

LOCK IN YOUR INVESTORS

Managers need to come up with innovative ways of keeping their investors interested, so performance fees are in for a shake-up

BY SIMON THOMAS

It is a challenging time to be a hedge fund manager. Assume that you have built a profitable hedge fund business over a number of years, adding analysts and traders in an effort to diversify your income streams. You are now seen by investors as a 'second generation manager' with a solid track record and a substantial amount of funds under management. However, over the past two years your flagship fund's performance has been flat, markets have been volatile and it has been increasingly difficult to reach your high watermark. Those all-important performance fees are no longer rolling in. Your analysts and traders are making eyes at other firms, seduced by their promises of large bonuses.

What do you do? Your investors would presumably hope that, as a disciplined and responsible investment manager, you will not begin to make bigger bets in the hope of recovering your losses. You may begin to feel trapped in a vicious circle.

One high-profile fund manager in the US reportedly suffered this dilemma, saw no way out, so he liquidated his fund and returned money to his investors. And yet after a brief hiatus, he was back with a new fund trading a similar strategy. You can imagine what his former investors thought of that, even with assurances that they could re-enter the new fund on preferential terms.

VARIABLE HIGH WATERMARKS

In launching his new fund, this manager presumably gave some thought to the problem of how to manage the business and incentivise his staff if the fund's returns are flat or negative over an extended period. In the past year, an increasing number of hedge fund managers have addressed this issue up front by incorporating a variable high watermark into the calculation of their performance fee.

This enables a manager to reset the high watermark in the event that the fund's net asset value

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declines for two consecutive years. This is also referred to as a one-year loss carry-forward because losses are, in effect, carried forward for one year and are then extinguished for purposes of calculating the manager's performance fee. Although it is not a new idea, the hedge fund industry, particularly in the US, has become more receptive to this.

Investors often get quite exercised over this issue, particularly when they encounter it for the first time. On its face, the fund manager may be collecting a performance fee twice for the same performance, which certainly seems objectionable.



Notwithstanding this objection, the controversy surrounding variable watermarks may be largely theoretical. After all, how many investors are willing to put up with poor performance? If performance is flat or negative over an extended period, would investors not be expected to vote with their feet and withdraw from the fund? Conversely, if they are happy with a manager's fundamental strategy, would they not want to incentivise him and his staff?

UNLIMITING LOCK-UPS

Besides variable high watermarks, another trend investors may have noted recently is a lengthening of lock-up periods. Historically, lock-ups – the initial period during which an investor cannot withdraw from a fund – have tended to be limited to one year. In an effort to take advantage of increased institutional allocations to hedge funds, a number of managers have launched funds with longer lock-up periods, sometimes up to three years.

In some cases, investors are offered a reduction in the manager's performance fee (from 20% to 17% for example) in return for the longer lock-up. This would appear to be a much harder proposition to sell to investors.

In our experience, many managers have found it difficult to persuade investors to commit for three years, even with the inducement of a reduced performance fee.

While management fees tend to be less variable than performance fees, there are nonetheless some interesting exceptions. Some US fund managers, for example, do not charge a management fee, but

charge all their operating expenses through to the fund, including salary and overheads.

The rationale for this arrangement is that the manager is incentivised to incur only those expenses that benefit the fund and enhance returns to investors. Moreover, as the fund grows in size, the expenses of the investment manager, as compared to the fixed management fee, should be less of a drag, proportionally, on the fund's net asset value.

Some start-up managers have considered this arrangement in the UK, although it appears unlikely to become an emerging trend, for if nothing else, the UK tax and regulatory position will take careful thought.

So, if you are considering starting up a new fund, or restructuring an old one, it is time to do a little research on what the market will bear. The days of the standard 2% and 20% fee with a fixed high watermark could be behind us.



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Key Points

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