



ATLANTIC GROUP

April 2014

To Our Valued Asset Management Community,

John and I have had an exciting year launching our Investment, Marketing and Investor Relations talent practices for the asset management community. Since launching in September of 2013, we have been fortunate to partner with clients who have enabled us to grow and enhance our business.

Our mission in building a retained front office practice has been realized within the context of The Atlantic Group, a robust organization of 40 recruiters that provides tremendous resources in back, middle and compliance recruitment solutions. The collective growth of our firm has philosophically maintained a research-driven core and dedicated time for candidate development, creating superior consulting services to our clients.

Over the past year we have found that candidates are becoming more discerning and demanding of the recruiting community, and hiring managers are looking for deeper product expertise. We could not be more thrilled to flex our muscles as both John and myself come from industry, having spent years in senior investment analyst and marketing roles.

We have also developed additional products beyond talent acquisition. We have added valuable members of our team to provide corporate intelligence, capital placement, and manager/fund acquisition services.

Along those lines, we are pleased to announce our recent senior team member hire, Gontran de Quillacq, who is responsible for expanding our capabilities on the investment side by building a quantitative investment practice, as well as spearheading research. Gontran joins us with 20 years in the quantitative space and a background in theoretical physics.

Our intention with this newsletter is to bring you thought leadership pieces from trend setters in the asset management community, as well as to keep you posted on the development of our Front Office Practice. In our first issue, we are thankful to have Brian Portnoy, Managing Director at Chicago Equity Partners, to contribute an article that reflects his newly published book *The Investor's Paradox*.

We hope you enjoy this issue and we strongly encourage you to reach out to learn more about how The Atlantic Group can augment your business.

Sincerely,
Alexis and John

Due Diligence in the Age of Convergence

A funny thing has happened during the meteoric rise to prominence of alternative investments: The use of and reference to the concept of “hedge fund” has become so ubiquitous that it has been rendered largely meaningless. We can take some steps to define what hedge funds are *not* (primarily long-only equity and fixed income vehicles), but what they are (beyond a simplistic definition of a private investment fund) remains a source of both confusion and controversy. And what counts as “alternative” is even more of a lost cause.

This dilution of meaning in the course of surging popularity is not an unprecedented phenomenon. Quite the opposite, when any element of culture moves from the margin to the center, when the periphery begins to cast a long shadow on the core, a once (maybe) useful term begins to obfuscate more than it reveals.

In music, the notions of “rock” and “rap” in the 1950s and 1980s, respectively, ultimately gave way to myriad distinctions which reflected increasingly broad acceptance of those art forms, with the primacy of nuances *within* those labels over the usefulness of the blunt reference itself. In history, the pre-modern, post-war, and post-Soviet notions of the “Orient,” “Third World” and “Emerging Markets” themselves reveal a progression of understandings of less wealthy nation-states (itself a historically specific phenomenon). But given this past generation’s massive change in the rate of economic growth and technological integration, the notion of Emerging Markets as a blanket descriptor, while not useless, is not particularly edifying.

The categories or labels aren’t mere words. They are highly consequential cultural signifiers that drive resource allocation, create or undermine shared understandings which inhibit or drive conflict, and motivate individual choices impacting careers and livelihoods.

Ironically, a category’s rise to prominence also augurs the transformation of the category itself. It’s probably not true that the blanket term *ever* clarified sufficiently, but shorthand for marginal categories might prove useful; plus, it’s certainly true that it now halts the conversation with questions of “what do you mean by that?” more so than it accelerates the dialogue.

So it is the case with “hedge funds,” especially as we have squarely entered an era of “convergence.” While the surface understanding of convergence is simply the mashing together of the mutual fund and hedge fund industries, a more nuanced understanding this phenomenon is that of a process of distinguishing the market risk that investors take from the packaging that risk arrives in. In this sense, convergence is more importantly a process of pulling apart than bringing together.

Many of the largest hedge fund firms have already launched, or are giving serious consideration to launching, products that are available to the broad public through 40 Act and/or UCITS structures. The endless queue of smaller hedge funds, who must now grudgingly accept that the chance of attracting meaningful assets is slim, are wondering out loud whether they'd have a better shot at growth by choosing the road (for now) less traveled. Intermediaries like fund-of-funds are launching retail-friendly products. While most allocators such as pensions and endowment-shave long invested in both traditional and alternative products, many have now synthesized their due diligence efforts in ways that bucket together formerly distinct investments (a key point I'll return to in a moment). And regulators are both reactively and proactively shaping rules that will, when all is said and done, facilitate the rapid mainstreaming of so-called liquid alternative investments. (Contrary to naïve critics of government interference in the economy, the economic history of regulations shows time and again that regulatory intervention accelerates market development versus curtailing it.)

The topic of convergence produces many threads on investing worth following, but let's choose one that hits close to home: Our careers. What does it mean to do manager due diligence in an age of convergence? What does it mean to be a hedge fund analyst when, as just suggested, the concept and application of the hedge fund term is in flux?

Generally, there is a market for talent in fund evaluation, one that can be highly remunerative. But because what's involved with picking managers is typically given far less systematic thought than what's involved with directly choosing securities such as stocks, bonds, or commodities, it follows that a career in fund evaluation is nebulous. Certainly no one grows up dreaming about picking money managers, the books written on the topic are far and few between, and what training exists in this vocation tends to be on-the-job and informal. The art of picking winning fund managers is broadly folkloric compared to, say, equities analysis.

So let's start with what we know. Flows into alternative funds continue at a brisk pace, as John Jaenisch details elsewhere in this newsletter. The industry, approaching \$2.5 trillion in AUM, is at peak assets. There's good reason to think that number will increase on an absolute basis, and more importantly as a percentage of the overall allocation pie. As alternatives continue on this path, we could expect that the demand and premium paid for hedge fund expertise is surging as well.

Or is it? An alternative hypothesis is that the demand for pure hedge analysts, and the market premium offered for them, is peaking or has peaked already. We might suspect that the narrowly defined career category of hedge fund analyst – as is also the case with the category of mutual fund analyst – will continue to evolve into a broader bucket of general manager due diligence, of manager analyst.

Two key trends underlie this line of thinking. The first is the consolidation and downsizing of the pure allocators, the fund of funds. In terms of assets, the likes of Blackstone, Grosvenor, and Permal are beginning to eclipse much of the industry; meanwhile, many smaller fund-of-funds are finding it hard to grow and facing existential pressure. Arguably the incumbents will face a virtuous cycle of increased market share and more resources to embolden their franchises. This will make them the go-to solution for outsourced alternative manager selection and portfolio management, even more so as they have explicitly begun to offer consulting services to their clients. But they will do so in an industry that also appears to be in secular decline, as fund-of-funds manage a steadily decreasing percentage of overall hedge fund assets. Allocators are increasingly “going direct.”

Second, as acceptance of alternatives into the mainstream, it has created a variety of analytic initiatives at the level of both fund selection and portfolio construction that blur, if not fully erase, the old categorical distinctions. One of those is the now-brisk debate over “smart beta.” Leaving aside the question over whether that debate is just a retread of the decades-old discussion of risk factor analysis, it does force us to consider whether supposedly unique and hard-to-access forms of alpha are actually betas that haven’t yet been fully articulated and packaged. Another is the surge of interest in “liquid alternatives,” which we can expect to be a \$1 trillion market by the end of this decade, from effectively nothing a few years ago.

As a result, we are forced to transcend old job descriptions and think about the foundational features of effective manager due diligence, independent of labels or legal vehicles. What exactly is the distinction between a long-only equity fund analyst and a hedged equity fund analyst? Why exactly would the degree of beta in a fund drive professional distinctions on who should be interrogating that manager. One can argue that the existence of benchmark, and often tight tracking error around that benchmark, makes the long only “game” categorically different than the supposedly unconstrained hedged equity manager. Yet this is a false dichotomy. The benchmark-tied fund manager will have *some* discretion around which securities he can choose, the sizing of those positions, tilts in sector, cap, or geographical exposure, and so forth. Meanwhile, the hedge fund manager will have *some* practical constraints over net and gross exposures, position count and sizing, market focus, etc.

The same logic applies to credit managers. As we know, many (not all) credit hedge funds run with a long bias. In addition, many own equities. These two facts render the beta and correlation profile quite high, thus eradicating that fake line between traditional high yield funds and alternative credit funds. Comparing funds from each category might very well reveal stark differences across multiple dimensions, but that’s a *conclusion*, not the starting point of analysis. Hedge fund centric categories like “event” or “macro” are not immune to the same reasoning.

Indeed, the central task of manager due diligence anchors on the setting and managing of expectations across a variable set of relevant dimensions. The higher the number of dimensions, the more by definition the manager is unconstrained or perhaps “alternative.” Degrees of risk taking, and thus manager due diligence, operate on a dial, not a switch. There are degrees of complexity related to leverage, derivatives, nuances of shorting, liquidity and so forth, but we need to recognize that we operate along a spectrum, versus operating in two distinct camps.

Ironically, the hedge fund strategies’ spike in popularity might be undermining the relevance of the pure hedge fund analyst. Perhaps the halcyon days of being an expert in alts due diligence have already come and gone, an artifact of the brief but intense golden age from about 2002 to 2008. The more “pure” roles certainly continue to exist, but with fund-of-funds consolidation, the premier jobs in pure hedge fund evaluation are typically held by highly experienced yet (compared to many professions) relatively young incumbents, thus suggesting fewer seats in the near to medium term. The upshot of this somewhat disconcerting process of industrial reorganization is that could very well presage an era in which the analysis of fund managers, from the simplest to the most complex, will be executed with increased rigor and insight, but also that a career in this field will be more dynamic and fulfilling as well.



Brian Portnoy, Ph.D., CFA, is the author of *The Investor's Paradox: The Power of Simplicity in a World of Overwhelming Choice* (Palgrave Macmillan, www.investorsparadox.com). He is also the head of alternative investments and strategic initiatives for Chicago Equity Partners, a \$10 billion asset manager.

ABOUT US

The Atlantic Group is a leading boutique search firm focused on placing talent globally at asset management firms. The Front Office Practice specializes in Marketing, Investor Relations, and Investment positions, partnering closely with clients to identify and place professionals. Philosophically, the practice is research driven and customized to produce quick value added results. Alexis DuFresne and John Jaenisch head this practice and both come from their respective industries; Alexis is a former hedge fund marketer and John Jaenisch was a buy-side and sell-side analyst.

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