OW INVESTORS TURNED THE TABLES ON HEDGE FUNDS

In the aftermath of the financial crisis, hedge fund investors are wielding new power and pushing hot-shot managers to lower fees and offer better redemption terms.



REUTERS/ANTHONY BOLANTE

BY EMILY CHASAN NEW YORK, MARCH 17

EIL CHELO'S JOB IS TO BE able to tell good hedge fund managers from notso-good ones.

An investment analyst, Chelo honed his skills under the tutelage of Harry Markopolos, the forensic fraud investigator

widely credited with spotting Bernie Madoff's Ponzi scheme years before it imploded. And the most important lesson he learned is you have to ask lots of questions.

"I'm not a conference room type of quy," sniffed Chelo, director of research for Tacoma, Washington-based Benchmark Plus, a \$1.8 billion so-called fund of hedge funds that invests money with 25 managers.

"It's very easy for people to fake it for two hours in a conference room, but it's a lot more difficult if you are at their desk going through their portfolio."

Chelo, 39, typifies the new, harsher reality facing the \$1.9 trillion hedge fund business. In the aftermath of the industry's generally terrible performance during the financial crisis, institutional investors such as pension



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funds, university endowments and non-profit groups are far more finicky about where they put their dollars.

These newly-empowered investors are increasingly demanding -- and receiving -- a cut in fees, as well as provisions that require managers to meet certain performance goals and provide greater flexibility to ditch a fund if it flounders. And like Chelo, they are also doing a lot more snooping around before writing a check.

Gone are the days when a trader could leave some Wall Street firm with a few of his buddies, snap his fingers and raise several hundred millions of dollars overnight. While new hedge funds are launching all the time, industry observers say more money is going to either established funds or upstarts led by traders with a well-known track record, like those coming off of Goldman Sachs proprietary trading desks.

"For the biggest funds there's no question the investor is ruling the roost," said Stephen Keller, managing director at Bank of America Merrill Lynch's prime brokerage.

Perhaps most startlingly, investor pushback is chipping away at the hedge fund industry's once ironclad fee structure. D.E. Shaw & Co, one of the world's largest hedge funds with about \$19 billion in assets under management, recently lowered its fees in the wake of the firm's poor performance in 2010.

The fund founded by David Shaw, but now run by a six-person executive committee, is now charging its clients a 2.5 percent management fee, and skims off 25 percent of the investment profits. That's still higher than the industry standard "2 and 20" fee structure. But it's down from the 3 percent management fee and 30 percent incentive fee that D.E. Shaw previously had charged.

Kenneth Griffin, another hedge fund luminary whose Citadel investment funds took a beating during the financial crisis, is also mulling a fee cut to mollify his investors, say people familiar with the firm. Citadel

Hedge funds snapshot

Money has been pouring back into hedge funds and assets under management are nearing their previous all-time high of \$1.93 trillion. But the biggest hedge funds are attracting the most capital, and aspiring managers are still facing difficulties in launching new funds.



Reuters graphic/Stephen Culp



declined to comment on the issue.

A number of small funds are doing the same. Indeed, investors say that in the wake of the financial crisis it is far easier to get hedge fund managers to talk about discounts because it's now become a regular part of the pre-investment negotiations.

A frequent target for investors is the management fee, which enables a hedge fund to rake in hundreds of millions a year for simply holding onto their client's money.

"There's no way there should be a 2 or 3 percent management fee for a firm that is managing over \$1 billion -- it's obscene in

my opinion," said Michael van Biema, who runs van Biema Value Partners LLC, a value-focused fund of hedge funds in New York. "The fact that many people in this profession could not perform at all and are still flying around on private jets on a regular basis, we think is absurd."

He says he often looks for funds that charge management fees as low as 1.5 percent or 1 percent. He'd rather pay a higher incentive, or performance, fee in return for a manager willing to forgo much of his management fee. That way van Biema says he is simply paying for outsized performance and not for

a manager to hold his money.

To get a feel for a manager van Biema will now negotiate deals that let him commit a little bit of money to a fund before deciding to take a bigger plunge. "Until you are actually an investor in one of these firms, you may not really understand everything about their operations and investment process," he said.

Last year, in an attempt to give investors even more leverage, the Greenwich Roundtable, a consortium of investment firms that controls some \$4.5 trillion in assets, issued a 76-page document on best practices for hedge fund due diligence. The document is a how-to for grilling hedge fund managers about their investment processes.

PENSION FUND PROWESS

BUT IT'S NOT JUST the fallout from the financial crisis that is letting investors get more of their way with hedge funds. The changing dynamic also reflects the fact that more public pension funds are directly investing in them.

Historically, many pension funds made indirect investments through funds of funds, but now more pension funds want to manage their own money and cut out the extra layer of fees.

In some respects, public pension funds are starting to go down a path long ago blazed by CALPERS, which was among the first to recognize how much hedge funds could boost investment returns. In the past few months, other public pension funds that have moved to cut out the middleman and changed their strategy to make direct investments in hedge funds include the \$48 billion Massachusetts Pension Reserves Investment Trust, and the \$8.7 billion Orange County Employees Retirement System.

"There's a learning process with any new asset class," said Timothy Walsh, director of the New Jersey State Treasury's division of investment, describing how pension funds typically began investing in hedge funds through funds of funds, but now are comfortable investing directly.

In 2004 and 2005, New Jersey's funds had started allocating to hedge funds through funds of funds, which were perceived to be safer, but today the state has 75 percent of its hedge fund allocation directly invested and only 25 percent through funds of funds.

But direct pension fund investing also means fewer hedge funds are getting in on the cut. Many pension funds will only invest directly in the biggest ones because they have restrictions on what fees they can pay and



want to see more transparency from hedge funds. For managers that comply, pension funds offer some of the biggest checks out there.

"Ten years ago the industry was dominated by high net worth individuals, today it is dominated by institutions," said Don Steinbrugge, founder of Agecroft Partners, a third-party marketing firm for hedge funds.

In some respects, the biggest hedge funds "now look very similar to investment management firms," Steinbrugge said.

INVESTOR FLIGHT

THE SHIFT TO A MORE professional or institutional class of hedge fund investors is also having repercussions for the way managers run their firms. Historically, wealthy individuals tend to be stickier investors than pension funds, as they have more of a stomach for negative headlines and are seen as less likely to seek redemptions if a manager gets himself in the news for the wrong reasons.

A case in point is the recent closing of \$3 billion hedge fund Level Global Investors. After its offices were raided in connection with the latest government probe into insider trading last year, it announced it would shut down by the end of this month as it was faced with an unworkable redemption scenario. About 75 percent of the fund's investors would have been eligible to leave on March 31, and 100 percent could have exited by June 30, the fund's founder David Ganek said in a letter to investors last month.

Pension fund investors -- because they answer to taxpayers, beneficiaries and

public officials -- are also more demanding of transparency. That is driving the push for better terms from managers on redemptions and more information on how managers invest their money. All hedge fund investors now have more ability to vote with their feet, as fund managers are increasingly likely to provide yearly, semi-annual, quarterly, and even monthly, liquidity.

In fact, some worry that hedge fund managers have become too focused on monthly performance numbers to keep impatient investors from bolting from funds at the first sign of trouble. Funds, though, are now prepared for the worst case scenario. "Nobody launches a new fund today without clean up provisions," said Girish Reddy, who runs the \$5.8 billion fund of hedge funds Prisma Capital in New York.

THE ART OF THE LAUNCH

ALL OF THIS HAS MADE it harder to start new hedge funds, which seemed to sprout by the minute during the financial boom. Today funds are often spending a year or more raising capital. Even with established funds, institutional investors may take up to six months of due diligence before committing money. Prime brokers that provide trade clearing services for hedge funds say they hear "horror stories" of fund managers who have been trying to secure their capital for over a year.

Also, the amount of money a hedge fund needs to get going is a lot more than it used to be.

"You need to be a couple hundred million in size to be able to effectively run now. It's

"YOU NEED TO BE A COUPLE HUNDRED MILLION IN SIZE TO BE ABLE TO EFFECTIVELY RUN NOW. IT'S HARD TO BE SMALLER THAN THAT JUST BECAUSE OF THE EXPENSES THAT GO ON TODAY."

hard to be smaller than that just because of the expenses that go on today," said Daniel Ward, investment manager for the \$530 million Virginia Tech endowment.

And for established hedge funds, investors like Chelo are harder and harder to lure.

During a recent visit to a West Coast hedge fund that Benchmark was considering

investing in, he found one of the fund's top portfolio managers woefully unprepared to explain why she was shorting, or betting on a decline in the price of several stocks.

Chelo said the trader and her team of analysts hadn't done sufficient research on the stocks for him to get comfortable with the notion of committing money to the hedge fund.

When Chelo walked out the door, he didn't look back.

(Reporting by Emily Chasan; Editing by Matthew Goldstein, Jim Impoco and Claudia Parsons)



BIG MONEY: Girish Reddy, pictured on March 16, 2011, is co-founder of \$5.8 billion fund of hedge funds Prisma Capital Partners in New York. Over 95 percent of his firm's assets are managed on behalf of institutional investors, like pension funds. **REUTERS/BRENDAN MCDERMID**

NEW RULES FOR HEDGE FUNDS

FACTBOX

MONEY IS POURING BACK into hedge funds, and global assets under management in the industry are nearing their 2008 peak again. But hedge fund investors are allocating their capital differently, and have more power than ever before

Here are some of the numbers behind the shift:

- Investors allocated some \$149 billion to them in the fourth quarter of 2010 -- the largest quarterly increase in assets ever recorded, according to Hedge Fund Research. The previous record increase was an inflow of \$140 million in the second quarter of 2007.
- With \$1.92 trillion in assets under management at the end of last year, the global hedge fund industry is fast headed back toward its all time peak of \$1.93 trillion in the second quarter of 2008. It had shrunk to \$1.3 trillion in assets in the first-guarter of 2009.
- Investors expect to put some \$200 billion into hedge funds in 2011, taking the industry to more than \$2 trillion in assets this year, according to a survey by Deutsche Bank this month. But even though money is coming in, it is not arriving from the same sources.
- Half of all households with more than \$25 million in net worth had investments in hedge funds last year, compared to just 35 percent in 2007, according to a survey from Spectrem Group.
- Funds of hedge funds, which represented nearly half of hedge fund investors at the peak, are now just about a third of overall hedge fund investors.



MONEY MAKES THE WORLD GO AROUND: A picture illustration of U.S. dollar, Swiss Franc, British pound and Euro bank notes, taken in Warsaw January 26, 2011. **REUTERS/KACPER PEMPEL**

- The number of pension plans investing in hedge funds has grown more than 50 percent since 2007. There are now 295 public pension plans that are known to allocate assets to hedge funds, up from 196 in 2007, according to research from hedge fund tracker Preqin this week. The mean amount of assets that pension funds dedicate to hedge fund assets has also climbed from 3.6 percent to 6.6 percent over the same period.
- Hedge fund behemoth Och-Ziff Capital Management, has about \$28.4 billion in assets under management, but said on a conference call with investors this month its average management fee is 1.7 percent, below the 2 percent industry standard.
- Over 80 percent of new assets in the hedge fund space were allocated to firms with more than \$5 billion in assets under

management in 2010, according to Hedge Fund Research.

- In the third quarter of 2010, 260 hedge funds were launched and 168 hedge funds were liquidated, according to Hedge Fund Research. In the fourth quarter of 2008 at the height of the financial crisis, 56 hedge funds were launched and 778 were liquidated.
- SkyBridge Capital, a firm that focuses on seeding new hedge funds, looks at 600 to 700 presentations from funds each year, but only selects three or four of those to fund with \$25 million to \$50 million investments. Bankers estimate there is only about \$2 billion to \$3 billion of dedicated seed capital available in the industry.

(Reporting by Emily Chasan; Editing by Claudia Parsons)

COVER PHOTO: Benchmark Plus director of research Neil Chelo (R) stands in his company's offices with colleagues in Tacoma, Washington on March 1, 2011. **REUTERS/ ANTHONY BOLANTE**

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