The hedge fund industry had to quickly evolve following the turmoil of 2008, driven by new demands from investors and regulators alike. If there had been a proverbial “Rip Van Winkle” of hedge funds who was able to sleep through the tumult of the last twenty-four months, the media headlines and timbre of conversation he woke up to would have astounded him. Fees, transparency, double-blind credit insurance optionalities and a rogues’ gallery of hedge fund “bandits” led by a certain Bernard Madoff have transfigured the business. It’s a new world for serious hedge fund investors. The chummy, take-it-or-leave-it and too often opaque hedge fund industry of yore is gone, replaced by a more chaste, client-oriented and transparent modus operandi. The altered landscape underfoot means that only managers who are willing and able to adapt to change will thrive in this new environment.

Implementing high octane financial strategies unconstrained by limits imposed on beta-only strategies now requires a degree of agility and tact to respond effectively to rapidly evolving regulatory and marketplace circumstances. In the 12 months since the markets reached their collective nadir at the height of the crisis during the winter of 2008/09, the most astute hedge fund managers implemented considerable changes to their operations and made significant concessions to their clients. We believe the new circumstances in the hedge fund industry are conditioning a fundamental
redesign of how managers and investors engage. At the same time, instead of walking away from hedge funds, savvy clients are availing themselves of attractive opportunities in emerging areas of the business such as the secondary market.

Pressure to Reduce Fees Will Continue Through 2010

A tolerance for higher fees, along with an attraction to the potential for excess returns that ascend to “nose-bleed territory” in the double- or triple-digits, have traditionally distinguished the 3(c) (7) crowd from more conservative investors. On average, hedge fund managers charge a 1%-2% management fee and a performance fee of 20%-25% of returns, subject to a high watermark and loss carryforward.¹ A notable byproduct of the financial meltdown of 2008/09 was the disconnect between highly compensated fund companies and the absolute returns generated on behalf of their investors. Our proximity to the industry led us to conclude at a relatively early stage that one consequence of the market dislocation would be a spike in the number of managers who cut fees to help ensure that they were properly aligned with investors. Indeed, in principle, we believe that management fees should be more about covering the costs of running the management company, and less about generating outsized profits for the principals. Performance fees, on the other hand, should reward managers for attractive returns, while at the same time treating investors fairly—especially those who stayed the course during the darkest days of 2008.

In fact, the response from hedge funds has ranged from drastic fee reductions to more nuanced fee structures for client service and performance. While a number of managers simply reduced their management fees (even as performance fees dropped) in 2009, additional measures to decrease or to keep underlying fees to a minimum included:

- Incorporating or increasing a “hurdle rate” to calculate performance fees
- Charging lower fees on select asset pools, perhaps on assets not as actively managed
- Instituting size or term based fee discounts
- Granting the current high watermark on new investments
- Negotiating a revenue share

It remains to be seen how the various fee configurations are accepted and ultimately converted into established pricing norms, but the rapid response of the industry underscores the importance of the dynamic between managers and investors. Placing a premium on liquidity, for example, recognizes the marketplace’s need for access to cash to fulfill short-term obligations and the opportunistic disposition of funds. Distinguishing between management styles, and charging accordingly, also introduces a dimension of the mutual fund industry’s pricing paradigm.

Emerging from the crisis period into the “new now” of investment relationships, the negotiating power of the investor relative to hedge fund managers appears to have become more balanced than had been the case in the recent past. More prosaically, hedge fund managers are now tethered with a shorter leash to the desired outcomes of more investors. This may be particularly relevant as a greater number of institutional market segments test the hedge fund waters, particularly public funds, where fees and cost structures have taken center stage.

Greater Transparency Improves Risk-Management Practices

Following the disclosure of the fraud committed by Bernard Madoff at the end of 2008, the demand for increased transparency into the investments held by hedge funds escalated exponentially. Needless to say, most investors and even many managers in the industry have viewed this as an overdue initiative. With opacity increasingly viewed as an anachronism, access to information and clarity regarding portfolio holdings and management activity are becoming more of a norm in today’s investment arena. With risk management at the top of the investors’ priority lists, the ability to negotiate for more information should result in vastly improved sharing of portfolio data and manager insight.

However, transparency does not decrease the need for a thorough review of the risk-based and operational “checks and balances” implemented by—and imposed upon—a given hedge fund manager. We believe that increased transparency in many ways places a greater responsibility on investors to

¹ Loss carryforward is where previous year’s losses are carried forward, and these losses must be offset by future performance before any performance fees can be charged. A high watermark is similar, and is the highest value that an investor previously experienced, in that the value must be exceeded before any new incentive fees can be accrued.
enhance their own due diligence efforts. One of the areas of keenest interest to investors is exposure via overlap or over-concentration in specific positions, sectors, leverage and/or prime brokerage counterparties. This is a form of risk management that has long distinguished the most successful managers and, not surprisingly, a capability appreciated by the most experienced and demanding investors. Hedge fund-of-funds, in particular, need to be able to analyze this torrent of information in a robust and technologically advanced way, which means increased risk management staff and technology expenditures. In our view, that should give those fund-of-funds with both scale and capital a competitive advantage in the marketplace.

Consultants also have stepped up their scrutiny. Our experience in 2009 suggests that consultants in the institutional market, for example, are more closely studying risk management processes, and more than ever questioning hedge fund managers pointedly in order to determine risk at all levels of the process. For investors, the focus on fund-of-funds look-through capabilities shines a brighter light on portfolio exposures and how their money is being managed in the context of a broader strategy. This, in turn, may raise the standard by which all managers are evaluated. For instance, best practices may dictate that operational due diligence be conducted by seasoned professionals with specialized backgrounds, including in such fields as technical operations, trading, legal affairs and accounting. Fraud, in the case of Madoff, trumped the “audited” statements that accompanied his filed reports and statements. So while a manager may purport to be “transparent” and report all his or her positions to investors, those positions can still be fraudulent. In our view, only top-notch checks and verification processes can mitigate the risk of investing in a fraud.

As a corollary to that improved portfolio transparency, access to hedge fund managers and principals has also become more of an imperative. Indeed, the Madoff model of obfuscation and restricted access did not appear to pass muster with any of the leading institutional programs. The new paradigm calls for pulling back the “purple curtain” and engaging in frank, two-way conversations between hedge fund managers and their core investors. For the successful hedge fund-of-fund complexes, it has long been standard practice to require regular qualitative discussions with a manager regarding their investments, themes and implemented strategies. Ideally, that dialogue also includes key professionals such as traders, analysts, compliance officers and business administration managers.

Finally, increased transparency can also mean transparency into the terms a manager offers other investors. In our view, this expanded democratization of the industry bodes well for the interest of the institutional marketplace.

Changing of the Gates: Structure and Terms

As the financial crisis of 2008 made abundantly clear, the redemption terms a manager offers investors, and how that manager structures his or her balance sheet (including the liabilities or leverage the manager takes) are critical to ensure the stability of a fund, especially in times of stress. But we believe the terms that a manager offers should be consistent with the necessities of managing liquidity, and not simply as a means to keep investor assets in place for the benefit of the manager. Last year was a time of marked change in that respect. Many managers, acknowledging investors’ evolving liquidity requirements, adjusted their portfolio processes and strategies. Gated strategies were evaluated and modified to accommodate the exigencies of the marketplace. Examples of some of the changes made by managers in 2009 included:

- Eliminating gates, increasing the percentage that can be redeemed before a gate is triggered, and/or eliminating priority clauses in gates.2

- Granting investors more flexibility to opt out of side pockets, perhaps by creating non-side pocket share classes for any new investments, and, in several cases, allowing investors to transfer from their existing side pocket share classes to non-side pocket share classes.

- Eliminating or decreasing the duration of a manager’s lock-up to be more consistent with the liquidity of the assets managed. For instance, while a distressed credit manager may be able to justify a two-year lock-up given the illiquidity of the assets and the time it takes to take a company through a bankruptcy process, an equity long/short manager who invests in predominantly large capitalization stocks should not need one, or if he or she does it should not be too long in duration.

2 Priority clauses allow investors who were gated previously the priority to get out of the fund during subsequent redemption cycles, ahead of investors who were not previously gated. Unfortunately, such a clause can create a “run on the bank” scenario, where investors submit redemption requests to ensure that they are positioned in the priority category, if they anticipate that the manager will receive redemption requests that approach the gate percentage.
Increasing the redemption frequency (e.g., from semi-annually to quarterly).

Reducing the number of days notice required before a redemption could be processed.

Finding an optimal alignment of interests remains a priority for the near future, for both hedge fund managers and their investors. Managers need to strike a balance between offering investors liquidity terms that are too generous—which can put all investors at greater risk—and being overly restrictive. Finding this balance may force a hedge fund manager to engage with the marketplace in a new and unfamiliar role. Indeed, it bears noting that such engagement often is not an expertise of hedge fund managers. In some cases, the advice they receive in this regard from their counsel may even be flawed, putting an additional legal burden on the investor.

Secondary Market
As institutions with allocations to hedge funds sought liquidity coming into 2009, some investors found opportunities to purchase shares of select hedge funds at a discount in the secondary market. Many of the shares sold were held under a lock-up, gate, or under terms where redemptions were allowed only infrequently. In several cases, shares were offered in hedge funds that suspended redemptions or issued liquidating vehicles, as many managers did during the peak of the crisis. This presented what we believe to have been a “once in a blue moon” entry point for long-term investors, with typical discounts ranging from 10% to 30%.

The breadth and reach of the analytics applied during that type of opportunity evaluation suggests a checklist for the future. Hedge fund-of-funds managers, investors and consultants need to be able to recognize a good deal when they see it through their deep knowledge of product structure, terms and contingencies. Each transaction requires a different level of negotiation and execution effort, at times including negotiating with both the seller of the hedge fund shares for an attractive discount, as well as with the hedge fund manager to allow for a change in beneficial owner and the preservation of embedded high watermarks and liquidity seasoning (e.g., avoiding the re-setting of lock-ups, etc.). From our perspective, we believe that as liquidity gradually returns to most markets, the volume of secondary transactions will likely decrease in 2010, as will the discounts to NAV where these shares trade.

Redefining Hedge Funds
The survival of the fittest—in all senses of the term—is the subtext for the recent wake-up call to the hedge fund industry. Those capable of doing so have adroitly adjusted and adapted to the new ethos. And the drumbeat of change continues, threatening to leave hedge fund managers who have failed to come to terms with this shift in the zeitgeist even further behind. The industry as a whole continues to transform, acquiring a tighter protocol for engaging with sub-advisors, managing relationships with investors and deploying stricter, more thorough analytics and oversight.

The hedge fund of this decade will become, at some level, a product of the inevitable process of maturation of what most financial industry observers would agree is still a nascent asset management sector. No doubt hedge funds have been forced to embrace an accelerated rate of "maturity" following the events of 2008. But we believe the industry’s surviving players are generally stronger and better positioned to deal with market stress, as well as—importantly—being more aligned with the interest of their investors. What’s more, there is less competition as weaker hedge fund managers have folded and many proprietary trading desks have been downsized, which should allow existing managers to benefit (e.g., from less crowding in positions, etc.). Regulators are watching the industry closely, and their discussions on how best to mitigate systemic risks will further reshape the financial system and capital markets in the months and years to come. Hopefully, that will help prevent another repeat of the events of 2008, which would be a welcome development for all investors, hedge funds included. Finally, it is worth noting that hedge fund managers are less levered than they were immediately prior to the credit crisis. Clearly, they are much more keenly aware of the risks of leverage (including counterparty risk) than ever before. We believe all of this bodes well for the future of hedge funds and is a reflection of the industry’s ability to adapt during uncertain times.
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