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What are hedge funds?

Hedge funds are financial vehicles that consolidate capital from multiple parties to pursue specific investment strategies, such as long/short equity strategies, distressed debt investing strategies, credit- and mortgage-focused strategies, and algorithm-based trading strategies. Hedge funds differ from traditional mutual funds, which are generally “long only,” meaning they purchase equities with the expectation that the market will rise. In contrast, hedge funds are “market neutral,” meaning they are designed to make money for investors in any market, regardless of whether the market rises or falls. For example, a hedge fund manager may invest in one financial product, expecting it to rise, and invest in another, expecting it to fall—a strategy known as “shorting,” in which one can realize a return from a financial product that is losing value.

Because hedge funds traditionally pursue more complicated investment strategies than mutual funds, they are available only to accredited investors (i.e., individuals with a net worth of at least $1M or those who earned $200K in income during the previous two years). Still, accredited investors are not solely responsible for the capital inflows into hedge funds; institutional investors—such as public pension plans, corporate pension plans, and endowments—and family offices, which manage the personal wealth of ultra-high-net-worth individuals, are other typical hedge fund investors.
What do the data say about hedge fund recruiting?

Percentage of the MBA Class of 2016 Taking Hedge Fund/Investment Management Jobs

Source: School employment reports

Compensation for Hedge Fund Positions

Source: School employment reports

Because careers in the hedge fund industry are associated with prestige and a high level of compensation, the recruitment process can be very selective and challenging for candidates. Many business school students interested in entering this industry either will already have extensive experience in financial services or will dedicate a significant portion of their time at school to developing investment theses and pitching investments at case competitions and industry networking events, as well as via the school’s investment clubs. In addition, MBA students commonly take advantage of their program’s alumni network to identify and connect with hedge fund industry members.
Teams at hedge fund firms are generally very lean, and job titles are not well defined or consistent from one fund to the next. Investment professionals at hedge fund companies can be classified in three broad categories:

<table>
<thead>
<tr>
<th>Modelers/Researchers</th>
<th>Idea Generators/Analysts</th>
<th>Portfolio Managers</th>
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**Modelers/researchers** specialize in a particular area of research or a certain asset class. This category includes skilled traders, algorithm writers at high-frequency trading funds (i.e., funds that employ a computer-automated trading program), and individuals with technical, mathematics-based backgrounds who build models and tools for analysis. This role is much more than that of a typical IT (information technology) position, however, and candidates who possess both the financial acumen and the technical skills of a modeler are highly sought after in the hedge fund world. This role can vary widely in pay and prestige, and it is not necessarily on a linear promotion track with analyst tenure or experience.

Most candidates enter the hedge fund industry out of business school as **idea generators/analysts**. Regardless of their level of experience, hedge fund investment professionals are often referred to as “analysts,” even if they are very senior members of the firm. Analysts generally cover a specific sector, asset class, or geographic area, though some firms will start new analysts as generalists to determine where their competencies and interests lie. Depending on its size and the number of funds it manages, a firm will usually encompass a few small teams of analysts. A portfolio manager heads each team, and a chief investment officer (CIO) oversees the allocations among a number of portfolio managers and funds.

Analyst compensation is generally driven by the performance of both the portfolio as a whole and the analyst’s investment recommendations within the portfolio.
Depending on the firm’s culture, either individual performance is emphasized or the entire team is compensated based on the performance of the collective firm. Consequently, analyst compensation can vary widely; in other words, years with good performance can yield very high bonuses, while small or no bonuses are given in years when performance is poor.

A portfolio manager is typically a former analyst with a successful track record in investing. However, portfolio management and risk management skills are what make a portfolio manager successful. In addition, the attributes that make someone a strong hedge fund analyst do not necessarily equip that person to be a skilled portfolio manager. The portfolio manager is generally a higher-level employee who receives real-time updates from his/her team and decides whether to change the portfolio’s allocation based on his/her view of the overall economic landscape. A portfolio manager’s compensation depends highly on the fund’s overall performance. Total compensation generally starts at $1M, though it can be much higher, with some successful managers at large hedge funds earning more than $20M in a good year. Some portfolio managers also have business development responsibilities and are expected to personally interact with the fund’s largest investors. Despite having dedicated investor relations teams, most institutional investors want to be comfortable with the portfolio manager’s thought process and investing style before making an allocation to the fund. So, although sales orientation is not critical to being a portfolio manager, it can be a great advantage to someone who aspires to the portfolio manager level.

The “2 and 20” Compensation Structure

Hedge funds charge investors a 2% management fee, and this income is generally used to cover the business’s basic operating expenses. Thereafter, the fund charges an incentive fee of 20% of performance to cover the cost of employee bonuses. For example, a firm that charges the aforementioned 2% and 20% fees, manages funds totaling $5B, and beats its return benchmark by 5% in a given year would earn $100M in management fees and $50M in performance fees. Large bonuses are given only in years when the fund outperforms its benchmark or hurdle rate, which is a minimum return that the fund must generate to cover its performance fee—it is not paid just for earning ordinary market returns. For analysts, typical base compensation starts at approximately $150K, and bonuses can range from $150K to more than $1M, depending on the fund’s size and performance.
What is the job?

A day in the life of a hedge fund analyst can vary greatly depending on investment strategy, fund size, and company structure. Hedge fund investment professionals must contribute ideas to the portfolio and then manage the risk of these positions through continued analysis and oversight. Most analysts spend a considerable amount of time doing research—such as poring through a company's financial statements and listening to investor calls or learning everything possible about the mining industry in Australia, for example, to decide whether to allocate money to that sector. Hedge fund analysts generally have a high degree of autonomy in conducting their research, and that research could require travel and a great deal of outside interaction, or it could be very systematic and based on computer models, thereby requiring a large amount of on-site hours at one's desk. Although hedge fund analyst jobs generally involve 60-hour workweeks, this is shorter than those of bankers and individuals in private equity.
No, really, what is the job?

At most hedge fund firms, investment professionals spend a great deal of time identifying their next investment ideas as well as justifying and strategically managing the risk of existing investments in the portfolio. The following quotes help illustrate how much the role of an investment professional at a hedge fund can vary from one firm to the next. The level of interaction with industry participants, the amount of travel, and the extent of mathematical modeling can differ significantly.

Whirlpool was a big winner for us last year. We started with a really broad idea (second-wave effects of the housing recovery) and spent months narrowing it down to what we thought were the best investments within that category—we called it “housing derivatives”—before even adding any new names to the portfolio. We actively traded in and out of that theme for almost a year before winding that allocation down. Now I’m working on an entirely new idea.

I attend a lot of tech industry conferences. I’m constantly trying to keep up with all of the changes in the industry, and talking with other investors focused on tech is helpful and often provides me with a new framework to view my own investments. I also travel frequently to visit the management of the companies I cover. Since we invest in small cap companies, I’m able to interact with the management often.

[Recently], my firm had a significant allocation to RMBS [residential mortgage-backed securities]. I spent countless hours developing a dynamic stress test for the RMBS portfolio with a programmer. RMBS were really hot at this time, and the difference between being good and great was huge. Anyone could make money buying an RMBS at that time, but with a strong sell-side network and the most advanced risk modeling tools, we were able to beat the RMBS indices by +1000 basis points.

My firm is focused on distressed investing, and we have a really thorough and lengthy investment process. When sourcing new investments, we go through endless legal documentation to understand the fine print of the investment. Once we make the investment, we are an active member of the investment team and will corral other investors together to help make decisions that benefit the group. It can be a very frustrating process, but when it works, it really works.
What is good about the job?

Hedge fund firms can offer employees a high degree of intellectual rigor and creative freedom. Hedge fund investment professionals constantly need to come up with new ideas, and doing so often involves managing both large data sets and qualitative opinions. For example, a winning stock pick in one quarter may not be the best relative opportunity in the next quarter. Hedge fund analysts are constantly re-evaluating their ideas and incorporating new macroeconomic and company-specific data points. For self-motivated individuals, this work can be very rewarding and provides exposure to a variety of industries and asset classes.

Although most hedge fund investment professionals remain in the investment management industry throughout their career, the financial expertise one amasses and the exposure to corporate strategy one enjoys tend to yield a great skill set for those who want to eventually transfer into corporate roles.

A hedge fund job offers the following benefits:

- The opportunity to become an expert in a specific industry or asset class
- A challenging environment in which analysts and investment professionals must continually prove themselves and source new investment ideas
- Exposure to senior management in various industries with whom hedge fund analysts interact as part of the research process
- Unlimited upside in earning potential, even early in one’s career
- A meritocracy in which hard work and good ideas are generally rewarded
- Strong exit opportunities into other money management firms or senior corporate finance roles
But surely the job has pain points, right?

Hedge fund firms tend to have very flat cultures, and analysts must prove themselves anew each year by delivering novel and successful investment ideas. Although this environment can be exciting, it can also be frustrating. The high level of compensation these roles offer is a motivating factor for many, but hedge fund analysts must truly be passionate about investing, because that compensation can fluctuate significantly from year to year.

Working in the hedge fund industry has the following drawbacks:

- Competitive and sometimes cutthroat environments
- A high degree of variability in compensation if the overall portfolio or the analyst's individual ideas do not perform well
- A sometimes unclear promotion path or career trajectory
- The need to constantly prove one's worth by generating new investment ideas
- The risk of even short-term poor fund performance leading to instability at firms
What is the secret to success?

Although there is no single formula for success in the hedge fund world, two traits are common among successful hedge fund managers. First, most possess a strong sense of intellectual curiosity and analytical ability. And second, while all candidates for hedge fund positions are expected to be able to crunch numbers and analyze financial statements, what separates the average employee from the highly successful one is the ability to creatively source new investment ideas.
Who are the big fish?

Located in the popular hedge fund town of Greenwich, Connecticut, AQR has been running risk parity and quantitative trading strategy funds since 2006. The firm takes a rather academic approach to investing and offers four groups of strategies—traditional, alternative, investment vehicles, and environmental, social, and governance investing—that are based on well-documented behavioral finance trends.

The Baupost Group®

This Boston-based fund manager is known for flying under the media radar. With a low-leverage, value-oriented strategy, Baupost has proven to be one of the best-performing funds in the industry over the past 35 years. (Value investing is broadly defined as when an investor takes a long-term view on an underpriced security and waits for the value to converge, such as a stock that trades below the earnings ratio for its competitive set.) The firm’s founder, CEO, and president, Seth Klarman, is widely respected in the value-investing world, and his out-of-print book Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor is a must-read for anyone entering the hedge fund industry (as of the most recent update of this guide, new copies were listed on Amazon.com from approximately $700 to nearly $1,500).

BlackRock

This large institutional investment firm has grown its hedge fund group into one of the largest in the industry, expanding across a wide array of strategies, including several sector-specific and geography-focused strategies.

Brevan Howard

The largest of the European hedge funds, Brevan Howard is also a macro-focused manager, which means the fund takes broad bets on macroeconomic trends, such as currency valuation. The firm has several strategies targeting a number of asset classes with a concentration on fixed income, currencies, and commodities. Most of Brevan’s investment professionals are located in London and Geneva, with additional locations in such cities as Tel Aviv, Hong Kong, and New York City.
With approximately $160B in assets under management (AUM), Bridgewater Associates is easily the most dominant hedge fund player in the market. The Westport, Connecticut, fund was founded by Ray Dalio, currently the firm's chairman and chief investment officer, who espouses the no-nonsense motto "emotions and egos get in the way of healthy and sound business decisions and so those things must be left at the door." The firm is generally considered to have a diversified strategy across two main funds—one with a more directional strategy and one that employs a risk parity strategy.

Och-Ziff is categorized as a multi-strategy fund manager, which means the firm invests in several different investment strategies, including corporate credit, collateralized loan obligation funds, direct real estate, and public equity. The firm has been publicly traded since 2007 and has offices in London, Shanghai, Houston, Mumbai, Beijing, Dubai, and Hong Kong in addition to its New York City headquarters.
Who are other notable players in this space?

The hedge fund industry has become increasingly concentrated and dominated by approximately 20 firms that hold the majority of industry AUM. However, with larger institutions facing growing pressure to reduce money management fees, high-performing smaller hedge funds are beginning to experience significant capital inflows, partly because these smaller managers may be more likely to accept lower fees in exchange for sizable checks. The following funds represent significant industry players in various hedge fund strategies.

**Long/Short Equity**
- Adage Capital Management
- Appaloosa Management
- Lone Pine Capital
- Millennium Management
- Viking Global Investors

**Macro/Multi-Strategy**
- Davidson Kempner Capital Management
- Farallon Capital Management
- Paulson & Co.
- Two Sigma Investments

**Trading Oriented**
- BlueCrest Capital Management
- The D. E. Shaw Group
- Renaissance Technologies
How do MBAs fit into the investment management world?

In business school, hedge fund jobs are often categorized as part of the investment management field, which also includes traditional asset management (e.g., mutual fund companies such as Fidelity, T. Rowe Price, and PIMCO). Hedge fund roles constitute a relatively small portion of overall investment management jobs, and competition for these opportunities is intense.

Unlike other areas within the broader finance industry, hedge funds do not generally offer a defined career path for MBAs. Firms tend to recruit their junior employees from private equity firms and occasionally from investment banks. Whereas successful junior employees in the private equity industry are expected to temporarily leave their investment jobs to attend business school, committed junior hedge fund employees generally stay in the industry for the long term.

Because most hedge fund companies are relatively small in terms of head count, opportunities arise on an as-needed basis rather than following a strict hiring time line. Networking and fostering relationships within the hedge fund community are therefore imperative, because job openings are not always well advertised or marketed directly to business school students. This also means that business school candidates are expected to come in “hot”—in other words, they must be just as up to date on the market and prepared with investment ideas as a candidate who is already working in the industry.
How do I get the job?

Although most hedge fund firms have a strong preference for candidates with prior investing experience, career switchers and those from nontraditional backgrounds can still land a position in this industry. Firms want to see that a candidate has experience analyzing companies and investments, even if he/she has done so merely as an extracurricular activity or for a personal portfolio. Individuals who aspire to work in hedge funds should spend time developing an investment portfolio as well as several well-researched ideas.

If you interview with a hedge fund, that meeting will focus on your investment recommendations and the level of your analysis, including both quantitative modeling analysis and original qualitative ideas. For example, if you were to recommend a multinational consumer company, you would want to include financial projections for that company based on your original macroeconomic analysis. Firms want to see how you think through a complicated research process involving large quantities of data.

Take advantage of your summer internship and secure a role in the investment field, even if the position is with a long-only or mutual fund; while still competitive, these types of firms have more programmatic and institutionalized hiring practices. Hedge fund firms want their job candidates to demonstrate a true commitment to investing. Also, use the school year as an opportunity to practice researching stocks and delivering investment pitches. Most business schools have active investment clubs that allow students to present investment pitches in public forums or even to manage funds using real money (often part of the school’s endowment)! In addition, several MBA investment competitions are held each year, offering valuable experience as well as exposure to industry experts and representatives. Maximize your time in your MBA program by taking advantage of as many opportunities as possible to develop and present your investment ideas.

If you are targeting a job in the hedge fund industry for your summer internship or post-MBA position, get started now building your network, conducting informational interviews with classmates and friends at target firms, creating a hedge fund–targeted resume, and preparing for interviews. To learn more about how an MBA Career Coach can assist you in securing a hedge fund position by guiding you effectively through each step of the recruitment process, schedule a free consultation with us at www.mbamission.com.
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