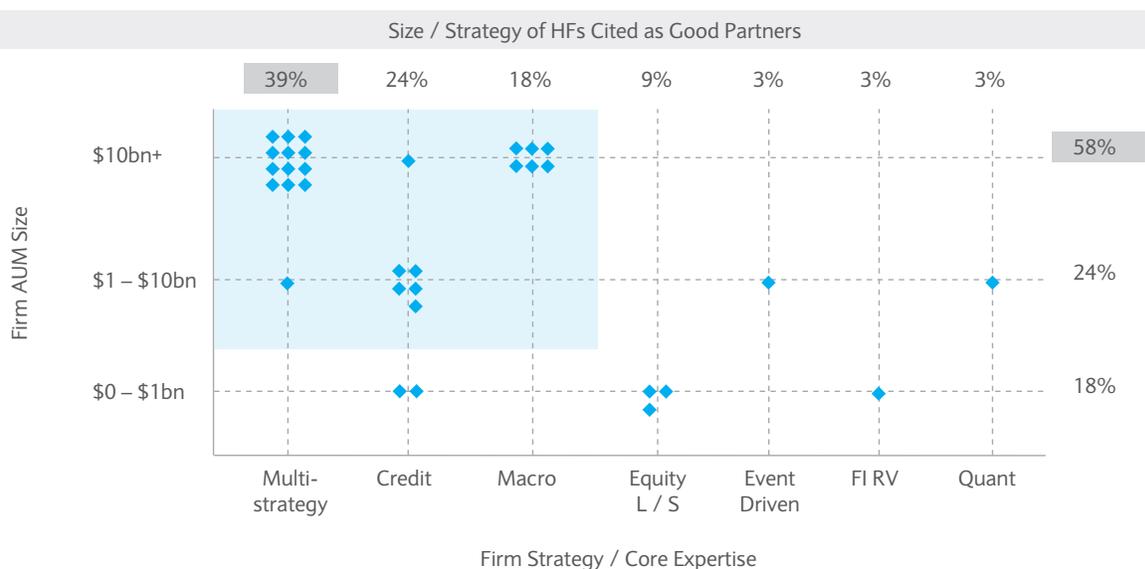
That said, almost one in five of the managers mentioned was a sub-\$1bn manager, which is a very high percentage considering the high proportion of large institutional investors in our sample. We believe that there are three main reasons for this. The first is that some investors, for example family offices, have a preference for smaller managers in particular. Secondly, smaller managers are likely to be more able to give access to PMs, a resource that is valued highly by some investors. Lastly, small managers with niche expertise may be able to add value to institutional investors in areas that larger managers may not.

In terms of strategy, multi-strategy firms are most often cited as good partners – they have a broad expertise and thus are potentially able to offer multiple elements of partnership. The next most popular group of firms contains those with a macro focus or asset-class-specific (equity and credit) expertise, which again can have a broad applicability that investors value, as it can be useful when thinking about in-house or long-only allocations. Similarly, macro can be helpful with overall asset allocation decisions and portfolio-level thinking. Moreover, credit funds, in particular, are likely to be of interest for partnership due to their ability to offer co-investment opportunities. However, more specialized strategies (e.g., fixed income RV, quant) appear to be less popular on average – but that should not be a deterrent to managers of these strategies looking to build partnerships. They must make sure, though, that they do consider which elements of partnership they will be best placed to deliver.

### Attitude to investors

The attitude of HFs is a crucial part of their suitability for partnership. There are certain metrics which are clearly of paramount importance when investors consider which HFs to partner with, as laid out in Figure 10. According to investors in our

FIGURE 9



Source: Barclays Strategic Consulting Analysis

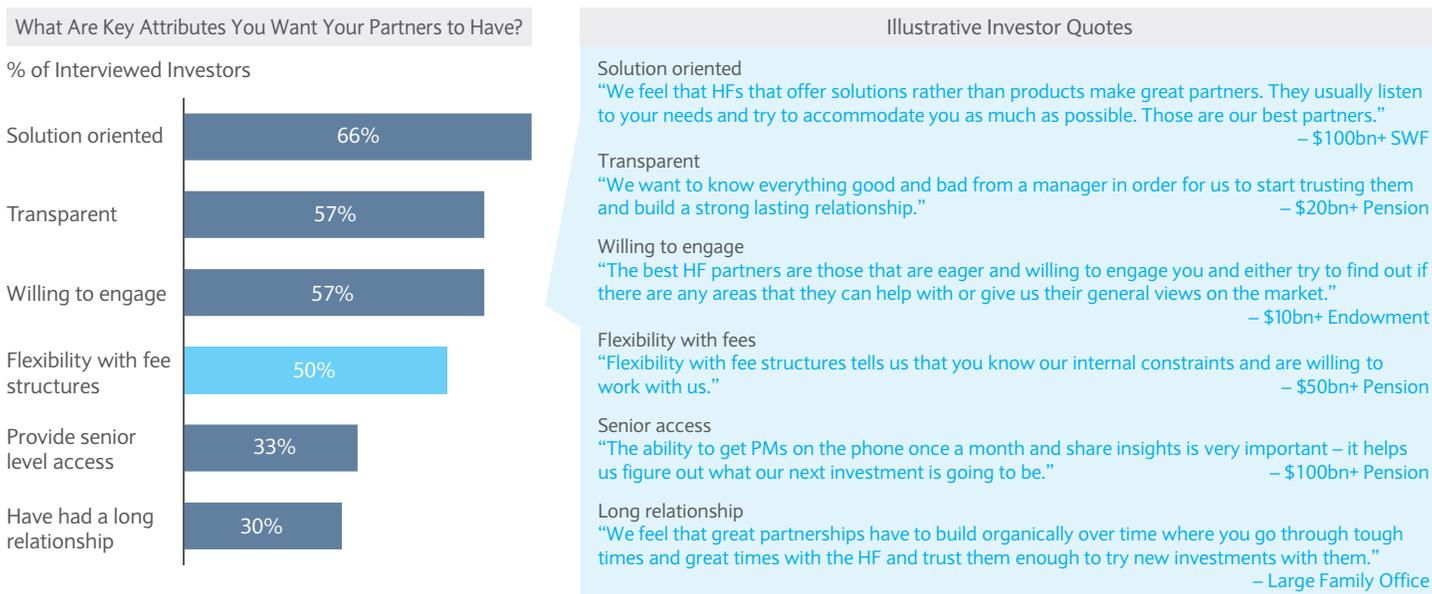
sample, being solution oriented seems to be the best attribute for HFs to have, which is unsurprising given that this solutions-based approach is at the core of the move toward partnerships. Other attributes of good HF partners include being transparent, willing to engage with investors, and flexibility with fee structures (of which more to follow). As such, HFs looking to build partnerships should ensure that, where possible, they meet these criteria, and if they can, position themselves as a solutions provider, rather than just a provider of HF products.

## Fees and partnership

As shown in Figure 11, investors are split on whether they consider fee concessions to be an integral part of partnership discussions, and it varies by type. Those investors who want to arrange fee concessions are generally doing so as part of the alignment of interests that partnership entails; others are structurally constrained in how much they can pay.

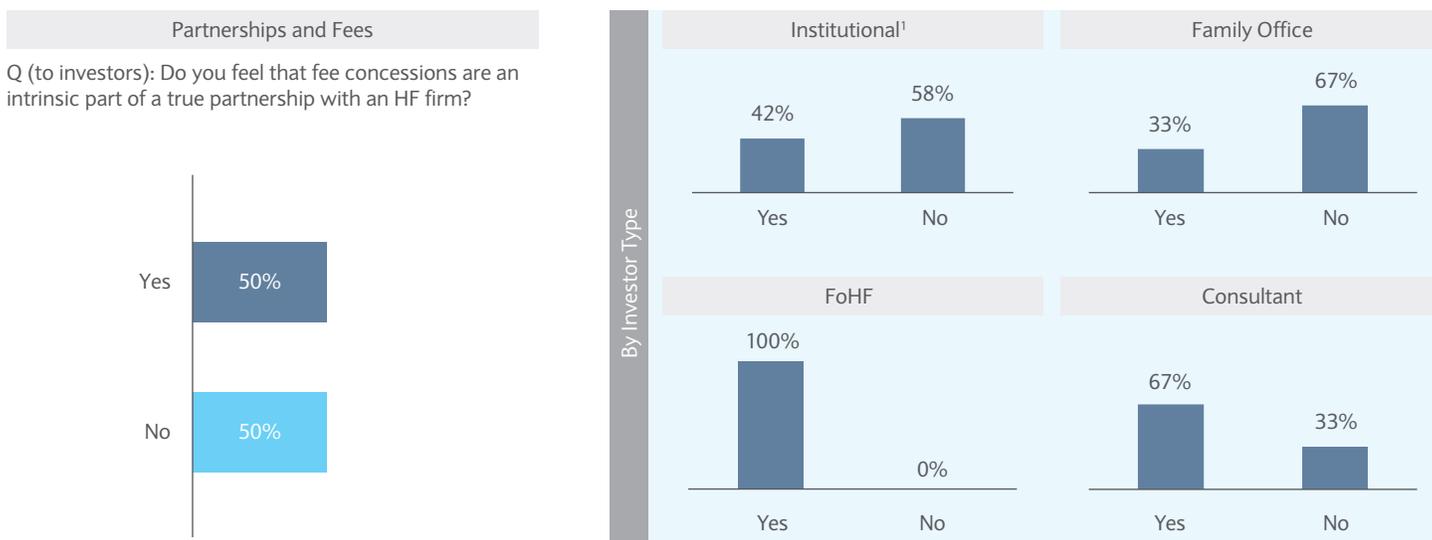
- Endowments and family offices are willing to pay incentive fees for stellar performance, so it might make sense to lower the management fee as a trade-off for higher incentive fees. As often as not, their attitude to fees is based purely on net returns – if these are sufficient, then the level of fees is not an issue.

FIGURE 10



Source: Barclays Strategic Consulting Analysis

FIGURE 11



Source: Barclays Strategic Consulting Analysis; 1. Institutional includes pensions, endowments and foundations, banks and sovereign wealth funds

- Public pensions tend to be fee sensitive, owing to the disclosures that they have to make on this front. However, they do have the ability to write larger tickets or agree to longer locks as a trade-off, and several pensions we spoke to did mention that they are willing to write larger tickets for a meaningful fee reduction.

## VII. Key considerations for HF managers

In light of all of this, what are the main considerations that HF managers should take into account when thinking about partnerships?

### HF strategies

The first consideration should be strategy and expertise, and what this allows in terms of partnership. Figure 12 sets out the potential of various strategies for the aforementioned elements of partnership, in general – although there will, of course, be exceptions to this. For example, in knowledge sharing, it is by and large macro and multi-strategy funds, with their broad range of knowledge and markets, which can most readily offer useful and widely applicable content to their investors. Likewise, in customization, the breadth of expertise of multi-strategy funds makes them well suited to producing bespoke solutions for their investors. By contrast, in the sphere of co-investments, the necessarily longer-dated and more concentrated strategies of distressed credit and activist managers lend themselves best.

### Resources

The question of resources is obviously crucial when it comes to partnerships. Smaller managers are more likely to be resource-constrained, which can be a limitation to their ability to deliver partnerships with investors. In fact, when one looks at the time spent on various investor-facing activities, as shown in Figure 13, it is clear that this holds true in reality. When we analyzed the

size of HFs against the focus of their IR / marketing and business development teams it became apparent that smaller managers comparatively spend more time on prospecting for new investors and coordinating efforts with third parties (third-party marketers and cap intro teams) – that is, building their firm and investor base. By contrast, larger managers spend comparatively more time on general investor relations and client service, and ‘investor advisory services’ – which can range from customized reporting to ad hoc strategic assignments for specific investors. More of their efforts (and the time of the marketing / IR teams) are focused on maintenance of the existing investor base and developing / deepening partnerships.

That said, smaller managers have certain advantages they can leverage. As previously mentioned, for those investors who really value access to PMs, it is easier to establish partnership with smaller managers, where such access is easier, than with larger ones. However, they must consider how they can go about building partnerships without harming their existing businesses or becoming distracted to the detriment of delivering performance.

### Investor attractiveness

Just as investors must consider which managers are the most attractive from the point of view of partnership, HFs must consider which investors they should target to partner with: attractiveness is about more than just size. In order to assess attractiveness of different investor types, we reviewed the size of the accessible asset base against interest in one or more of the elements of partnership discussed before, as shown in Figure 14. Investors generally fell into the following three categories:

- Ideal partners.** Investors with a large accessible asset base and significant interest in partnerships
- Good partners.** Investors that have a reasonably large accessible asset base and who are somewhat receptive to at least one of the partnership elements discussed

FIGURE 12



Source: Barclays Strategic Consulting Analysis

3. **Limited partnership potential.** All other investors

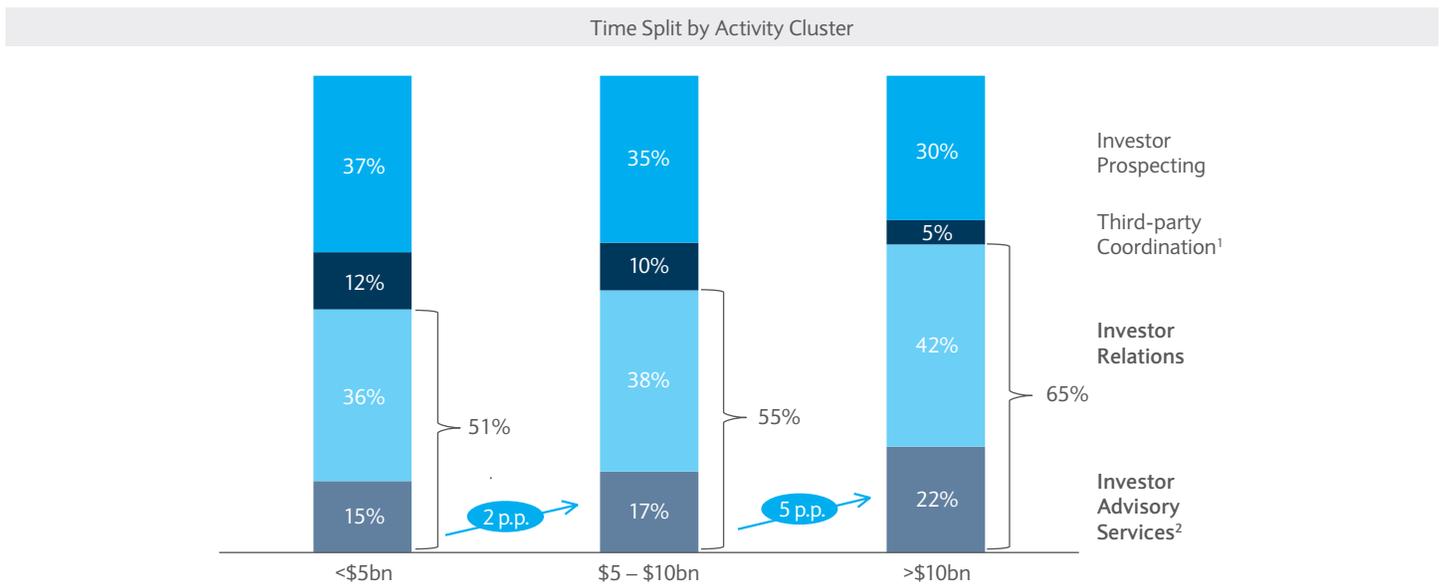
Although broad generalizations by investor type are always difficult, we noted the following common characteristics among the various channels:

- **Pensions** typically make for ideal partners for HFs, with large AUM, and an appetite for bespoke solutions.
- **SWFs** could also be ideal partners; however, some HFs we spoke to are also mindful that SWFs are also in a position to compete with them.
- **FoHFs** might not need to rely on HFs for expertise, but they are good partners for customized products and co-investments / seeding of new products as they can act quickly on exciting

opportunities. They are themselves dependent on innovating to stay competitive within their own universe, meaning that they are open to these newer solutions.

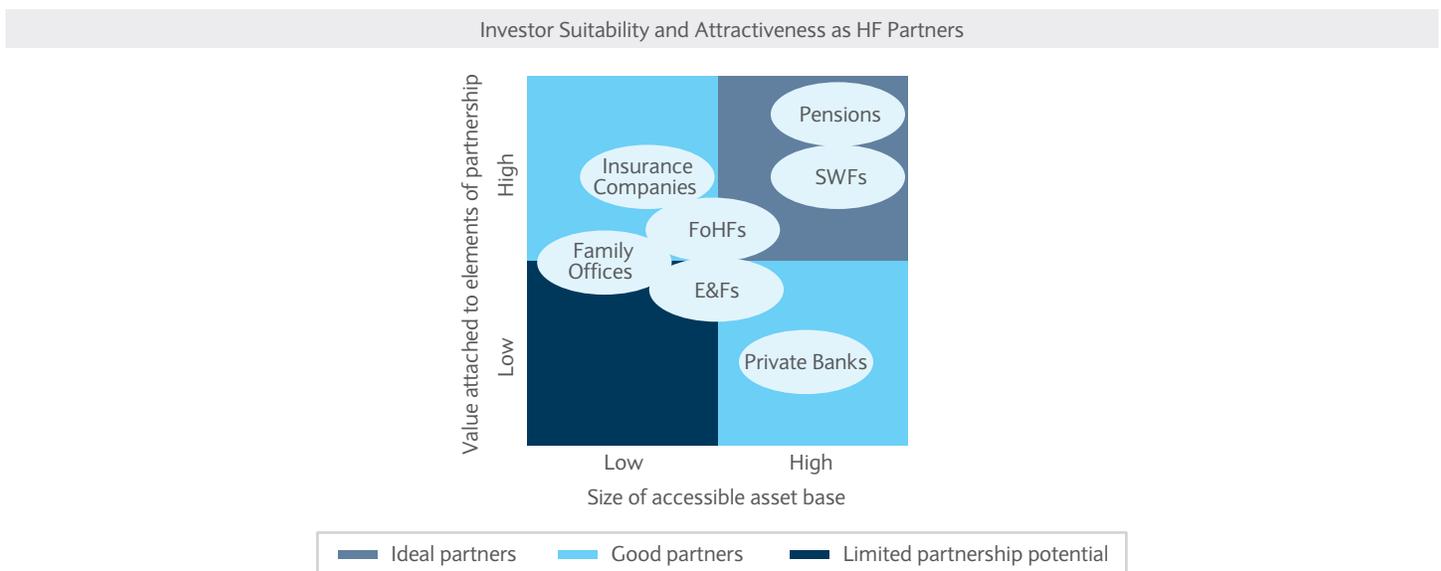
- **Insurance Companies** are highly regulated entities and, hence, have a limited size of accessible asset base for most HF strategies but are certainly interested in intelligent solutions provided by HFs, especially where this can be used to work within the constraints of regulations such as Solvency II.
- **Family Offices and E&Fs** tend to be well resourced internally relative to their AUM and tend to have a smaller asset base compared to pensions; although there may be areas where they can partner with HFs (e.g., co-investments), they tend not to be the ideal candidates for partnerships.

FIGURE 13



Source: Barclays Strategic Consulting Report, 'Raising the Game'; 1. I.e., Cap Intro desks and third-party marketers; 2. Developing customized / ad hoc assignments for investors

FIGURE 14



Source: Barclays Strategic Consulting Analysis

- **Private Banks** have a large accessible asset base but tend to be less interested in the elements of partnership set out above.

## Lessons from FoHFs

Successful FoHFs have in recent years oriented themselves away from being product-oriented businesses and toward a solutions-based model and, as such, can be quite instructive to HF managers on the subject of partnership. In order to stay competitive, FoHFs have adopted key changes to become more relevant to – and build stronger partnerships with – investors, transitioning from being product providers, focused on multi-strategy commingled funds, to having a solutions-based approach based on client needs. As shown in Figure 15, FoHFs have made a number of changes to their business models in two main ways:

- **Enhanced existing offerings** – They have improved returns through more concentrated positions or lower fees
- **Developed new products** – FoHFs have focused on understanding what their expertise is and how they can deliver this in a format that is useful to investors. This has taken the form of customized solutions, investing in emerging talent or seeding new products, investing in niche strategies, and advisory services

## Passing on partnerships

Some HF managers have considered partnership as an option, but ultimately made the decision not to seek partnerships for a variety of reasons, suggesting that this too can be a viable strategy in the right circumstances. Managers that don't offer or seek partnerships typically give four reasons for their decision:

- **Equal treatment of investors.** Some HF managers do not want to think they are prioritizing their investors or favoring one over the other. They would rather keep the business simple and focus on delivering one product and service level for all investors

- **Size.** For smaller HF managers, partnerships may not be a viable option, at least for the time being; many lack the resources to dedicate to partnership and want to avoid the risk of being distracted until their AUM reaches a certain level
- **Performance-only focus.** Some HF managers have taken a philosophical decision to continue to focus on simply delivering products that perform for investors
- **Transparency.** For some managers, their investment approach does not allow them to provide the enhanced transparency that would be part and parcel of any partnership

## VIII. Conclusions

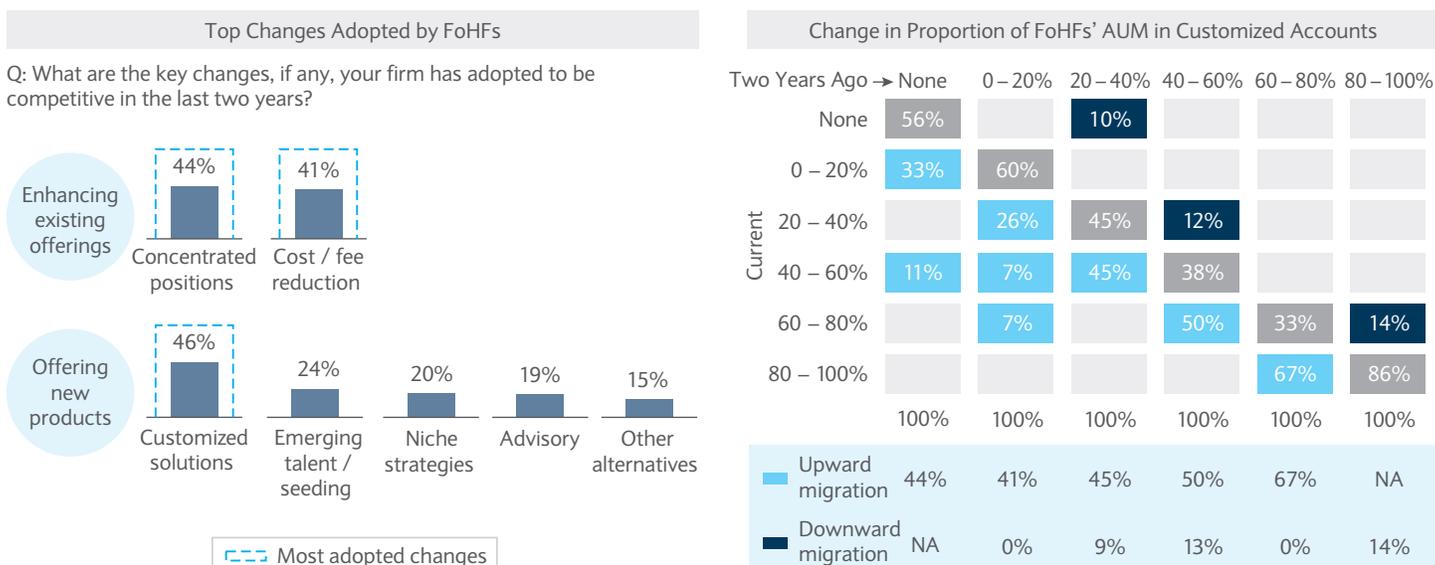
The growth of partnerships between HF managers and investors represents an exciting new direction for the HF industry as it continues to evolve.

Investors should certainly take advantage of the openness of the majority of HF managers to work with them to find the right solutions for their investment needs. It might require that some investors break down the silos between traditional investments and hedge funds / alternatives: this is not always easy to do but worthwhile according to the vast majority of the investors we interviewed.

For managers for whom this new direction represents an interesting concept, we would conclude with the following key takeaways:

1. **There are multiple reasons why both HF managers and large investors are increasingly seeking partnerships** with each other; both stand to benefit from a closer relationship.
2. **Not all HF managers can or should seek partnerships** – Based on size, capability set / approach, and strategy, some HF managers may be better off just focusing on making their product a success.

FIGURE 15



Source: Barclays Strategic Consulting Report, 'Battle for the Middle', August 2013

3. **Consider putting in place a strategy** if you decide that you do want to pursue partnerships with select investors, i.e., decide what form your partnerships should take in advance and plan accordingly:
  - What elements of partnership do you want to offer and why do you think you are well positioned to be successful?
  - Where is investment required within your firm to deliver on these elements?
  - Which investors do you plan to target and what are the criteria you used to come up with this list?
4. **Partnership is more than just client service, but enhanced client service is the first step** – Managers seeking to pursue partnerships need to:
  - Hire high-quality individuals in the client service area who have strong product expertise.
  - Structure organizations and client service teams to be able to deliver on the partnership value proposition.
5. **Don't try to be all things to all people** – One of the key risks of partnerships is that a manager tries to cater to the disparate needs of more than a handful of investors; this can be a distraction and hurt the business in the long run
6. **Choose your partners carefully** – The best partners aren't necessarily the biggest; managers also need to consider which investors are likely to make the best long-term collaborators, not potential competitors down the road

## IX. Barclays Capital Solutions

The Capital Solutions team within Prime Services offers a unique blend of industry insights and tailored client solutions for a broad range of issues.

## Capital Introductions

- Maintenance of ongoing investor dialogue to provide valuable feedback to HF managers.
- Introducing HF managers to a select number of interested investors.
- Hosting events that provide a forum for knowledge transfer and discussion / debate on industry issues that helps educate and inform both clients and investors.

## Strategic Consulting

- Development of industry-leading content, driven by primary analysis, on the HF industry and its participants (e.g., HF and FoHF managers, institutional investors, investment consultants).
- Provision of management consulting services to HFs and asset managers on business topics such as the launch of a new strategy, marketing effectiveness, product development and organizational efficiency.
- Acting as an HF competence center internally for Barclays.

## X. AIMA Investor Steering Committee

AIMA is the founder of the AIMA Investor Steering Committee – a group of institutional investors whose activities cover pension plans (public and private), endowments, foundations and family offices. It undertakes educational initiatives and provides practical guidance within AIMA, the global hedge fund industry association<sup>7</sup>.

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