As Big Hedge Shops Grab Share, Small Firms to Lead Deals

By Raquel Pichardo-Allison March 25, 2015

The big will keep getting bigger in the U.S. hedge fund market this year, but smaller hedge funds are likely to be at the heart of merger and acquisition activity in 2015, industry watchers say.

The industry giants – Bridgewater Associates, J.P. Morgan Asset Management, Och-Ziff Capital Management and BlackRock – are likely to gain further market share beyond the combined 13.5% of industry assets they control, according to a survey of managers in a recent **IBISWorld** report on hedge funds. But most of that growth will be organic, while the acquisitions activity will be among smaller hedge funds, as managers with less than $250 million in assets seek partners to increase scale and tackle the ever-increasing cost of regulatory compliance.

Big Firms, Low Concentration

The top four hedge fund firms control 13.5% of U.S. market assets

Firm	Total assets in $ billions	Market share
Bridgewater Associates	$110.4	5.5%
J.P. Morgan Asset Management/ Highbridge Capital Management	$72.5	3.6%
Och-Ziff Capital Management	$46.7	2.3%
BlackRock	$42.2	2.1%

Source: IBISWorld estimates

“A lot of the consolidation that may occur is in the smaller funds,” says **Stephen Hoopes**, lead analyst at industry research firm **IBISWorld**. “Revenue is highly correlated with assets under management so there’s a clear incentive to increase scale. A lot of times, markets like pension funds won’t even look at funds with under $250 million in assets, so if you’re not hitting that mark, you’re leaving a lot of potential [assets] on the table.”

Funds with assets topping $1 billion garnered 62% of the assets placed into hedge funds by U.S. public pensions between 2012 and 2014, according to data from Preqin. That compares to 20% snagged by funds between $250 million and $1 billion, and only 18% of assets going to funds below the $250 million mark.

Money placed by pension funds accounts for 34% of the $2 trillion in U.S. hedge funds assets, so not accessing this group means “leaving a third on the table if you’re not meeting this requirement,” adds Hoopes. “So there’s a huge incentive if you’re a smaller fund to try to increase your scale.”

In addition, compliance puts undue pressure on smaller managers. Data from KPMG, the **Managed Funds Association** and the Alternative Investment Management Association shows that compliance costs can range from $700,000 to an eye-watering $14 million, depending on the size of the fund, says the IBISWorld report.

The biggest U.S. hedge fund firms control less of the market than in other sectors, according to the IBISWorld report. It estimates that Bridgewater controls about 5.5% of U.S. hedge fund assets, or $110 billion, though the firm itself reports total assets under management of $169 billion.

IBISWorld's estimates also show that J.P. Morgan Asset Management, including its Highland Capital Management unit, manages 3.6% of U.S. hedge fund assets with approximately $72.5 billion; Och-Ziff controls 2.3% of assets with $46.7 billion; and BlackRock has a 2.1% stake of industry assets with $42.2 billion. Their asset-raising prowess and their resources to handle matters such as increased regulatory scrutiny give them an edge, according to the report.

Many of the headlines around merger and acquisition activity have focused on the bigger names recently. In December, Man Group announced its acquisition of **Silvermine Capital Management**, a $3.8 billion leveraged loan manager, and the acquisition of Merrill Lynch **Alternative Investment**'s $1.2 billion fund of funds portfolio. In June, the firm had acquired **Pine Grove Asset Management**, which touted $1 billion in assets.

Also last year, Neuberger Berman acquired **Orchard Square Partners** from **Ramius**. Orchard Square's long-short credit investment team ran $475 million in assets from insurance companies, institutional investors, family offices, high net worth investors, endowments and foundations.

But the big-name deals may take a backseat to activity likely to occur in the sub-$250 million market, which according to **Barclay Hedge**, accounts for about 80% of all hedge funds.

"Is there still a viable argument for consolidation? I'd say yes," says **Sol Waksman**, founder and president of Barclay Hedge. "The difficulty of raising assets for certain-sized managers has not gotten any easier. If hedge funds have a blowout year and do phenomenal, then all bets are off. But absent that, the factors that are driving consolidation are there."

In particular, he says the appearance of poor performance among hedge funds could push managers to seek a larger partner or to pair up with another smaller player. The Barclay Hedge Fund Index showed hedge funds were up 3.16% in 2014, while the S&P 500 returned more than 12% in the same time period.

"Whenever you are in a situation where the funds are perceived to underperform, you will see this happening," says Waksman. "The major part of the payout to the manager is the incentive fee. If they're underperforming, the incentive fee is small, but their expenses are fixed. So what do you do? You go out of business or you merge. It's an economic decision."

There nevertheless should be mergers and acquisitions activity across both big and small hedge funds this year, says **Steven Levitt**, managing director at Park Sutton Advisors, an investment banking firm.

"I do think we'll continue to see small hedge funds looking to link up with different partners that can help them in different ways," he says.

However, Levitt says the activity around larger funds will entail selling stakes of their businesses. "We'll continue to see some larger hedge funds looking to sell smaller stakes to sovereign wealth funds or other partners as they look for some monetization for founders," he says.

Last week, **Dyal Capital Partners**, a private equity arm of Neuberger Berman, acquired a 20% stake in activist investor **Jana Partners**, which manages $11 billion in assets, **as reported**. The proceeds will be invested in Jana's funds, and some on behalf of Jana employees, essentially serving as a retention bonus.