

Re-Starting A Hedge Fund?

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Hedge funds lost two vital revenue streams in 2008--those that come from management fees and those stemming from performance. It was the worst year ever for hedge fund performance, despite the fact that the industry managed to eek out gains in December.

The typical fund charges investors a 2% management fee on top of a 20% performance-related fee, so after the dreadful performance posted by most funds in 2008, many managers are taking a noticeable hit to their income.

Indeed, firms such as Renaissance Technologies, a hedge fund with \$25 billion under management, have lowered management fees to retain investors' capital. Last week, Renaissance waived its 1% management fee for an underperforming \$3 billion fund, a source close to the firm confirmed. Renaissance declined to comment.

And, the other side of the two-pronged fee structure is also under fire. Once a hedge fund stops generating returns for investors, a pit most of the industry fell into last year, it is obligated to return the hedge fund back to its peak level of returns before collecting any more performance-related fees, a so-called high-water mark.

Given the divide between some of the losses suffered last year in relation to peak return levels during boom times--the average fund was down 18.30% last year, according to Hedge Fund Research (HFR)--some managers are abandoning poorly performing hedge funds and launching new ones in pursuit of fees.

Here's how it works: Say, for instance, an investor has \$100 dollars in a fund. If that investment grows to \$130, but then the fund loses 50%, the investor is left with \$65. In order to return to the peak level of \$130, the investor needs a 100% return because they have already paid an incentive fee on the initial gain. Essentially, the fund manager must return to break even and mathematically, it requires a higher return than the percentage loss.

According to HFR, the hedge fund industry is on pace for a record 920 fund liquidations in 2008, exceeding the previous record of 848 set in 2005. "As capital is being pulled out and as hedge funds fail to generate revenue because their performance is so far below the high-water mark, these firms basically are forced to shut down a fund," says Adam Sussman, director of research at Tabb Group, a research and advisory firm. "Does that allow them in a down year to put the shingle back up and start fresh? Yes, but I don't see a lot of hedge funds that are shutting down now cropping up again and being

able to attract the same amount of assets," he adds. Indeed, this option was much more viable 12 months ago than it is today.

One reason is that the liquidity of assets in a fund can determine the expediency with which the fund is wound down. It could also interfere with a firm's plan to launch a separate fund, especially if the new fund is dependent on the capital from the orphan fund to operate. "We have clients who have told us that it could take three to four years to liquidate their portfolio in an orderly manner. It depends very much on the hedge fund's strategy and the state of the market. There is no market for some securities right now," says Drew Chapman, chair of DLA Piper's alternative asset management practice group.

Of course, investors need to know that if they agree to transfer capital from one fund to another that their best interests are being looked after. "I think there are many good fund managers who have investors' interests at heart. I think there are many who do not, especially the more recently formed hedge funds," says John Jacquemin, president and founder of Mooring Financial Corp., a private investment firm that specializes in the management of alternative assets. (According to HFR, the number of hedge funds increased by 55% over the past five years.)

Jacquemin's two flagship funds are up for the year, but one of them failed to meet the firm's own 11% hurdle rate for returns. "There won't be any incentive fees for 2008," says Jacquemin, who has never liquidated a fund. He does, however, take issue with the motives behind abandoning one fund for another. "What is happening with the shutting down of a fund to start a new one all over again with a new high-water mark is a hedge fund version of the privatization of profits and the socialization of losses. They are saying, 'I'll take my share of gains, but when it comes to taking my share of the losses, forget it,'" says Jacquemin.

Of course, the decision can be justified under certain circumstances. For instance, many hedge fund managers were burned last year applying a long/short equity strategy, where simultaneous long and short equity positions are taken. If a fund manager is dumping a particular fund because the investment strategy isn't working, and launching a fund tied to a strategy that is more likely to succeed in current markets--say, investing in distressed real estate--it stands to benefit investors and fund managers alike. "New strategies may present new opportunities," says Sussman. "But if the new strategy looked like the old strategy, that would raise some eyebrows."

Chapman has been advising hedge funds through the new market terrain. He has clients that were involved in trading strategies that declined significantly last year and who instead want to launch a different fund, and in some cases want to set up distressed opportunity funds. While different fund managers have different motivations for closing down a fund, Chapman says, a high-water mark is something that a manager can't ignore. "If he thinks it is unlikely, or that it will take too long to climb back from a high-water mark, a manager might say 'what am I doing?'"

When it comes time for investors to decide whether or not to transfer their capital over to a new fund, it's time for negotiations. "The balance in the world has changed and now favors investors. One year ago, it favored fund managers," says John Godden, chief executive and founder of hedge fund consultant IGS Group.

Importantly, not every hedge fund that closes one for another does away with the high-water mark set from the original fund. Tontine Associates, a hedge fund with \$11 billion in assets under management, is closing down two of its hedge funds after losses of more than 60% last year, and plans to launch a new fund next month. Tontine, however, plans to honor the high-water mark established by the liquidating funds to investors who invest in the firm's new fund, according to sources close to the firm. The hedge fund was generating returns of about 37% annually prior to 2008. Tontine Associates declined to comment.

A high-water mark serves several purposes, chief among being to motivate a firm's staff, according to Christopher Miller, CEO of Allenbridge Hedgeinfo, a company that rates hedge funds. "It's not happening in the same way right now. Because the industry is downsizing, staff are mainly happy just to have a job, let alone a bonus."

The high-water mark is also there to protect investors. "It ensures managers are being paid just once for each absolute gain," says Godden. Given what has unfolded in the industry over the past 12 months, the function of the high-water mark is more than likely to change. "The high-water mark was supposed to give hedge funds the incentive to continue to outperform the markets even after a down year. Because of the catastrophic impact last year has had on the industry, the high water mark wound up being a relatively ineffective mechanism," says Sussman.

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