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Inside the hellacious hedge fund money-raising environment, where 'even the big funds have to get creative'

Bradley Saacks 18h

REUTERS/Jim Young

- New hedge fund launches are at their lowest levels in more than a decade, and funds big and small are struggling to grow their assets.

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- Hedge funds now have to get creative to raise money. They're doing this by posting their ideas online and offering specialized products and fee structures to large investors.
- Hedge fund managers are now focused on "pitching ideas" instead of marketing a specific strategy or fund.

It's never been easy to be a small hedge fund in an industry full of trend-setting giants.

But with the balance of power tipping more toward the largest investors in the industry, and poor performance and outflows plaguing everyone, smaller funds are making once-wonky methods of fundraising mainstream.

Hedge funds, especially smaller ones, are growing their presence on digital platforms like SumZero and DarcMatter, while traditional in-house marketers have become less desirable at big and small funds, data show. Since last July, 160 hedge funds have joined SumZero's platform, including 50 this year, according to the company. Marketing recruiter Jensen Partners also found that hedge funds of all sizes hired 16% less marketers last year than in 2017.

See more: Investors are asking hedge funds to move to a '0-and-30' fee model, and it's putting pressure on a big chunk of the industry

At Bison Interests, a small Houston-based oil and gas hedge fund, more than $60 million has been raised using SumZero, an online platform for managers to post their investment theses that investors can view before investing. Bison CIO and founder Josh Young said the traditional ways of fundraising have not yet been fruitful for his young fund, even as they have gotten traction and investments online.

"I think the allocation environment is still pretty negative towards small funds, and the bar for assets to not long be considered a small fund anymore keeps going up," he said. His fund tried to get a meeting recently with the endowment of the alma mater of a member of his senior leadership team, and was quickly shut down despite the firm performing better than other similar oil and gas funds.

"If this was 20 years ago, we would already have $2 billion and be closed" because you could raise capital on performance, he said.

The largest funds have pulled in more than $4 billion this year despite underperforming compared to smaller funds which are seeing investors pull money, according to eVestment.

While hedge funds have posted strong returns so far this year, it's still been the fourth-straight quarter of outflows. Nearly $15 billion left the industry in the first quarter, according to eVestment.

The pool of money available to the industry's thousands of hedge funds may start shrink as well. Hedge funds' most loyal investors, family offices, have been growing out their internal investment teams to bypass hedge funds and make large bets themselves.

Ross Perot's family office, for instance, recently hired former Och-Ziff managing partner Boaz Sidikaro to be its CIO, and nearly a third of hedge fund investors told EY that they wanted to increase their direct investments this year, while only 3% plan to decrease.

See more: Hedge-fund investors have moved toward 'ultra customization,' and it's changing how funds raise money

It's not just small funds that are feeling the pressure

Some sophisticated institutional investors that work with Goldman Sachs' prime brokerage are cutting down the number of managers they work with, and are looking for a closer relationship with the funds they keep on, said Kristin Kramer, US head of hedge fund capital introduction at Goldman. Soros Fund Management, George Soros' family office, reportedly redeemed money from 27 out of the firm's 65 external hedge fund investments, and asked several funds it stayed invested in for better terms.

The funds that don't want to be left out in the cold by investors need to have the ability to quickly cater to whatever request these investors have for them. Research from Jefferies found that a quarter of new money that flowed into the industry last year went into customized funds offered in a separately managed account or fund-of-one structure to one investor.

"Even the big funds have to get creative."

"We've seen a tremendous amount of creativity in developing new products for specific investors," Kramer said.

These specialized products are often "best ideas" funds that package a manger's highest-conviction investments and separate them from the rest of the portfolio for a single investor, said Andrew Saunders, founder of Castle Hill Capital Partners, which helps alternative managers raise money.

"Before it was give me money and I'll do what I want. Now, it's 'I have this idea, and there's extra capacity beyond just what I can do in my fund, here's the opportunity for you,'" said Saunders.

There's also been a shift on fees. Management fees are at their lowest point in at least a decade, according to HFRI, at an average of 1.43%, while performance fees are on average less than 17% — a significant drop from the once-common 2-and-20 structure.

Commonfund, an investor that controls $25 billion of non-profits' assets, requires for the hedge funds they work to adopt a 0% management fee and 30% performance fee structure to get their money, and D.E. Shaw gives its biggest investor Blackstone access to smaller, niche products as well as lower fees.

See more: It's not enough to be 2 guys from Goldman Sachs in a room with $5 million — the bar for launching a hedge fund is rising in 2019

But while large funds can afford to offer concessions to investors, it's more challenging for small funds

Small and mid-sized funds are struggling to keep up in the current environment. Creating custom-made products for investors increases the cost of running a business at the same time fees are dropping.

"It introduces some complexities into what a hedge fund firm looks like and what kind of talent is needed," with additional operational and compliance challenges, Kramer said.

With costs for data and technology rising, cheaper, scrappier ways of raising money will continue to be used, Young said.

"To be successful in a competitive environment, you have to try every avenue available," he said.

More funds were liquidated in 2018 than were launched Shayanne Gal/Business Insider