



BLUE PAPER

HEDGE FUNDS BUILT TO LAST:

Achieving long-term competitive advantage through active talent management

SpencerStuart

The hedge fund industry has experienced exponential growth in recent years, with more than 8,000 funds managing more than a trillion dollars in assets. This phenomenal growth has made the sector a draw for high-profile traders and portfolio managers and, increasingly, for top talent in functions such as sales and marketing, investor relations, legal, operations and technology, finance, risk management and human resources. Despite the recent credit crisis, hedge funds are expected to continue to attract investments from institutions and individuals looking for alternative investment strategies. Hedge funds will need to attract talented leaders from traditional asset managers, investment banks and other financial services firms as management complexity grows and expectations from investors, particularly institutional investors, expand.

Spencer Stuart has been serving hedge funds and alternative investment firms for more than a decade in a wide range of executive searches and talent studies. To deepen our knowledge of the talent trends facing the sector, we interviewed hedge fund leaders across a range of functions (e.g., founding partners, talent management/human resources executives, marketing and investor relations professionals, and operations, compliance and risk management executives) to get their observations about best practices in talent management for hedge funds. Through the course of these discussions, we also uncovered a series of tips for professionals considering making the leap from a more traditional corporate environment to a hedge fund. Among our conclusions include:

- > As the industry grows and investor expectations increase, competition for top talent across all functions will intensify.
- > A shortage of key executive talent may emerge as a more significant impediment to growth than access to capital.
- > Hedge funds that actively manage their funds' talent needs will be best positioned to compete for the best talent over the long term.

LACK OF TALENT: THE REAL BARRIER TO GROWTH?

Almost by definition, hedge funds tend to start out small. Without the bureaucracy of a large organization to slow them down, hedge funds have developed a reputation for being nimble and able to act quickly and decisively to produce out-sized returns and to go after the best talent in the market. The traders and portfolio managers who start hedge funds typically are risk-taking entrepreneurs who reject organizational complexity and the headaches of navigating large, complex corporate environments. This, in turn, helps them attract strong talent out of traditional corporate environments and often makes hedge fund founders resistant to adding talent. "Everyone always thinks the size the firm was when they joined is the right size. We look at this all the time," observed the head of talent management for one multibillion-dollar, multistrategy hedge fund.

While the advantages are clear, the pitfalls of this entrepreneurial spirit are less obvious and often do not emerge until a hedge fund has achieved some success — and moved beyond a small team of friends and former colleagues. Investment success often leads to rapid growth in assets under management, which presents a paradoxical problem for some funds — more demand for their investment expertise than talent to meet the demand. It turns out that one of the most important constraints on growth for many hedge funds is not access to capital but a lack of sufficient talent to manage the capital. “Nothing is more important than having the right talent. Our goal is to grow from \$3 billion to \$4 billion. It’s not liquidity that limits our capacity to get there, though; it’s the talent to invest the capital that is our biggest constraint,” said the founding partner of a \$3 billion long/short hedge fund. As one former hedge fund managing partner put it: “There is more money out there than quality managers.”

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Success also leads to changing talent needs in other parts of the firm. As they grow larger and their business matures, hedge funds must bring on professional talent to manage a larger business efficiently, including professional expertise in general management, operations and technology, human resources, legal, risk management and compliance. And, when hedge funds seek to attract institutional investors, a different caliber of talent is required in sales, marketing, client service and investor relations. Institutional investors also demand greater transparency and institutional quality policies and procedures. Hedge funds must establish more sophisticated processes to provide the transparency, reporting and risk management required to attract higher quality money.

Hedge funds that wait too long to develop a long-term talent plan — one that establishes a strong foundation for recruiting and a framework for making talent decisions — may find it difficult to recruit the highest quality talent later. “Hedge fund founders think they’re getting away from the big firms and making their own rules, but then they get so big they realize they need the rules — so they go back to Wall Street and try to hire business people,” observed the CEO and founder of a company providing outsourcing services to the hedge fund industry. “If you want to go to the next level and have 40 to 50 people, you need to run it like a real business.”

In today’s highly competitive talent environment, the best managed hedge funds are positioning themselves to ensure they have access to the best talent available to support their expected growth. Increas-

ingly, these funds are making recruiting and talent management a front-office function. Senior-level managers at these funds pay close attention to talent decisions to ensure they attract and retain the best quality people. Many funds are recruiting senior human resources executives to lead talent management and giving those executives a “seat at the table.”

RECRUITING THE SENIOR OPERATING LEADER

One of the most important roles to put in place early, according to our research, is the senior operating leader. Having operating management expertise from the outset can pay a number of dividends later in both growing the business and developing the firm’s pool of talent. Many of the hedge fund leaders we interviewed recommend that hedge funds recruit a strong operating leader early on to oversee the day-to-day management of the business, to establish processes for managing costs and risks, to maintain close contact with first-round investors and to manage talent. A senior operating leader also helps to increase the fund’s credibility with investors and potential hires, while freeing up valuable time for the investment professionals to focus on what they do best — managing money.

In particular, fast-growing hedge funds with many trading teams may benefit from having a chief operating officer or chief administrative officer early on, according to a former managing director of a \$2.5 billion multistrategy hedge fund. “A fund really should have someone in this role from the very beginning. The COO/CAO can help to build out the firm properly and avoid problems later. You need a fierce, detail-oriented person who knows the business — an operating person who understands business growth — and who will tell you that you can’t put Picassos on the wall.”

The benefits for the founders and investment team are obvious, although they many not always seem so when things are just getting started. “If you are a fund manager, don’t underestimate the amount of time it takes to build the business rather than running the money. Think about this early,” advised the chief operating officer of a \$3 billion long/short hedge fund. “Traders starting a hedge fund often won’t bring on someone right away to run the business side of things because they don’t want to share the economics of the business. But I have saved the fund managers a lot of time. Our investors dealt with me from the beginning, so they didn’t feel put off not having access to our traders. It’s harder to wean investors off later, which has to be done when the business grows, when they’re used to having day-to-day contact directly with the fund manager.”

A senior operating leader also can and should play a key role in managing the fund’s ongoing talent needs, including participating in decisions about when and whom to recruit for specific roles and negotiating compensation packages that align individuals’ interests with those of the firm. In addition, a high-caliber operating leader is more likely to attract the best professionals to non-investment roles and to bring along his or her own network of contacts, increasing the firm’s access to high-quality people.

THE TALENT PLAN: AVOID OVERHIRING EARLY AND CAREFULLY CONSIDER OUTSOURCING OPPORTUNITIES

Hedge fund senior managers should commit to a talent plan that regularly evaluates the fund's talent needs, assesses the appropriate mix of internal and outsourced resources and pays close attention to the impact of growth on the culture of the firm. Developing a plan for building out the team, including deciding what functions can be outsourced, can never be done too early.

As they consider which positions to hire internally, fund leaders should carefully consider the long-term needs for the function and then clearly define the role and the level of seniority required for the specific position. Hedge funds should be cautious about hiring too quickly to “fill seats,” particularly for needs that may be short term. For example, one common error is to recruit very senior executives too early to build infrastructure in back- or middle-office functions. Once these areas are established and running smoothly, however, very senior professionals often become bored with the more mundane day-to-day management of these functions in a smaller firm. Funds may be better off outsourcing the development of the functions and hiring less senior people to manage them once they are in place. More seasoned functional executives can be recruited later, to larger more appropriate roles, when growth and complexity have increased to a level that will challenge them — and better justify their price tag.

When the decision is made to bring on outside talent, it is important to be sure that the job definition is clear and that expectations about the role are well defined. “Have a clearly defined sense of what you are hiring for and a feeling that the need will be long lasting,” advised the head of investor relations of a \$1.5 billion hedge fund. “Get internal buy-in and a clear definition of what the person will be doing. Get as good a read as early on as possible as to what the job will really be before you hire. Don't hire on the basis of short-term needs.”

Senior professionals from traditional buy-side or sell-side firms are likely to want a significant role in the decision-making process — and it is not uncommon for them to leave if they have less influence in decisions than they expected to have. One fund leader described the potential pitfall this way: “Funds tend to jump from \$150 million to \$1.5 billion really fast and then they experience a huge disconnect because they've grown so rapidly. They hire very high-profile people — paying lots of money and thinking they will make their lives easier — but they don't give them any authority to run the business. Usually the new hire gets fed up and quits with a payout.”

The stakes are high. Not only can hiring mistakes be expensive, they also can cause significant disruption at a hedge fund, where staffs tend to be small and people have to work closely together. “One person's actions really can affect other people at a small firm in a way that doesn't happen at established institutions. There is nowhere to redeploy a person who is not working out,” one hedge fund executive said.

One way to avoid the pitfalls of hiring mistakes is to outsource. While approaches to outsourcing vary depending on the size and culture of the firm, ideal functions to consider are those that are not mission critical but for which deep subject matter expertise is required. Also, some funds look to outsource functions such as analytics that can be done less expensively in lower cost regions.

While funds will differ in their outsourcing philosophy — some preferring to outsource almost everything and others almost nothing — the unifying theme should be finding a balance that maximizes effectiveness and control at minimal cost and risk. For example, the philosophy at one multibillion-dollar long/short hedge fund is to outsource as many noncore functions as possible including onshore/offshore administration, audit, tax and legal, and to manage outsourcing partners very closely. “We strive to keep our business as simple as possible, and we do a vigilant job of managing our vendor relationships. We spend time with them once or twice a year,” said the firm’s founding partner.

FINDING THE RIGHT TALENT

Unfortunately, some professionals who make the move to hedge funds from traditional financial services organizations are unprepared for the differences they face when they get there. Once a fund discovers that it has made a hiring mistake, it is important to act quickly, hedge fund leaders said. “One of the risks of hiring very experienced people is that it can be distracting to have a hardworking, bright person who wants to have impact but is not a fit. You respect them. You want them to do well, so you may hang on to them longer than you really should,” observed the founding partner of one hedge fund.

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How can hedge funds avoid a recruiting mistake? In addition to clearly defining the role and agreeing on a set of shared expectations with the potential employee, fund leaders should consider whether the person represents a good cultural and personality fit with the organization. Successful hedge fund executives are likely to be entrepreneurial and comfortable operating with less structure and formal processes, hedge fund leaders said. “The resources available in a startup or small hedge fund are going to be less than what many successful executives are used to. A senior leader in a hedge fund won’t have a vice president, an associate and an analyst working for him or her. They need to be willing to roll up their sleeves,” observed one hedge fund leader. “Recruit people who have proven the ability to do this and who will not complain about it.”

ADVICE FOR NEW RECRUITS

Many financial services professionals are drawn to this growing, vibrant sector. How can they evaluate whether a hedge fund represents a good fit for them? How can HR executives help candidates understand if they will be successful in a hedge fund? Below are some recommendations from hedge fund executives who have successfully made the switch and from hedge fund talent managers who have seen both successful and unsuccessful transitions.

Understand the role and influence of the founder. Know the founder. Spend as much time as you can with him or her, especially if you are considering a very young firm. Use your network to learn what the market thinks about the firm and the founder. Cautioned one hedge fund executive: “Do your due diligence on the founder. You will be closely associated with that person in a way you never would be in a much more established firm. So, it’s vital that you know what his or her reputation is and that you can feel good about representing the firm.”

Know the culture and the team. Hedge funds tend to be smaller than other financial services firms, and each individual can have an outsized impact on the culture. Understand who you will have as peers and decide whether you are comfortable working at that level. “This is not a generic business. Each hedge fund has a unique culture, and you need to understand what the culture is,” explained a hedge fund human resources manager.

Make sure you are comfortable with the hedge fund’s work style. Do your homework to learn how decisions are

made. Is it a top-down, dictatorial culture? How is work delegated? Are people held accountable? “Know yourself,” advised one hedge fund executive. “Will you enjoy a more entrepreneurial firm where there is less structure? Even if you get a bigger title, you will probably have less support and will have to roll up your sleeves in a way you didn’t have to before.”

Understand the role and compensation model. Come to agreement with the hedge fund about the responsibilities and influence of the position before you join. Consider how the fund’s long-term needs for the function match up with your ideal career path. Similarly, find out as much as you can about the fund’s compensation model: What are the processes and policies behind the compensation? How is compensation aligned with the fund’s performance? How are compensation decisions made and when are bonuses paid? As one former hedge fund managing director observed, “You don’t want to be sitting around on Christmas Eve wondering when your bonus is going to get paid.”

Consider the timing and how the opportunity fits with your current situation. Consider whether the timing is right for you. Examine the level of risk you are willing to take at this point in your career. Ask yourself, “What’s the worst case for me if I fail?” and “What’s my exit strategy?” While they may sound exciting, hedge funds are not for everyone and even well-known, seemingly stable funds can fail. Be aware that a large paycheck now may not make up for lost paychecks later if you make a bad decision and find yourself on the job market again.

Within the hedge fund community, firms have different approaches and styles, often dictated by the style and personality of the founder. “The biggest hurdle in hiring is finding someone who is a cultural fit with the organization and a personality match with the founder. For example, our firm’s style was an open investment committee with a lot of honest, back-and-forth dialogue,” said one former hedge fund managing partner. “Some people can’t handle that. It’s hard to know from a few meetings or interviews if

someone is going to work out. Some firms now have prospective candidates spend hours with them at the trading desk before an offer is made.”

“When considering whether to bring on talent, we constantly balance internal talent development with the need to bring in outside perspectives. Where we’ve made mistakes it’s been hiring people who don’t fit with our culture. We have trouble with people who bring the “big firm personality” with them — they are too political, too rigid or don’t work well with peers,” said a hedge fund head of talent management.

“Have a clearly defined sense of what you are hiring for and a feeling that the need will be long lasting. Get internal buy-in and a clear definition of what the person will be doing.”

The founder and his or her leadership team can help reduce personality and cultural conflicts with new hires by carefully recruiting individuals who will be a good fit and by setting clear expectations with the professionals about their roles — how strategic they will be, who they will report to, the milestones they need to hit, their role in decision making and their access to the founder. The chief operating manager or head of talent management or human resources can play an important role in these discussions and in providing strong counsel to the founder on talent-related issues.

LONG-TERM TALENT DEVELOPMENT

Once they have hired the right people, how can hedge funds retain key talent and keep professionals motivated? Hedge fund executives said it is important to identify a career path for professionals so that they will continue to be engaged over the long term. Typically lacking the size and tiers of management of large organizations, hedge funds have to be more creative in developing career paths and new opportunities required to keep their teams motivated.

“Find like-minded people, get them into jobs where they see the upside, and constantly revisit their career paths,” advised the managing director of human resources for a \$3 billion multistrategy hedge fund. “In a smaller, more entrepreneurial environment like a young hedge fund, you have to pay special attention to making sure your people are challenged and that they feel they are learning more and contributing more than they could in a more traditional buy- or sell-side environment. You have to give people a path for success or they will use you to learn, then move on to other opportunities, and you’ve wasted your investment in them.”

One hedge fund talent development manager's firm invests in education and training and provides ongoing feedback to managers to help them improve their skills. "At a small firm, people can't change jobs all the time, but they still have to grow. We invest in training and development. We pay for M.B.A. and C.F.A. courses and other continuing education," this executive said. "We also provide detailed and personalized coaching to managers to help them become better people managers. We've been using the Myers-Briggs Type Indicator to help people learn about working collaboratively with people with different styles. We do talent reviews — person by person. We take all of this very seriously."

CONCLUSION

With capital expected to continue to flow into hedge funds, the industry will increasingly face the need to attract the best talent — in investment and non-investment roles. A shortage of top talent could be a greater impediment to growth at successful firms than access to capital. Hedge funds that recognize the importance of talent management to their future growth and success and actively manage their funds' talent needs will be best positioned to compete for the level of talent needed to drive long-term success in this very competitive business.

ABOUT THE AUTHOR



Elizabeth J. Fisher

Liz Fisher brings more than 20 years of experience to Spencer Stuart and specializes in recruiting senior executives in the financial services industry, with particular focus on asset management, sales and marketing, and consumer financial services. Based in San Francisco, Liz brings her experiences and knowledge from careers in both the East and West coasts to assist her clients in their recruitment efforts.

Liz joined Spencer Stuart after a diverse management career in financial services. She was managing director of JPMorgan Chase Asset & Wealth Management Group and president and CEO of BrownCo, its brokerage subsidiary. Liz was also an executive vice president with Fidelity Investments in Boston. Her responsibilities included marketing and product management for the banking, broker-dealer, RIA and capital markets client bases. Before joining Fidelity Investments, Liz was with Union Bank of California in Los Angeles, where she was CEO of the bank's broker-dealer and related activities.

Liz began her career at Fidelity Investments after earning her Bachelor of Science degree in marketing from Boston College. She currently serves on the board of directors of the Financial Women's Association of San Francisco.

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Spencer Stuart is one of the world's leading executive search consulting firms. Privately held since 1956, Spencer Stuart applies its extensive knowledge of industries, functions and talent to advise select clients — ranging from major multinationals to emerging companies to nonprofit organizations — and address their leadership requirements. Through 51 offices in 27 countries and a broad range of practice groups, Spencer Stuart consultants focus on senior-level executive search, board director appointments, succession planning and in-depth senior executive management assessments.

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