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Hedge fund outlook 2010

The fourth quarter of 2009 has been promising for the industry—but what lies over the horizon?

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What does the near future of the hedge fund industry look like? Predictions are always difficult to make, but a few themes have emerged. Some reflect the beginning of a recovery phase for the industry. Others reflect that the industry has a long way to go before the problems of 2008 will be behind it.

Broadly speaking, hedge funds are riding through the fourth quarter on positive returns. This of course is good for investors, who are recouping losses, and for managers, who are earning their way back to or above 2008's high-water marks. Months of net outflows of assets have recently given way to steadily increasing net inflows. Fundraising remains a challenge, but investors, cautiously yet in impressive numbers, are again interested in and returning to the industry.

The markets for many side-pocketed assets have bounced back, enabling some funds to reduce the big side pockets and liquidating trusts created last year to deal with unprecedented illiquidity. While legacy illiquid assets will continue to be a thorn in the side of many investors, there has been progress. Managers are working out or liquidating some of these assets, and investors, aided by a better understanding of the condition of their portfolios than earlier in the year, have adjusted their expectations and in some cases sold off these holdings. These situations are far from perfect and will take a long time to resolve, but tensions between investors and managers over these issues have decreased. Investors, however, have required and received better transparency, shorter lockups and assurances of better portfolio liquidity.

The year started with substantial speculation that the failure of hedge funds to provide absolute returns would lead to the end of the "two and twenty" fee structure. As the conversions between investors and managers played out (notably publicized by several public pension funds), confirming that the interests of investors and managers were aligned became the dominant theme. As a result, industrywide repricing of fees has not occurred. Instead, fee repricing has largely been limited to new products and funds that restructured earlier in 2009, which for midsize and larger firms usually means a management fee in the range of 1.25% to 1.75%. Also, to a lesser extent, some funds have offered a year-over-year clawback of incentive fees if performance declines as a way to keep interests aligned. Other than reductions for longer lockups, the 20% performance fee remains the standard.

Now that performance compensation is no longer a hypothetical

consideration, firms are revisiting their employee compensation structures with an eye toward retention. On the agenda for many managers is requiring the investment professionals to reinvest a portion of their bonuses in the fund, multiyear vesting of bonuses and subjecting bonuses to a clawback based on future performance. Another trend toward awarding firm equity to key personnel, which waned since 2007-2008, is probably not far behind.

For some managers, stellar 2009 performance may not be enough to preserve the franchise. In most cases, 2009 performance will need to exceed the 2008 high-water mark by a large enough margin to compensate satisfactorily the investment professionals. This is especially true for the many firms that did not have meaningful inflows of new capital not subject to high-water marks. Early 2009 was about pulling fund portfolios through the credit crisis and post-Lehman market downturn. The industry was below high water, the job market was contracting, and management dictated changes in their investment and operations teams. Late 2009 is about not losing your investment team next year. Proprietary trading profits and substantial bonus pools at banks have changed the bonus dynamics, as will the funds that collect substantial performance fees this year. As a result, early 2010 may see another wave of downsizing or closures of established firms.

New manager startups, unfortunately, continue to face substantial obstacles. Barriers to entry continue to increase: investors demand substantial operations and compliance infrastructure, and the prospect of increased regulation and compliance costs is on the horizon. Investors' attraction to the safety of large, established firms and fear of operational and compliance risks of younger and smaller firms continue. While there are a significant number of startup firms in the queue, platforms offering infrastructure, seed money and investor demand for emerging managers are scarce.

Finally, the impact of new regulation remains a wild card. On the legislative front, the industry has accepted the inevitable prospect of adviser registration and increased reporting in the U.S., but the European Union's hostile regulatory agenda is clearly a concern.

Next year will certainly be another transitional year for hedge funds, but hopefully it will offer a more stable environment and renewed growth. ■

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