Making the Most of the Hedge Fund Talent Shortage

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We are near the end of a third consecutive year in which hedge funds have struggled to justify their existence. The response of some industry veterans has been to say relax, stay the course, we've been here before. They're wrong. We have not been here before.

Even as the stock market has gone steadily up since 2012 the average return of all hedge funds will be flat to negative[1] for the third year in a row at the end of 2016. The reasons for this aren't only too do with poor investment strategies. Behind those strategies is the talent, or the lack of it, making uninspired choices.

Prominent US hedge-fund managers have gone on record this year with concerns about the thinness of talent, pronouncing themselves "blown away" about the difficulty of finding what they consider "great people". Outside the United States the talent shortage is even more acute.[2] But the problem is broadly the same: Too many funds and an insufficient supply of talent.

According to Hedge Fund Database, there are roughly 20,000 hedge funds in the world today—about 16 times the number of firms 25 years ago.[3] Hedge-fund pioneer Julian Robertson, founder of Tiger Management, has observed that not only are there too many firms chasing the same talent but the sameness of the available talent is leading to a sameness of investment strategies, with awful consequences for returns. As Robertson puts it, "There's too much talent in the same game."

In any other industry sputtering performance and the absence of significant business innovation would prompt management to think again about its strategic approach to talent. But hedge funds remain committed to a talent strategy that has not changed in nearly 30 years.

The reflex response to the broadly acknowledged talent shortage is to poach from competitors, especially smaller firms. In other words, keep looking in the same reservoir but fish in a different end of the pool.[4] That's not the way to go. Recruiting a new genius from a competitor is a costly move that pushes up compensation costs. The acquirer of talent pays a premium to do it. So does the firm stuck refilling a critical position.

There's no questions that compensation for top talent has taken a hit in the past several years as performance has declined. But comp remains eye-popping even by the standards of financial services.[5] A business with high labor costs and downward profitability should be reinventing its talent strategy, not staying the course.

Stop looking in the mirror

When most hedge funds do a search for talent they look for what they probably see in the bathroom mirror every morning. White, male, Wall Street background.[6] The problem with this isn't only confirmation bias. It's the group think that results.

Even in good years hedge funds are not noted for breakthrough innovation. For example, name three mold-breakers in the hedge-fund industry with the name recognition of Elon Musk, Jack Ma or Mark Zuckerberg. Don't bother. You can't.

For that reason alone the new talent-development model[7] can't look like the old one. The world has changed too much. The new model will be derived from nontraditional talent and nontraditional sources.

Some funds are making a push into social media as a way of spotting new talent. It's a start, but a better model is to learning to be consciously unconventional in hiring. In just the past year, for example, one fund giant made news recruiting senior HR talent from well outside financial services, specifically a software maker and an aerospace company.

For hedge funds, attracting—and keeping—the right talent now has a strategic urgency directly affecting sustained success in the industry. And, in strategic terms, openness to nontraditional sources is directionally correct.

If all that is true, then why aren't the smart people who run hedge funds following the lead of other firms with an openness to nontraditional hiring?

A major reason is that, historically, funds do not benchmark against their competition on any basis other than investment performance. There is a virtual absence of structured competitive intelligence in the industry. Talent is a specific omission.

But here's a prediction: The industry's future talent pool will be liquid and look more like an organized market for independent contractors (or teams of them) than today's traditional one-to-one employment relationships. Hedge funds will need to develop talent strategies that enable consistency of purpose and direction despite a dynamic talent supply. That will begin with hiring outside conventional Wall Street channels.

Hedge funds need a new talent pool to fish in, one with different fish in it. Attempts to import Silicon Valley talent have had mixed success, but they are at least a gesture toward renewed industry innovation.

Hedge funds need to develop agility and adaptability in the ways they think about talent. That means making creativity as important as functional skills. With that will come the return of sustained performance.

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1. Source: Barclay Hedge Fund Index.

2. Why Asia's Hedge Fund Growth Lags So Badly. Leslie Shaffer. CNBC.com. 2 October, 2015.

3. Sohn Conference 2016: Fraught Hedge Fund Managers Are Facing Their Biggest Critics. *International Business Times*. 5 May, 2016.

4. See, for example, Six Ways Hedge Funds Need to Adapt Now. SEI Knowledge Partnership. 2013.

5. Hedge fund employees expect drop in bonuses, survey finds. Christine Williamson. *Pensions&Investments*. 21 October, 2016.

6. Something is missing from the hedge fund industry. Rachel Levy. *Business Insider*. 13 September, 2016.

7. The Hedge Fund Dilemma: Finding the next rock star traders. Kate Kelly CNBC.com 31 May, 2016. See also Beyond Banking: Traditional Talent Pool Dries Up for Hedge Funds. *Financial Times*. 12 November, 2015.