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"2 and 20" Fading, Managers Need Big Assets or Performance to Profit: Citi Prime Finance Survey

Economics Fosters Investor-Manager Alignment of Interests

NEW YORK – The business of hedge funds is caught between rising costs and falling management fees, holding little profit for managers who don't perform. That's one key finding from the second annual global survey of the economics of hedge funds in the just-released **Citi Prime Finance 2013 Business Expense Benchmark Survey**.

According to the survey, the traditional "2 and 20" model of investment manager compensation – 2% management fee and 20% of the profits -- has declined to fee levels as low as 1.58% of assets under management for all but the largest managers. As a result, hedge fund managers, unlike their counterparts in traditional, long-only funds, barely break even simply collecting fees. For example, after paying expenses, funds with $500 million in AUM realize operating margins of 69 basis points, rising to 82 basis points for a manager overseeing $900 million, survey data show.

"Fee compression continues to reshape the business of hedge funds, lowering fees even as expenses rise, all but eliminating fee-only operating margins, and raising the level of assets needed for a hedge fund business to succeed," said Alan Pace, Global Head of Prime Brokerage and Client Experience. "And while it's clear that there is little room for additional downward pressure on management fees, at current average fee levels, investor-manager interests are well aligned – both parties are focused on performance."

"Our latest survey takes a deep dive into the business challenges of running a hedge fund," said Sandy Kaul, Global Head of Business Advisory Services for Citi Prime Finance. "Today, a hedge fund needs at least $300 million in assets just to break even. The survey also uncovers dramatic regional differences in business and regulatory expenses."

In this latest survey, Citi Prime Finance surveyed 124 hedge fund firms in North America, Europe and Asia representing $465 billion, more than 18% of total industry assets. Select findings of the new survey:

Expenses, Fees & Margins

- "Emerging" hedge funds -- those with assets of less than $1 billion -- struggle to cover expenses based solely on management fee collections and do not realize comfortable operating margins.

- Pressure to offer founders' share classes or accept seed capital to launch with sufficient AUM has helped push management fees down from the industry standard "2.0%" benchmark. The Citi survey shows average fees for managers with less than $1.0 billion AUM ranging from 1.58%-1.63%.

- "Institutional" size hedge funds, with assets between $1 billion to $10 billion, begin to realize higher operating margins as they surpass $1.5 billion and can see appreciable profits as they approach and move beyond the $5.0 billion threshold.

- Average management fees for institutional size managers are well below the historical 2.0% level, ranging from 1.58% to highs of only 1.76% for the largest firms in this band.

- The largest "franchise" firms, those with more than $10 billion in total assets, become more profitable due to a broadening set of product offerings that expand beyond hedge funds.

- On average, management fees for franchise size firms were 1.53%

- For the largest firms, operating margins based solely on management fees were slightly above the 1.0% level noted for institutional managers, rising to 1.2%. This illustrates that adding lower-fee products actually helps expand operating margins.

Regional Differences

- The majority of European hedge funds responding to the survey had higher management company expenses than similarly sized U.S. funds. Across several different firm sizes, European management company expenses were at least 20% percent higher than at U.S. firms.

- Marketing was the single largest category of expense variance between the U.S. and Europe. For smaller hedge funds with between $100 million and $500 million, European marketing expenses were 150% to 200% higher than in the U.S., due mostly to compensation differentials. European funds surveyed hired more senior marketing personnel early in their development cycle.

- Survey respondents from Asia were confined to lower AUM thresholds -- $100 million, $500 million and $1.5 billion. At each of these levels, average management company expenses were lower than in both the U.S. and Europe.

- $100 million Asia-Pacific hedge funds had average management company expenses 20% lower than the mean costs noted in the U.S. and Europe for similarly sized firms. This differential expanded at $500 million AUM with APAC funds registering expenses 42% below the mean and staying quite discounted at 39% under the mean for firms at $1.5 billion AUM.

Impact of Regulation

- Total compliance spend by firms with $100 million AUM is 18 basis points -- half of which covers internal compensation for compliance related personnel and the other half of which relates to third-party outsourcing and software charges.

- More institutional size hedge funds, from $500 million to $10 billion, spend between 3-4 basis points on compliance, with at least 70% of these costs going toward compensation for internal headcount.

- Franchise firms spend about 1 basis point on compliance, but increase their use of software and third-party services as their product mix includes more regulated and long-only offerings.

- Regionally, European-based managers had the highest levels of concern about the impact of regulations, citing both SEC/CFTC and AIFMD registration, compliance and reporting as likely to have a severe impact on their organizations and Dodd-Frank/EMIR OTC derivative rules and FATCA likely to have a moderate to significant impact.

The full report can be viewed at: 2013 Business Expense Benchmark Survey.

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