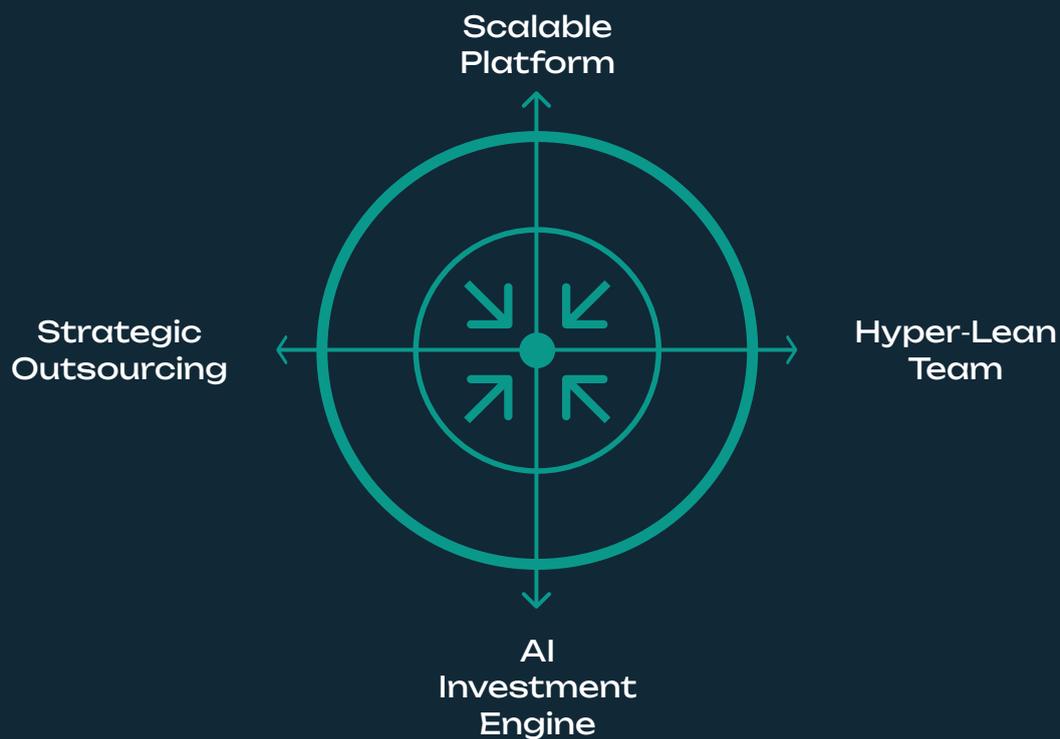


Three Horizons Capital

Case Study: The "Lean Scale" Fixed Income Manager

This report presents a comprehensive strategy for developing a startup fixed income management firm that delivers actively managed investment products at exchange-traded fund (ETF) pricing levels, while aiming for technology-like valuation multiples.

The primary objective is to establish a scalable investment platform operated by a hyper-lean team, leveraging significant outsourcing and advanced artificial intelligence (AI) investment processes.



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Executive Summary

Objective

The firm aims to create a suite of actively managed fixed income products with ETF-level pricing specifically, **35 basis points** while achieving premium valuation multiples similar to those seen in ETFs (13x–16x EBITDA), rather than the lower multiples typical of traditional asset managers.

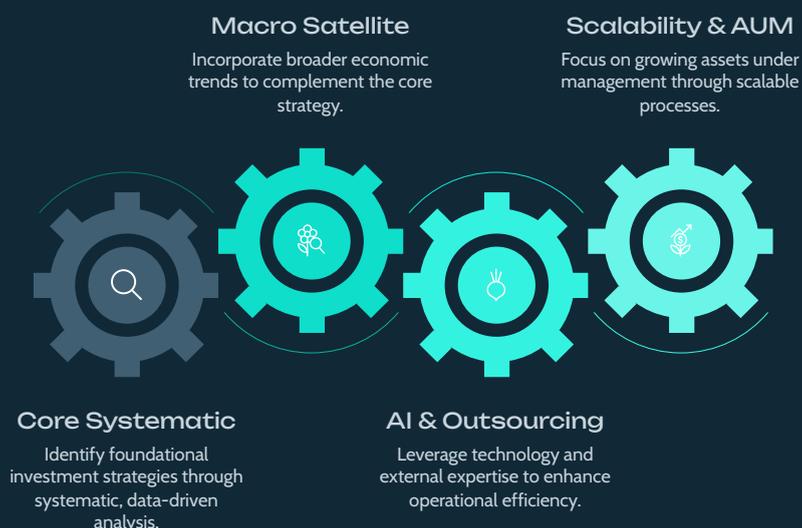
Core Strategy

The central strategy is based on a **"Core + Satellite" investment model**, managed by a highly efficient team of four portfolio managers (PMs), with the potential to scale up to \$15 billion in assets under management (AUM). This approach utilizes extensive outsourcing and an AI-driven quantitative and asset allocation stack to maximize both efficiency and scalability.

The core team manages part of each portfolio using a systematic, ETF-like process, enabling management of multiple products with varying credit quality and durations in a scalable and repeatable manner. Portfolio managers design custom indices and use technology to implement these efficiently, allowing for significant AUM scalability.

The macro satellite team oversees a single alpha portfolio, which is blended with various core portfolios to form the product lineup. The alpha team focuses solely on generating alpha, without the constraints of mass production and scaling.

This agile approach integrates macro trend-following with long-term correlation-based diversification, a method favored in institutional portfolio construction. The two strategies are negatively correlated: when long-term correlations in core portfolios fail, the macro team identifies short-term trends to enhance risk-adjusted returns. This structure enables the creation of strong alpha-generating portfolios at scale, supporting ETF-like valuation multiples.



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The Financial Framework

Achieving ETF-like valuation multiples requires emulating the scalable financial structures characteristic of technology platforms. This includes maintaining high revenue retention, predictable cost structures, and expanding profit margins.

Target Operating Metrics

Metric	Target Range	Strategic Rationale
Revenue Yield (Fees)	35 – 45 bps	Positions the firm in the "Sweet Spot": fees are high enough to fund active management yet low enough to effectively compete with passive index funds.
Operating Margin	30% – 40%	Demonstrates efficient conversion of revenue into free cash flow, highlighting operational effectiveness.
Break-Even AUM	\$2B – \$3B	Reflects a higher hurdle than traditional funds due to lower fees, necessitating rapid distribution to overcome the "Valley of Death."
Valuation Multiple	13x – 16x EBITDA	Represents a premium over traditional active managers (8x–10x), justified by the scalability of the systematic platform.

Fee Structure Sensitivity

Fee Level	Market Context	Breakeven AUM	Time To Breakeven	Revenue at \$15bn	EBITDA at \$15bn
35 bps	ETF Competitive	~ \$3.4bn	~7 yrs	\$52.5m	\$16.3m
50 bps	Standard Active	~ \$2.4bn	~5 yrs	\$75.0m	\$31.5m
70 bps	Retail Active	~ \$1.7bn	~3.5yrs	\$105.0m	\$47.3m

Break Even vs. Operational Leverage

Fee structure determines speed to profitability, not the fundamental economics. Operational leverage driven by variable costs and outsourcing creates premium valuation regardless of fee level. The strategic choice is between market positioning and time-to-profitability: lower fees enable aggressive competition but require patient capital, while higher fees accelerate returns. Both paths converge on the same scalable, technology-enabled platform with identical margin characteristics.

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Valuation Analysis: The \$15B Scale Model

This model evaluates the firm's performance at scale, managing \$15 billion in AUM with the proposed operating structure:

Revenue (35 bps)

\$52.5 Million

Cost of Goods Sold (COGS, 50% Outsourced)

(\$26.25 Million)

Covers trading, middle office, back office, and settlement functions.

Internal Operating Expenses

(\$10 Million)

Covers four core PMs, macro team, sales, legal, and technology costs.

EBITDA

Approximately \$16.25 Million

Implied Operating Margin: About 31%

Based on these metrics, the firm could be valued between **\$210 million and \$260 million** (using a 13x–16x EBITDA multiple). The business model appeals to investors due to its "Systematic Core," which functions as scalable, sticky software. As scale increases, there may be opportunities to negotiate lower outsourcing costs, further enhancing the exit multiple.



Outsourcing Savings

Realize cost reductions through external partners.

Scale Benefits

Leverage growth for increased advantages.

Systematic Core

Establish the foundational operational framework.

Valuation Range

Assess the financial worth and potential.

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The AI-Augmented Investment Process

Managing \$15 billion in assets with only four PMs is made possible by using AI to perform the roles traditionally filled by junior analysts and quants. The PMs act as **"System Architects,"** overseeing three AI-driven pillars: Asset Allocation, Quant Support, and Risk/Compliance.



Asset Allocation (The "Brain")

- Systematic credit core combined with macro alpha satellites, supported by AI tools for dynamic weighting between these components.
- Core portfolio construction involves building and testing the starting point for each product within the core portfolio process.
- Risk control is enhanced with AI engines providing daily insights and optimal adjustments to the balance between core beta and alpha satellite exposures across client portfolios.



AI as (The "Junior Analyst")

- Instead of junior analysts conducting data cleaning and basic analysis, AI tools perform these tasks more quickly and efficiently.
- AI collects, analyzes, and summarizes macro sell-side research, identifies potential credit trades, and writes product summaries for clients.



AI as "Risk & Compliance" (The "Governor")

- Automated surveillance by AI monitors thousands of line items across more than 50 portfolios in real time, ensuring compliance with each account's Investment Policy Statement (IPS).
- Predictive risk management uses AI to run "what-if" scenarios (e.g., impact of a 50 basis point rate hike and 20 basis point spread widening) and flags only the portfolios that would breach risk limits.

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Human Capital: The "System Architect" Portfolio Manager

The four PMs who manage this platform must possess a hybrid skill set, focusing on distribution partner relationships, AI and outsourced service provider management, rather than traditional bond selection.

The "CIO-for-Hire" (External Facing)

- PMs serve as sales closers, with distribution partners facilitating introductions but relying on PMs to secure final investment committee approvals.
- They must be able to articulate how the Macro Satellite interacts with the Credit Core to dampen volatility, demonstrating fluency in macroeconomics and representing the brand to clients.

The "Product Engineer" (Platform Integration)

- PMs ensure product customization to fit distributor requirements, such as architecting solutions for specific strategies or tax-efficient wrappers using AI and system tools.
- They bridge the gap between passive factory approaches and high-touch services.

The "System Guardian" (Risk Accountability)

- With only four people overseeing \$15 billion, maintaining extreme risk discipline is essential; PMs must be empowered to reject trades or modifications that carry unacceptable risks.
- Their oversight ensures compliance and risk management, providing both licensing and liability coverage for the firm.

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Summary of Risks & Mitigations

Risk	Impact	Mitigation
Partner Concentration	If one distributor leaves, you're dead	PMs must cultivate relationships with multiple gatekeepers at distribution firms to avoid reliance on a single contact.
Distribution Access	Slow AUM growth, extended break-even period	Multi-channel strategy, competitive revenue sharing, strong PM relationships
Net Fee Compression	Distributors demand 40 bps (up from 35).	PMs must demonstrate that the Macro Alpha overlay adds sufficient value to justify the fee split; poor performance may reduce pricing power.
Market Downturn	AUM decline, revenue pressure	Variable cost structure, diversified product suite, strong performance track record

Strategic Conclusion

This strategic approach transforms the firm into a **"Fixed Income Technology Platform,"** departing from traditional fund management. Offering actively managed, customized fixed income products at 35 basis points creates a substantial competitive barrier for legacy managers with higher fee structures. By replacing junior quants with AI and trading desks with outsourcers, the firm maintains a flat headcount even as assets grow, fostering a valuation multiple more aligned with scalable, high-margin technology businesses.

