

When You Have Lemons, Make Lemonade

by Nadia Papagiannis, CFA | 02-17-09 | 06:00 AM

You can't blame investors for wanting to throw in the towel on hedge funds. Too many of them have turned out to be lemons. Dean P. Foster of the University of Pennsylvania and H. Peyton Young of the University of Oxford published a working paper in March 2008 describing the "lemons" problem with hedge funds. Because of information asymmetries between hedge fund managers and investors, low barriers to start a hedge fund, and fee structures that favor the hedge fund manager over the investor, hedge fund investors are faced with an industry of used cars. These used cars tend to run well for a while during favorable market conditions, making the investors think that they procured a skilled "alpha" manager. Sooner or later, though, the transmission goes out alongside the market, revealing the "beta," or market-driven nature of the hedge fund manager and strategy (or nonexistence, in the case of Bernie Madoff), and costing the investor a good chunk of change.

The lemons story ends with a deep discount for used-car buyers because there is no good way to eliminate the risk from information asymmetry. Similarly, hedge fund investors are now selling partnership interests in top-name funds secondhand at substantial discounts on platforms like Hedgebay Trading. The hedge fund story can't end here, under the yellow lights of a used-car parking lot. First, there are skilled hedge fund managers, and second, the institutional market needs their services. Hedge funds need to be fixed, not discarded. We think that increased transparency and realigned incentives are the answer.

The Incentive Problem

Hedge funds are typically structured as a "heads I win, tails you lose" proposition for the fund's management. Managers get larger-than-mutual-fund monthly fees whether they make or lose money, and each year that they earn any "profits," realized or unrealized, they take a 20% (or more) cut of the gains. In years when most financial assets are rising, these performance fees can become very large for even ordinary performance. Hurdle rates, which require hedge fund managers to earn a minimum return (such as the risk-free rate or a more appropriate benchmark) before taking a cut, have steadily declined since 2005. Furthermore, claw-back provisions, forcing managers to return past fees, have never really become mainstream.

In contrast, if hedge funds lose the "profits" or even principal on which they have already charged fees, managers are not required to refund fees. Indeed, we are now seeing managers just close up shop and start new funds, perhaps first waiting until market conditions are favorable and investors have forgotten their previous failures. This way, the managers can more quickly earn the 20% incentive fee again. John Meriwether of Long Term Capital Management is the classic perpetrator of this ruse.

Failed hedge fund managers who don't shutter can stay in business with redemption gates, a fine-print provision that forces investors to remain in the fund and pay management fees until the fund manager feels that it is the right time to meet redemption requests. Investors may wait years to fully redeem, as the more illiquid assets are sometimes siphoned off into "side pockets" for an indeterminate period of time.

How We Got Here

Institutions are to blame for these misaligned incentives, for they allowed hedge funds to gain the upper hand in the first place. Over the last few years, pension funds and endowments have poured money into "absolute return" investments, which include hedge funds and other private investment vehicles, with few strings attached. One of the primary reasons for this negligence was that hedge funds were actually (at the time) outperforming the market, and pension and endowment managers didn't want to underperform relative to their peers.

It turns out that many of these "absolute return" funds were anything but and had achieved their outsized returns frequently through the use of leverage and high-risk investments. Take Bear Stearns Asset Management, for example, whose motto was "Risk Managed, Value Added." It took subprime CDOs and levered to the hilt, calling this strategy "capital markets arbitrage." We all know how the Bear Stearns story ended.

Funds of hedge funds were probably the biggest disappointment of all. These funds charge investors an extra layer of fees, typically 1% management and 10% incentive fees, to diversify manager risk and conduct due diligence for those who lack the resources, while promising smaller institutions access to "elite" hedge funds managers. The proof is not in the pudding--funds of hedge funds performed worse than the average hedge fund over the last five years, as measured by the Morningstar Hedge Fund of Funds and Morningstar 1000 Hedge Fund Indexes.

Furthermore, the Bernie Madoff scandal showed that some funds of hedge funds, Fairfield Greenwich and Tremont, for example, failed to conduct even basic due diligence, relying entirely on Madoff's reputation rather than investigating his strategy, investment team, and operations before investing billions. These funds also failed to follow the basic portfolio-management tenet of diversification, putting all of their eggs into one fraudulent basket.

How to Fix It: Increased Transparency

Transparency is paramount to any type of hedge fund reform. Hedge fund registration, as the current version of the Hedge Fund Transparency Act would require, is the first step. This bill would require funds larger than \$50 million to provide basic contact, service-provider, and assets-under-management information in order to register with the SEC. Although this provision alone is fairly unremarkable, the bill opens the door for the SEC to take further steps, whether in creating new regulations or in subjecting hedge funds to inspections. Hedge funds of institutional-investor magnitude would fall under the reach of this act.

Indeed, the regulation needs to go further. Hedge funds should publicly disclose portfolios and leverage information over a regular interval (for example, quarterly) with a sufficient lag, to protect hedge fund managers from copycats, to allow potential hedge fund investors and third parties to assess the risks of the strategy, and to see if the hedge fund managers are living up to their words.

In addition, custody, pricing, and reporting of hedge fund assets through independent, approved third parties (banks or broker dealers) are necessary steps. Otherwise, we will find ourselves in another Madoff dilemma, where self-custody, self-reporting, and cronyism facilitated a massive fraud.

Critics argue that increased transparency and regulation will drive hedge funds to seek shelter in less regulated, manager-friendly domiciles. But crooks will always seek shelter in the shadows of regulation. We learned this lesson with foreign exchange, and now we are learning it with hedge funds. Institutions must not be so naive as to fall for this rhetoric again.

The transparency effort will have to be worldwide. Fortunately, the process is already under way. When Germany hosted the G8 summit in August 2007, it attempted to push through global regulation of hedge funds. Germany's calls fell on deaf ears then, but France has recently revived the effort. Governments still enabling hedge funds to be opaque, such as Luxembourg, are attracting heavy global scrutiny, while governments formerly considered secrecy havens, such as the Cayman Islands, already require registration and reporting of most funds.

Re-aligning the Wheels

To fix the problem of incentive misalignment, David Swensen, CIO of Yale's Endowment, offers a promising direction. Swensen, whose large fund and even larger reputation allow him negotiating power, takes the private equity approach to investing. He demands lower management fees from the funds in which he invests but, in return, offers the carrot of high performance fees upon realizing gains above a hurdle rate at the termination of the fund. In addition, he is willing to make concessions about the liquidity of his investment. This structure gives managers time to achieve their goals and a handsome payoff should they succeed, while eliminating fat short-term payouts for funds that prove to be longer-term failures.

The Utah Retirement Systems is one of the first to take on the realignment initiative. Instead of the standard fixed 2% and 20% fee structure, the Utah pension fund offers hedge fund managers a tiered fee schedule, with management fees and performance fees declining to 1% and 15% for investments over \$50 million. Furthermore, it will only pay performance fees on new profits above a hurdle rate of Treasury Bills plus the management fee. Finally, in exchange for a larger initial investment, rolling 12-month lockups, and liquidity gates, the institution will defer payment of performance fees, paying out only 50% at the end of the first year and the remainder over the next two years if the profits persist.

With the backing of its peers (the Teacher Retirement System of Texas is already on board), institutions like Utah Retirement Systems could go even further. A better management-fee structure might be fixed at 1% annually, or it may decline as the fund's total assets grow, a common practice in the mutual fund industry. Incentive fees could be fixed at a high rate, for example 30% on new profits, above a more difficult hurdle rate, such as 8%, a common practice in private equity. Alternatively, performance fees could increase as the level of outperformance increases.

To be fair, lockups should also be longer--two years or more--especially for hedge funds in less-liquid or longer-term investments, such as distressed securities. Many investors accepted two-year lockups in 2005, when some hedge funds increased lockups to avoid impending (and subsequently failed) SEC registration requirements. We heartily encourage the continued growth of this trend.

It is time to rethink the hedge fund proposition. Institutions now have the upper hand, as they still have funds to invest and long time horizons, while many hedge fund managers are out of jobs. The credit crisis has already served to weed out many of the less-skilled managers, as the bear market has forced liquidations, leaving skilled managers in their wake. Going forward, institutions need to use their clout to demand better terms from hedge funds. Transparency, less money up-front, longer lockups, and more money on the back end would transform hedge funds from an industry of used cars into a fleet of luxury vehicles.