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Hedge Fund Investing in a New World

Castle Hall Alternatives

The credit crisis which first began in mid-2007 – with the failure of a hedge fund managed by Bear Stearns – has now accelerated to create the most severe financial market dislocation since the Great Depression. It goes without saying that, after the events of the past 18 months, markets will not be the same: both investors and money managers will face a "*New World*".

The hedge fund industry will not be immune: while some hedge funds have performed well, many have faltered and some have failed spectacularly. Current market events will unavoidably lead to a re-evaluation of the hedge fund model and, in the short term, a contraction of industry capital. This is not to say that hedge funds will not remain integral to diversified, institutional portfolios, and we expect investors to retain confidence in the long-term validity of alternative investment strategies. Indeed, a period of retrenchment may be helpful: after the astonishing growth of hedge fund assets over the past five years, the current environment gives the opportunity to adjust, refine, and over time create a stronger and more stable industry.

Going forward, investors will be more rigorous and systematic in their hedge fund selection and due diligence process. Irrespective of the manager under consideration, it will no longer be possible to rely primarily on manager reputation and historical track record. Operational risk will also become a greater concern as investors grapple with a multitude of non-investment issues ranging from counterparty risk management to the use of withdrawal gates and provisions to suspend redemptions.

Current events prompted us to review our posts over the past year and, while we have touched on numerous issues, several common themes emerge. We have distilled these themes into five questions which, we believe, are of relevance to both investors and managers in this *New World*.

1. Is 2 and 20 Fundamentally Flawed?

In the *New World*, investors will ask whether a 2% management fee and 20% incentive fee remains a valid compensation structure. It can be argued that the current hedge fund fee model has multiple flaws:

a. Hedge fund managers receive an incentive fee on any positive performance, not just performance above the market (ie for all the talk of alpha, hedge fund managers get paid on beta as well)

b. There is a frequent misalignment between the annual cycle for the manager's incentive compensation and both the investment time horizon and the period over which investors must commit their assets.

c. Unlike private equity managers, hedge funds pay themselves incentive fee compensation on unrealised appreciation – paper profits – as well as realised gains.

Taking the first point, if the hedge fund industry truly is about alpha, we expect more investors to question whether incentive fees should be paid on outperformance, not just performance. One option would be to apply a hurdle rate equal to at least the cost of capital to any performance fee. This would also better align hedge fund fee structures with the compensation framework applied to more traditional asset classes.

On the second point, if a hedge fund has an investment time horizon longer than one year, we question whether the incentive fee should be calculated – and paid – over a matching, multi-year period. At a very minimum, there is an argument that incentive fees should not be paid over a period shorter than the redemption frequency available to investors. If a fund has a three-year lock-up, for example, it seems logical that the manager should not receive any incentive fee until the three-year mark, which is the first opportunity for investors to decide whether they want to retain capital with the firm. Other mechanisms which could be considered include "look back" provisions or other means to "claw back" incentive fees in the event of a subsequent decline in performance.

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Third, we highlight a critical difference between private equity and hedge funds. In the private equity world, managers generally take their 20% "carry" only when an investment is finally sold. Not only does this process often take several years, it is also unambiguous: the final gain or loss upon sale is tangible and definite. A hedge fund, however, takes its 20% every year (or, in some cases, every quarter or even every month) based on the net asset value (NAV) of the fund. Crucially, the NAV includes unrealised appreciation – paper profits – on securities which are yet to be sold.

This is not a particular problem for long/short equity and CTA funds which hold exchange-traded instruments (investments classified as Level 1 under the new FAS 157 standard). This is, however, a much greater issue for funds trading complex, hard-to-value paper. The problem is compounded if the hedge fund's portfolio manager marks his or her own book, creating a clear conflict of interest.

In the *New World*, the industry could consider whether hedge fund managers should be paid like private equity managers and take 20% only of realised gains. This would have two benefits: first, this change would reduce the risk of hedge fund valuation fraud as the incentive to manipulate mark-to-market prices essentially disappears if the manager cannot include paper profits in the incentive fee calculation. Second, many hedge funds now trade assets which are unavoidably "hard to value". Paying fees based on actual disposal prices removes the problem of paying compensation using estimated, hypothetical values. Such values may, of course, prove to be much different from the prices realised on eventual disposal.

2. Do Hedge Funds Need Better Corporate Governance?

Corporate governance is one of the hedge fund industry's weakest points. In the US domestic hedge fund industry, there is simply no corporate governance at all: the general partner of a domestic limited partnership is the investment manager, meaning there is no independent oversight and control.

In the offshore world, funds structured as corporations have a board of directors who, as the "governing body", retain ultimate responsibility for the fund's activities. It is notable that several recent "best practice" initiatives, such as the UK's Hedge Fund Working Group and the AIMA valuation guide, all defer regularly to the ultimate authority of the board. The administration industry, in particular, consistently points out that it is the governing body, not the administrator, who is ultimately "responsible" for pricing.

While this sounds good on paper, it is unfortunately unrealistic to say that the directors of many of today's hedge funds provide effective governance. Virtually all offshore hedge funds have a small board with a representative from the investment manager and one or two employees of corporate secretarial firms based in locations such as the Cayman Islands. These "independent" board members serve for a modest sum and are hired and fired by the manager, not investors – hardly the best recipe for vigorous oversight of the manager's activities. There is also the practical point that some offshore directors can sit on hundreds of hedge fund boards. At only 200 directorships – which can be a conservative number — an individual has a maximum of ten hours a year to spend on each fund, equivalent to 50 minutes per month. This is obviously not sufficient time to provide for anything beyond simple corporate secretarial support.

We believe that effective corporate governance will be critical in the *New World*, even if this means that investors will have to pay more to attract capable candidates to serve on hedge fund boards. As an immediate priority, investors need a board which can provide genuine, active oversight in two key areas: portfolio valuation and situations in which funds elect to impose gates or suspend redemptions.

The valuation issue is paradoxical. While the board may have "responsibility" for pricing, the notion that most offshore hedge fund board members can somehow resolve a pricing dispute so serious that a third-party administrator and the manager cannot agree is obviously unrealistic. If we are to solve the valuation "problem", one element of the solution will be more active boards, capable of meaningful oversight over the pricing process.

Redemption restrictions are a more immediate problem as, in the current environment, many funds will impose redemption gates, suspend redemptions or otherwise restructure. One of the key protective mechanisms for investors when a hedge fund cannot meet its published redemption terms is effective oversight from the board. A capable board should not "rubber stamp" the manager's instructions, but should make an independent decision whether a redemption restriction will truly protect value in the portfolio and ensure equitable treatment amongst investors.

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In our view, best practice calls for a majority of a hedge fund board to be composed of active, experienced and independent directors. Clearly, a situation where investors have hundreds of millions of dollars at stake yet their interests are protected by an offshore director charging a few thousand dollars per year is unsatisfactory.

3. Is there an 'Expectations Gap' in the Administration Industry?

Castle Hall has always been an extremely strong proponent of the value – and necessity – of independent, third-party oversight. We continue to believe that vigilant oversight from an independent administrator remains by far the most effective protection investors have against manager errors, be they honest or dishonest.

Increasingly, however, there is an *expectations gap* between the services administrators can provide – or are prepared to provide – and the services investors think are performed by an administrator. Many investors continue to assume that, if a recognised administrator has been appointed, then that administrator will independently prepare the books, calculate the NAV and price 100% of the portfolio. In reality, administration servicing can vary enormously: some administrators perform no accounting and merely send out shareholder statements; others perform limited checks on the manager's accounting under a "NAV Lite" arrangement and, even on "full service" engagements, there is an increasing trend for administrators to accept manager prices for that portion of the portfolio which is truly hard to value. It goes without saying that it is precisely these challenging instruments where investors have the greatest need for independent oversight and control.

In the *New World*, administration servicing will need to respond to new expectations:

a. If the investor pays the bills, then the investor is the client.
The starting point for hedge fund administration is to remember that the investor, not the manager, is the "client." After all, administrators are paid by investors, not the manager, as the administrator's fees are charged to the hedge fund. Investors pay the administrator to be an independent watchdog, tasked with calculating each NAV independent of the manager and thereby providing a mechanism to help prevent fraud.

b. Anything other than full service administration is not administration.
Our target here is the practice of "NAV Lite", whereby the administrator performs some sort of check on the work performed by the manager. While a NAV Lite allows funds to "tick the box" when investors ask if an administrator is in place, this type of servicing is significantly less effective in terms of investor protection.

c. Outsourced back office is not necessarily fund administration.
"Traditional" fund administration has come under significant fee pressure. In response, several administration companies now provide outsourced mid and back office processing in addition to their traditional administration business, attracted by higher fees and margins.

Outsourcing has two potential drawbacks, however. Firstly, outsourcing means that there may only be one set of accounts: if a manager has no means of checking the work of the administrator, there is no straightforward way to catch errors if something goes wrong. More fundamentally, in the outsourcing model the administrator is now working directly for the manager, diluting the traditional watchdog role.

d. Investors need independent valuation.
Pricing is the biggest issue at stake in the world of fund administration and the hardest for everyone concerned.

Many investors continue to assume that, in order to calculate the NAV, the administrator must also price the portfolio. Today, however, much of the administration industry is emphatic that they perform only the services of a "verification agent", responsible for checking marks, not a "valuation agent", responsible for originating prices. This is a relatively moot point when dealing with exchange-traded securities, but becomes significant when a hedge fund trades hard-to-value instruments.

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As a "verification agent", many administrators have amended their legal contracts to allow the right to "consult with" the manager and, indeed, accept prices from the hedge fund manager without further checks. We completely agree that administrators may perform some verification of manager marks. Some firms, despite restrictive liability clauses, do so carefully and have relatively robust internal procedures. Others do not, however, and we consistently find that procedures vary enormously across the industry, and can vary widely even within the same administration firm. In too many cases, little is done to vouch manager marks (we remain surprised, for example, that many administrators accept copies of broker quotes provided by the manager rather than received independently, despite the evident risk of manipulation – it costs less than US$1,000 for a manager intent on fraud to buy Adobe Photoshop). Ultimately, taking prices from the manager is uncomfortably similar to a police officer issuing speeding tickets on the basis of asking drivers how fast they were going.

In the *New World*, investors and administrators should begin a dialogue to redefine the administration servicing model. We believe there is broad agreement across the investor community as to the scope of servicing investors would like to see from administrators. Investors should, however, recognise that they will get what they pay for: effective, independent administration will likely cost significantly more than ten basis points. Compared to losing 10,000 basis points in a fund failure, however, higher fees for better administration servicing remains excellent value.

More specifically on pricing, there may also be an opportunity for third-party valuation specialists, separate from the traditional administration companies, to assume the responsibility for pricing securities for the purposes of each monthly NAV. Again, investors will need to pay for this service – third-party experts capable of pricing complex derivatives are hardly free – but the fees for independent pricing remain reasonable compared to the cost of potential price manipulation.

4. Is the Prospectus Written for the Manager or the Investor?

One of our favourite phrases is *prospectus creep*, which we use to describe clauses added to offering documents by the oligopoly of legal firms who draft the majority of hedge fund prospectuses. For investors who review a large number of these documents, it is a familiar story to see a new clause inserted in one document which, six months later, has somehow become the industry "standard" for all new funds.

The problem is that, individually, such clauses are unlikely to be investment dealbreakers. Cumulatively, however, the evolution of standard terms means that today's offering documents are weighted heavily in favour of manager interests at the expense of the investor.

Often, legal advice emphasises that fund offering documents should be drafted in as broad and unspecific a manner as possible to retain maximum "flexibility" for the manager (despite this bias it remains the case, of course, that the law firm's fees are charged to the fund and therefore paid by investors.) There is a paradox, however, as the same lawyers advise allocators that hedge fund investing is a world of buyer beware, where the terms of each product are clearly set out on a take it or leave it basis. In our view, this argument is disingenuous: today's offering documents are typically drafted to give maximum freedom of action for the manager and often permit unrestricted investment activities. Investors are also faced with offering documents which list every possible risk factor in an attempt to absolve the manager from responsibility under virtually all loss scenarios.

In the *New World*, investors will need greater specificity in fund offering documents. The terms and obligations related to each investment product should be unambiguous and include detailed guidelines and restrictions.

5. Is it Possible to Hold Illiquid Assets in an Open Ended Vehicle?

Our final question is more conceptual. Virtually all hedge funds are open ended vehicles, meaning that they offer their shares for sale, typically monthly, and allow redemptions every month, quarter or year. In our view, perhaps the biggest question facing the hedge fund industry is whether, in the *New World*, an open ended fund is the best structure for many of today's alternative investment strategies.

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An open ended hedge fund has two problems. Firstly, it is forced to cut a NAV, usually monthly, meaning that it must regularly price and "mark to market" assets irrespective of their nature or liquidity. Secondly, some strategies hold investments which are inherently illiquid, creating a mismatch between the liquidity of the portfolio and the frequency of the redemption terms in the product sold to investors.

In our view, many hedge funds do hold investments which are unavoidably "hard to value". Assets such as holdings in private companies, direct loans, illiquid distressed debt, structured securities, hard assets such as power plants or any of a multitude of other instruments are traded privately with no ready market. These may be attractive investments, but holding them within an open ended fund can be equivalent to pushing a square peg into a round hole: it may simply not be possible to price these assets with any demonstrable accuracy month to month. For some securities, there may simply be no market at all or, for others, there may be no reliable bids during a period of market dislocation.

Yet, an open ended structure forces hedge fund managers to "mark to market" all assets in the portfolio every month. Even if a fund has a long lock-up, the NAV will be used to set the entry price for new investors, with those investors purchasing a pro rata share of the unrealised, paper profits in the existing portfolio. A NAV which is too low lets new investors come in at too cheap a price, while a NAV which is too high unfairly pays out exiting investors who exchange their share of unrealised gains for cash. The industry needs to consider carefully whether open ended funds are really suitable vehicles to hold assets which, in reality, cannot be priced with reasonable accuracy during their holding period.

The second problem is the mismatch between portfolio and fund liquidity. The current market environment has shown that some of today's complex hedge funds may not be capable of liquidating assets on a timely basis if faced by significant redemption requests. As a result, numerous funds will impose redemption gates or, alternatively, decide to suspend redemptions and impose a lengthy payout process. We certainly agree that current market conditions are unprecedented but, with hindsight, investors may well identify at least some funds which operated on the basis that exiting investors could always be paid with cash raised from new investors.

In the *New World*, some investors will elect to avoid commingled funds completely and will move towards managed accounts. We also expect the fund of funds world to adapt and to offer an increasing range of "funds of managed account" products. For some of the largest institutional investors, trading teams may be brought in house with "hedge fund" strategies executed on the institutions' own balance sheets rather than outsourced to third-party money managers.

For other investors, it may be that permanent capital vehicles, drawdown, private equity style structures or closed end funds (with or without an active secondary market) may be more appropriate. While these alternatives pose many choices for managers, investors are also implicated: allocators will have to temper their desire for frequent redemption opportunities if they wish to access the returns which can be generated from longer term, illiquid strategies. That truly would be a *New World*.

Going forward, the current crisis may well lead to a recognition that the structures and conventions accepted in the past may not be the best for the industry in the future. The *New World* will require new choices and the hedge fund industry will impede its success if it does not adapt and learn from the lessons of today's markets. Ultimately, challenge brings opportunity: we remain convinced that a better, stronger hedge fund industry can emerge from the difficulties of today's markets.

Castle Hall Alternatives is one of the industry's leading providers of operational due diligence, working with a group of leading institutions, endowments and funds of funds. In addition to completing due diligence on several hundred hedge funds worldwide, Castle Hall also publishes a regular commentary on operational risk entitled ***Risk Without Reward****.*

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