Odyssey's Quarterly Buyside Newsletter - Q4 2016

In this Newsletter

More bad news affecting the investment industry came out this past quarter - asset outflows, fee pressure, fund shutdowns. The financial pages read as bleakly as the front pages covering the Presidential race. In this edition of our Newsletter, we look at how these industry factors are affecting the way front-office professionals are thinking about their compensation. We also look at a couple of the brighter spots of industry hiring, in terms of analysts and data scientists. Fund performance has continued to be positive in recent months (+3.5% throughout Q316 according to the Barclay Hedge Fund Index), so there's perhaps some hope for blue sky behind the clouds. And for those funds brave enough or capable of bringing people on, they are able to attract some stellar candidates currently.

As ever, we'd welcome the chance to discuss these topics with you: newsletter@ospsearch.com or contact us directly as below.

The Odyssey Search Team.

In order for this newsletter to be as informative and useful to you as possible, we'd love your feedback and suggestions for topics. If there are industry questions you're looking for answers to, please let us know and we'd be happy to explore and discuss in future distributions!

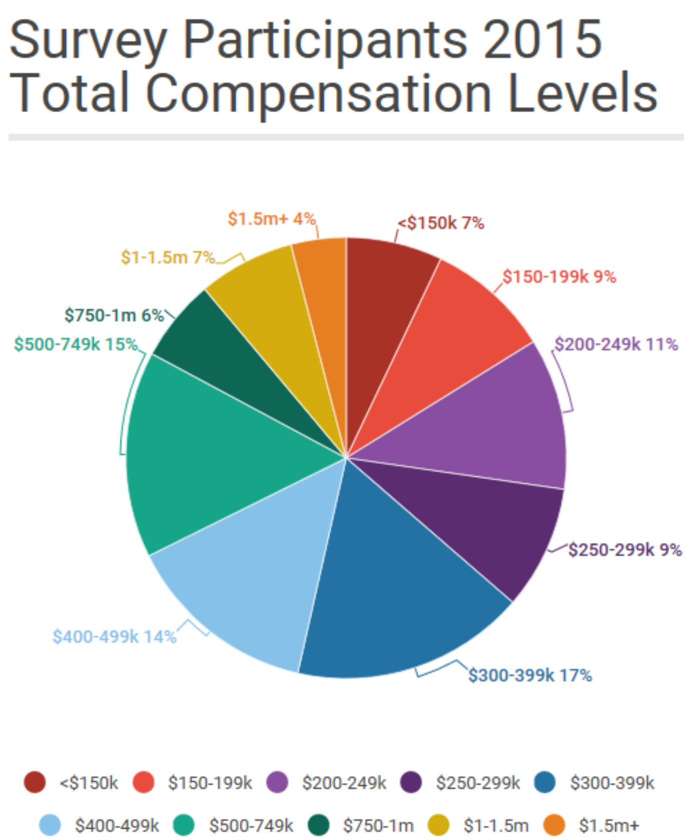
Suggestions Welcome

Not So Great Expectations: Hedge Fund Compensation in 2016 Predicted to Decline Dramatically

Over 500 investment professionals (currently at fundamentally driven public investment firms) responded to an online survey from Odyssey Search in September of 2016. Respondents were asked about their specific role, the firm they represent, past compensation history, and expectations for 2016.

It's no secret that investment professionals are a well-paid bunch relative to the average American. That's what you get for sitting 80 hours a week in front of a Bloomberg. But Wall Street may want to brace itself, as the investment professionals we surveyed are expecting a tough bonus season for the fiscal year ending 2016.

Full-year compensation packages are expected to be almost 10% below the $570k average in 2015. That's including a 3% bump in average base salary, from $168k in 2015 to $173k this year. Given that year-end bonuses account for the majority of an employee's compensation, industry cuts in bonuses will have an outsized effect on overall compensation.



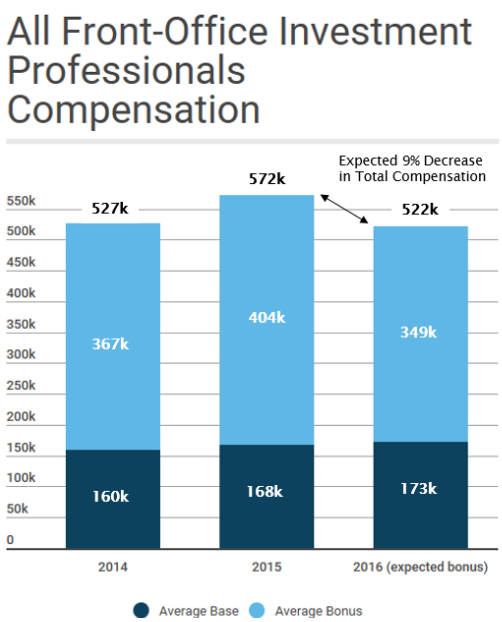
Unfortunately, there remains an expectation-gap in the minds of professionals whose bonuses are discretionary. Looking at professionals with at least 5 years of experience (given that juniors with less than 5 years rarely receive a formula-based percentage), those with payouts at least partially formula-based expect their compensation to decline drastically, by a whopping 21% on average. This pessimistic viewpoint is justified, given the poor industry performance of 2016. However, those who receive a purely discretionary bonus are actually expecting their compensation to rise by an average of 5% this year. Their optimism stems from their presumption that management will dip into its fee structure in cases where performance fees have not been earned. If history is any guide, those with such a rosy outlook are likely in for a rude awakening.

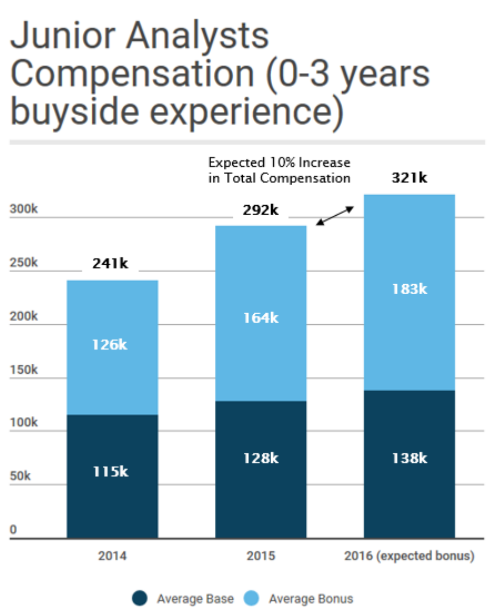
But not all compensation packages are created equal. Following are 3 disparities in expected compensation based on key metrics:

1. Years of Experience

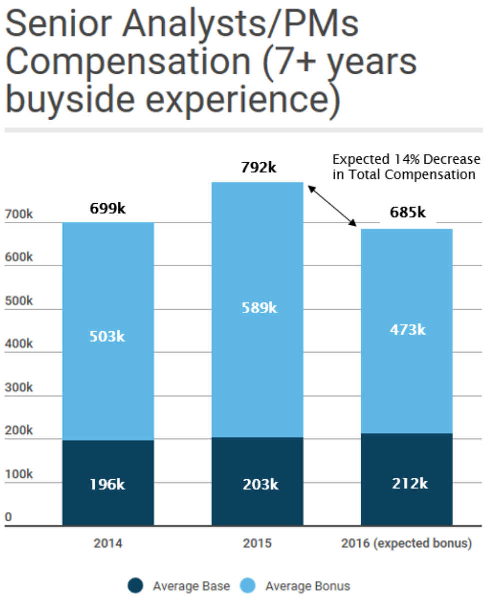
Junior Analysts are the most optimistic of this category. Those with less than 3 years of buyside experience expect their compensation to rise, on average, 10% this year, from $292k in 2015 to $321k.

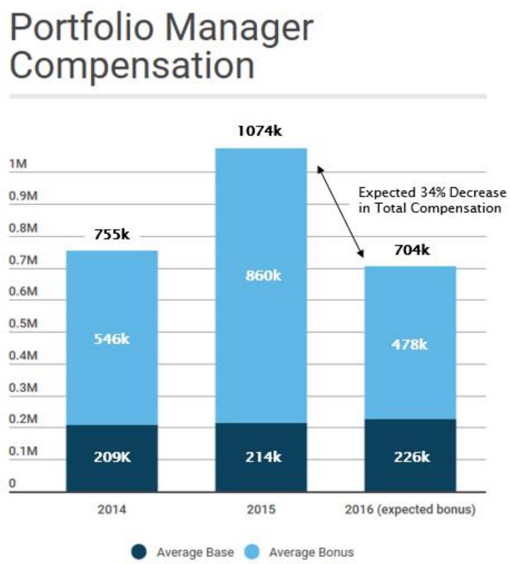
An industry source explains the positive outlook: “The young, smart guys have a range of options, including going to private equity and entering the tech world. They’re hard-working, productive, and relatively inexpensive, so it’s no surprise to me that compensation for this group has continued to rise.”





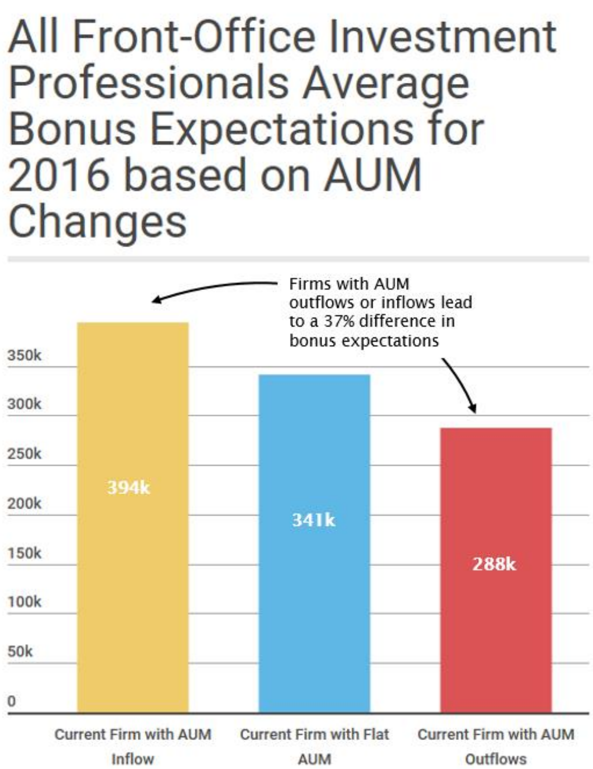
At the more senior level (those with 7+ years of buyside experience), employees expect their total compensation to decline by 14% on average. Portfolio Managers, while the highest paid segment of those surveyed, expect their compensation to decline by a massive 34%.





2. AUM

As would be expected, a firm's growing or shrinking balance sheet throughout the year impacts the expected bonus. Employees whose firms experienced outflows in 2016 expect their bonus to be 37% less than those whose firms experienced inflows ($394k versus $288k).



3. Investment Strategy

Long/short equity professionals are predicting a 21% drop in compensation, while those in long-only funds are predicting flat compensation on average. Interestingly, employees of distressed funds are expecting a 5% bump in year-on-year compensation.

Energy investors are the only sector-specialists who expect higher compensation this year versus last; however that's coming off a dismal 2015 for the energy industry.

Key Takeaway

2016 should prove to be a belt-tightening year. Younger professionals and those in the energy sector can expect modest pay bumps, but for the rest of Wall Street, it seems that winter is coming…

Bonus – some interesting tidbits gleaned from our research:

Ivy League Blues: Interestingly, employees in 2015 experienced a 15% premium for NOT attending an Ivy League college. The average total compensation was $514k for Ivy Leaguers, compared with $591k for non-Ivies. The discrepancy exists solely in the bonus, as reported base salaries were approximately the same.

New York Bias: Employees expect a 20% discount for living outside of NYC. NY-based total compensation in 2015 reported an average of $601k, vs. $501k for those based outside of New York.

Private Credit Moves

Name	Joining	Leaving
Arthur Martini	Owl Rock Capital	Apollo Investment Corp
Barry Osherow	Level Equity	Enhanced Capital
Brian Miazga	CIT Sponsor Finance	Fifth Street Finance
Chris Lanshe	AB Private Credit Investors	Fifth Street Finance
Holbrook Forusz	OFS Capital	Enhanced Capital
Jim Clippard	The Beekman Group	Prospect Capital Management
Kevin Genda	Launching New Fund	Cerberus Business Finance
Marc Adelson	Monroe Capital	Medallion Financial
Marcus Meyer	Madison Capital Funding	NXT Capital
Michael Johnson	Cerberus Business Finance	Goldman Sachs
Winston Chow	GCM Grosvenor	PineBridge Structured Capital

Note: We came across these moves in the course of our business; they do not include Odyssey placements, respecting the confidentiality of our candidates and clients.

High Anxiety: On-Cycle Recruitment is Right Around the Corner

The 2017 on-cycle recruitment season is fast approaching, and that can mean only one thing: Anxiety, and lots of it. The possibility of tapping an untouched pool of the world's best and brightest is enticing to say the least, yet the practice itself is laborious and time-consuming. From meeting candidates to making offers, every step in the process is driven by speed, in a desperate bid to outdo the competition. As such, firms often make hiring decisions very quickly and with incomplete information – a risky proposition to put it mildly.

Yet firms aren't the only ones feeling scared. Even more foreboding than a creepy clown sighting, candidates often lose sleep over the ever-present fear of missing out on that golden-ticket offer. In Odyssey's 2016 Investment Banking Analyst survey, we reported that nearly half of all candidates did not feel adequately prepared to interview by the time on-cycle recruiting had started. While Wharton Finance undergrads with a handful of New York buy-side internships under their belt may feel prepped and ready, feelings of apprehension abound for candidates who live outside the tri-state area, as well as those from non-finance backgrounds.

There's also the problem of "drop off" – reneged offers from candidates who continue to interview. Testing the waters after signing an acceptance letter is clearly unethical, but good luck holding these recent college students accountable. While the candidate may have been given 24 hours to accept the offer, there often then exists a 1.5-year gap until the job actually starts. That's a significant portion of anyone's life, let alone that of a 21-year old. Circumstances can change, and even the choicest of offers are sometimes not taken up, much to the exasperation of everyone involved.

So how are buyside firms reacting? We've seen three approaches:

Fishing upstream – The latest trend in buyside recruitment is focusing on recent college graduates. A few fundamental firms are swooping in to pick up what they see as the best of the college senior class. It is also the favored route of the more quantitative hedge funds where backgrounds in math and science are more germane to the responsibilities of first-years than are traditional banking skills. In both cases, candidates with full-time work experience (let alone banking skills) require extensive training to prepare them for analyst positions, and only the largest firms capable of allocating resources for human capital development are making these investments.

Participation in on-cycle recruitment, but with a lowering of expectations – We've spoken with firms who are participating in on-cycle recruitment, yet expect to miss their hiring quotas during the short sprint in February and March. By accepting off-cycle recruitment as a viable Plan B, firms remove the added pressure to trump the competition by making an immediate offer, and therefore limit their downside risk.

Movement to an off-cycle/'on-demand' hiring model – When firms evaluate 2nd and 3rd years still in market, they often fall prey to what psychologists call 'the bandwagon effect' – operating under the assumption that if other firms have not already scooped up the candidate, he or she must be sub-par. Yet this form of groupthink can prove detrimental, as we are aware of many 2nd and 3rd years in market who are in fact stellar candidates. Their reasons for remaining in market vary: Perhaps they were excessively selective during 1st year recruitment in an attempt to maximize their investment banking training and exposure, or just felt too busy to properly prepare to interview. Perhaps they were undecided on career trajectory, and needed the extra year to sharpen their focus. Or perhaps their reasons are more pedestrian, such as a change in group or location. As one recently placed 2nd year banker told us, "I knew I wanted long-short equity, and I understood enough about the ongoing nature of hedge fund hiring that roles would come up intermittently over my banking period. I didn't participate in 1st year recruiting because it felt like a distraction, and rushed, and I'd probably have felt compelled to accept a sub-optimal option". In today's world with issues around "consensus trades," shouldn't we value someone confident in their own abilities and willing to stand apart from the crowd?

So while we expect the usual flurry of hiring activity this spring, it's encouraging that people are increasingly thinking beyond the confines of the on-cycle hiring process to land their analyst talent.

Hedge Fund Moves

Name	Joining	Leaving
Aaron Kapito	Delonix Capital Management	Elliott Associates
Ari Barzideh	Strategic Value Partners	BlueMountain Capital Management
Benjamin Fund	Point72 Asset Management	Apollo Global Management
Clayton Gardner	Carbonado Capital	Farallon Capital Management
Jason Breeding	ValueAct Capital	Marcato Capital
Jeremy Grant	Elliott Associates	Oak Hill Advisors
Johann De Sousa	Valiant Capital Management	Seven Harbour Global
Josh Ross	Bain Capital Public Equities	Adage Capital Management
Matthew Pascale	Balyasny Asset Management	ShearLink Capital
Nick Rugoff	Third Point	Moore Capital Management

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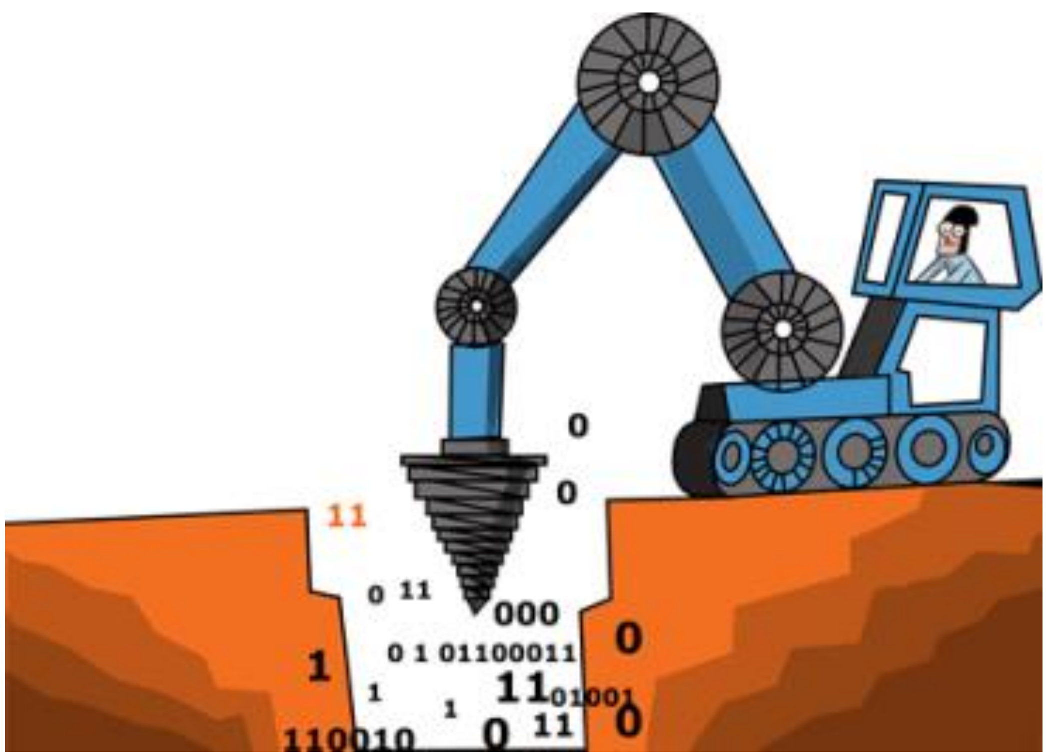
Big Data, Big Hiring

When most people hear the terms “proprietary data analyst” or “alternative data specialist,” they think Silicon Valley, not Wall Street. But this new cadre is rapidly altering the complexion of front-office investment teams everywhere. As one retail investor confided, “When I first started in the industry, it was considered good homework to visit stores and check out their merchandise, inventory, and maybe speak with a few shoppers. Then we started surveying stores by calling a sample of them, or maybe running an online survey. Now we can web-scrape more about products and prices than we ever dreamed of, just from sitting at our desks.”

If you’re wondering what a proprietary data analyst actually does all day, you’re not alone – mere mortals who lack backgrounds in math and statistics are often clueless when it comes to data mining and quantitative analysis. Typical responsibilities include performing regression analyses, suggesting correlations, and back-testing those theories. Data miners are skilled in data manipulation and basic coding, yet eschew the ‘computer science’ label their software engineering peers don so proudly. Ideally they additionally sport financial backgrounds, which help them communicate with investment professionals and understand the context in which they are operating. Many come from equity research or more quant-like trading desks, though some also derive from academia or even the tech world. Tech sector hedge fund Coatue Management, for example, just hired a Data Scientist from Google to join their team.



Many on the street are wondering what's driving this latest trend. Our research has uncovered 3 important factors:

1. Growth of data providers – firms such as Earnest Research, Yipit, and Orbital Insight act as research providers, packaging data into a digestible format for investors. Orbital analyzes millions of satellite images from around the world to glean insights into socioeconomic trends that might help investors predict macro-events before they happen. The three-year-old company recently landed a $15MM Series B funding round led by prominent investors such as GV and Sequoia Capital.

2. Proliferation of data sources – Statistics on things like weather patterns, road traffic, or freight volumes, once considered esoteric pieces of information that could only be gathered through more traditional means, are now readily available to anyone willing to take out a pickaxe – or in this case, software program – and mine through them. As digitization becomes ubiquitous, so does the gathering of information. For example, as retail purchases shift online, the proportion of goods paid for by credit cards over cash has increased, which in turn leaves a clearer trail of electronic records for analysts to pour over. Bigger servers, cheaper memory, and faster internet speeds all mean one thing: more data, which in turn leads to more data analysis.

3. Desire for a smart, legal edge – Data-mining is seen as legitimate, ethical, and cuts to the core of why LPs use professional investors in the first place: because they work harder and smarter to acquire those market-beating insights. As a source in the data-mining community told us, "One challenge of getting information from individuals is that they might tell you something they shouldn't. Extracting insights from aggregate data doesn't carry the same compliance concern."

Despite the rising trend in data analysis, not everyone remains convinced of its reliability and predictability. After all, if a brand is bashed on social media, that doesn't necessarily mean its revenue or stock price will be affected. The key to unlocking these correlations lies in the talents and abilities of those seeking to evaluate data sources and derive insights through analytics. And these days, Wall Street firms are placing bigger and bigger bets that data scientists are up to the task.

FUN FACT: 60% of respondents under the age of 44 check someone out on Google or LinkedIn before taking a meeting (Financial Planning Association)

The Art of Succession Planning

In 2008, legendary NFL quarterback Brett Favre retired from the Green Bay Packers. The departure of one of the greatest quarterbacks of all time could have easily upended the entire organization. Fortunately for Packers fans, while Favre was tiptoeing towards his *(first)* retirement, the Green Bay front office was busy grooming his eventual successor, Aaron Rodgers. In fact, they planned their succession so perfectly that Rodgers was able to lead the Packers to the franchise's 4th Super Bowl in only his 3rd season as a starter.

Succession planning can be tricky. When a fund manager is producing year over year, it's tempting to slap the blinders on and simply ride the highs. As an equity stakeholder in the alternative investment space told us, *"A lot of people get caught up building and shaping the firm in their image. They don't spend time on succession planning, then suddenly when it's upon them it's too late."* But even if your firm has its own Brett Favre, there's no reason why you shouldn't start prepping an Aaron Rodgers for that inevitable takeover.

Benefits to Succession Planning

Everyone wins when a solid succession plan is in place. Here is how succession planning impacts the various faces of the company:

- **Employees** – Succession planning alleviates employee anxiety over the fund's future, and reduces the likelihood of workers spending valuable time and energy on a potential transition. To quote an Associate at a $1B long-short equities fund, *"The job market is fluid. If your boss isn't thinking of your future, then you have to be. Uncertainty breeds disloyalty."*
- **Employer** – It may seem counter-intuitive, but prepping a successor benefits the fund manager as much as anyone. As one corporate advisory CEO put it, *"Having a plan in place provides comfort in the knowledge that the next generation will continue the traditions established by current management."* After all, the only thing more gratifying than creating a successful fund is watching it grow into a multi-generational franchise.
- **Investors** – A strong succession plan increases the value of the overall business by assuaging investor concern over future ROI. It also signals that you're planning for the long haul, which of course is music to any investor's ears. Remember, it's never too soon to prepare an exit strategy, even if you're still in the capitalization phase.

The 3-Step Process

Now that we know why succession planning is so important, let's take a look at how best to go about it:

1. Formulate a Strategy – Just as every building needs a blueprint, every succession plan needs a strategy. Start by identifying the key talents, traits, and skill sets that are integral to the fund manager's success. Think both quantitatively and qualitatively here – are there certain business fundamentals that must be mastered? How important are pure Portfolio Management skills relative to managerial expertise and experience leading LP interactions? Once these considerations have been established, the remaining question is whether to promote internally or seek outside talent. Each option carries with it a unique set of challenges – a current employee may harbor grievances with fellow colleagues that lead to alienation or disruption in work flow, while an outside protégé might stumble while absorbing a new firm's culture. There is no silver bullet here, unfortunately; one must simply be aware of the inherent obstacles and work diligently to overcome them.

2. Gradual Allocation – Filling the shoes of a successful fund manager can be a daunting enterprise. Not only must a successor cultivate the requisite talents and skill sets, he or she must also maintain the poise and confidence to exhibit them on a daily basis. That is why the formulated strategy in Step 1 must be gradually allocated over a period of time – several years preferably – so as not to inundate an already overwhelmed successor with too many responsibilities at once. A slow-build will serve to comfort the successor and help make a potential thorny transition as seamless as possible.

3. Communication & Trust – If you don't already know that communication and trust are the two building blocks of a successful relationship, then clearly you haven't been watching enough Dr. Phil. The successor must feel comfortable asking questions without feeling intrusive or subordinate, while the fund manager must proffer wisdom and advice without appearing overbearing. A delicate balancing act to be sure, but the established relationship of communication and trust will act as a safety net, reassuring both parties in times of crisis or distress.

Success Stories

In what has become a textbook example of proper succession planning, Tom Steyer turned over the reins of his $20B capital management firm, Farallon Capital, to Andrew Spokes in 2012, a Brit with whom he shared management responsibilities for the previous five years. Steyer hired and promoted Spokes long before the eventual succession, allowing many years for the grooming process to incubate. He also placed a premium on talent retention; Spokes' 19 partners had an average tenure of 11 years apiece at time of succession. Steyer also mitigated investor concerns by telegraphing his exit years prior, as well as leaving the bulk of his capital in Farallon for Spokes to manage. In short, Steyer formulated a strategy, gradually allocated it over many years, and built a relationship of communication and trust with his successor as well as the firm's investors.

Other examples of successful succession plans derived from our interviews include David Shaw's departure from D.E. Shaw, Value Act, Brigade, Renaissance Technologies, Apax Partners and Angelo Gordon & Co.

Succession in a Nutshell

There's an old saying: *"Failing to prepare is preparing to fail."* Those are wise words that every fund manager should heed. In the end, succession planning is all about preparation – the more you prepare, the greater the likelihood your organization can weather a difficult transition. Just ask Green Bay Packers fans… their team is a perennial Super Bowl contender, and it's all thanks to some wise succession planning.

Private Equity Moves

Name	Joining	Leaving
David Yang	Access Industries	Warburg Pincus
Evan Stein	Union Park Capital	Battery Ventures
Ian Vick	York Capital Management	3G Capital
Jason Palmatary	Hudson Hill Capital Management	TPG Growth
Kabir Sodhi	Solace Capital Partners	Aurora Capital Group
Kevin Guan	Bain Capital	Silver Lake Partners
Mark McLaughlin	Housatonic Partners	Technology Crossover Ventures
Matt Gilbert	Thoma Bravo	Summit Partners
Richard Brode	EQT Partners	Kohlberg & Co
Shain Rae	HIG Capital	DEUS Rescue
Tiffany Clay	L Catterton (formerly Catterton Partners)	TPG Capital

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Citi 2016 Investment Management Industry Conference, 10/5/2016 New York

Some take-aways from recent research conducted by Citi's Business Advisory Service:

Hedge Fund portfolios mirroring the markets: Hedge fund portfolios have become more correlated to the market. The HFRI Equity Hedge Index correlation to S&P 500 in 1995 was 0.5; the correlation has grown steadily over the years, and by this year the correlation stands at 0.9. Given that active managers are increasingly just capturing beta, there are now cheaper ways to get that exposure

Shift to passive management: Actively managed funds continue to lose ground to passively managed. The actively managed proportion of investment management industry assets represented 84% of industry assets in 2005; by this year, they have fallen to 69%; they are predicted to fall below 50% by 2021

Industry barbell structure continuing to take shape: As there's a reduction in size in long-only and long-biased strategies that replicate the market at higher fees, there's growth in both cheaper passive, smart beta funds and in actively managed, alpha funds

Role of active managers: They still have a role to enhance the return stream by creating alpha; strategies likely to succeed include quant, concentrated portfolio of high conviction ideas, and cross-asset investors who can dynamically shift assets across the capital structure

Strength of Private investing: A greater proportion of investment management assets have been going into private asset strategies. Between 2010 and 2015, Private Equity and Private Debt funds captured 77% of new investor inflows

Odyssey Search Partners

Adam Kahn
Anthony Keizner
Brent Zaterman
Brian Byck
Jeff Rosenblum
Vincent Colangelo
Lauren Neag
Mehrin Ali

Feedback Welcome

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