PUBLICATIONS

Midyear Update — Trends in Hedge Funds

SRZ Insight

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Strong 2020 Performance and Some Fundraising Trends Have Extended into 2021

Hedge funds are often loosely grouped into categories — such as equities (including long/short equity), global macro, event-driven (including activist and risk/merger arbitrage), credit, relative value (including various other forms of arbitrage), managed futures, multi-strategy and "niche" (including cryptocurrencies and other digital assets).

In 2020, the winning category among hedge funds was equities, delivering some +19.7%, according to research firm Preqin. Within equities, funds pursuing investments in the technology, health care and energy and basic materials sectors exceled. Other event-driven and certain niche strategies also performed well. Credit was the laggard hedge fund strategy, relatively speaking, with returns around +5.24%. Across the asset class, AUM increased by some 6%, notwithstanding net asset outflows of some $43 billion.[1]

The positive year-end momentum continued through the first quarter of 2021, with industry publications suggesting most managers have posted positive performance. Frequent commentator PivotalPath, for example, has reported positive performance in the low to high single digits for all hedge fund strategies through April 2021.[2]

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Despite these encouraging results, the fundraising environment for hedge fund managers is generally skewed in favor of more established firms. Notwithstanding data indicating that early life cycle hedge funds outperform their larger, more established brethren (true of each of the last eight years, according to Preqin), the more-established managers have a significant competitive advantage in raising capital, generally and in particular in times of crisis. We saw this clearly in 2020, with capital flowing much more readily to firms that had the resources necessary to tap existing relationships.

During the peak of the COVID-19 disruption, many established firms reopened previously closed funds to replace outflows or performance-based declines or build war chests to pursue specific opportunities. Some raised more-concentrated “best ideas” funds, or sleeves within existing fund complexes. (We discussed several of these fundraising options in our March 2020 report.) Meanwhile, although we worked on some prominent and highly successful emerging manager launches in 2020, many others were delayed or put on hold, and some funds were liquidated.[3]

2021 Is a More Promising Environment for Emerging Managers

Some industry developments in recent years have made cost containment much more achievable for smaller managers, which is a significant positive for those seeking to raise capital. For example, we are seeing much more frequent use of outsourced traders by clients; work-from-home technology and practices have been deployed; clients are making more targeted use of legal counsel and looking (in some cases) to serve up shorter fund documents with more “market” terms so as to shorten fundraising negotiations; and others are taking measures aimed at prolonging the availability of exempt reporting adviser registration status — all of which can mean a shorter path to launch and/or reduced costs. At the same time, given increasing competition among managers for talent, the opportunity cost of leaving an established manager to launch a new firm has diminished. In these conditions, emerging manager launches will be more common, and we are helping firms launch with a smaller capital base than was at one time considered necessary for success.

Generally, it is easier for emerging managers to achieve fundraising success with a niche strategy that is not overcrowded — and this

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continues to be true in 2021. Notable among our clients are new managers that are focusing on the crypto and/or blockchain space, healthcare and pro-diversity (governance) strategies. All are examples of "niches" that have received increased interest in the last year.

GameStop and the Effects of Increased Retail Participation

In January, the U.S. equity markets were roiled by an expansive "short squeeze" campaign ostensibly coordinated by retail investors using Reddit, a popular network of online communities, to target specific issuers. These issuers were known to have very high levels of short interest and to be among the short positions of several prominent hedge fund managers. In March, there occurred a GameStop reprise, as the price of this "stonk" (which had traded from $17 to $347 in January and back to $40 in February) once again rocketed to over $250.

In the wake of the GameStop developments, numerous regulators announced that they were reviewing whether laws were violated and whether regulatory changes were necessary to avoid similar market events. It is not yet clear what regulatory action will ultimately be taken in respect of these developments. Some of the public suggestions, e.g., proposed limitations on short sales, are rash. Short selling plays an important role in the efficient operation of the equity markets — exposing flaws and protecting investors. Calls for new regulations should be approached cautiously, as the markets have a proven ability to self-correct.

What is clear is that we are witnessing increased retail participation in the financial markets, and generally, this should be a net positive. However, in casting themselves as the David to the hedge fund industry's Goliath (if one reads the comments on the relevant Reddit threads, one finds many expressing a desire to teach hedge fund managers a lesson), the "Redditors" seem to lack an understanding of the many benefits delivered by hedge funds to "main street" — not least of which, investing and diversifying the investments of private and public pensions.[4]

What is the industry response to increased retail participation and the experience of GameStop?

1. Managers are working on long-only products — accelerating a trend that was underway prior to GameStop;

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2. Managers are buying products that monitor and analyze discussions on Reddit, Twitter and similar platforms;
3. Some short sellers have ceased publishing their short selling reports;[5]
4. Managers are updating offering materials to add or expand risk disclosures relating to short squeezes; and
5. Investors and consultants are questioning short selling practices in due diligence.

The retail participation that resulted in GameStop and other "meme stock" phenomena has arisen at the same time as, and at least partially as a result of, the notable social media presence curated by prominent corporate and investment management personalities such as Tesla's Elon Musk and ARK fund manager Cathie Wood.[6] The Wall Street Journal points out that the notion of a market influencer isn't new — retail investors have for many years read Warren Buffett's investor letters, for example — but it is interesting to wonder aloud: Will these developments continue to the point where we see "stock influencer" or "social media sentiment" focused products, or will regulators act to stifle the influence of such individuals?

Are Liquid Credit Strategies Making a Comeback?

Among hedge fund strategies through the end of 2020 and into 2021, credit was a performance laggard, although many of our established credit clients (particularly those using closed-end fund structures) had successful fundraises.

As distressed credit is highly dependent on capital inflows and investments, the COVID-19 disruption presented a brief, rich opportunity for managers and secondary investors with deployable capital, before governmental stimulus flowed into the markets. Some clients are still finding opportunities, particularly in the most hard-hit industries, like retail, travel and entertainment, which are now recovering.

Overall, 2021 should see liquid credit hedge funds do better, both in terms of performance and asset flows. Preqin reports a number of promising 2020 data points that support our experience:

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1. For each of Q2, Q3 and Q4, credit hedge funds generated positive returns, with those funds with lower exposure to mortgage-backed securities posting the best numbers;

2. Although for the year the number was negative, in Q4 2020 credit hedge funds attracted positive asset flows of some $7.0 billion, with AUM across the segment slightly positive for the year;

3. Of Preqin's annual survey respondents, some 80% of investors indicated they would look to either maintain or increase their exposure to credit strategies in 2021;

4. Credit strategies were again resilient in 2020 in terms of new fund launches (~110) vs. liquidations (~90), with something of a movement away from managers focused on long/short credit toward fixed-income and asset-backed securities; and

5. Through April, Preqin reports positive 2021 performance for liquid credit strategies of some 3.25%.

Further, liquid credit funds should benefit if investors move away from frothy equity markets, and if the spigot of governmental support is turned off, opportunities for outperformance in the credit space should improve.

Private Investments, "Hybrid" Funds and Other Customized Products

For many years now, we have helped clients customize their fund structures, often with closed-end features and "private equity lite" terms, to help capture a broader range of investment opportunities. For example, provision for capital commitments to be drawn as and when needed, rather than fully-funded at the time of subscriptions, is a closed-end fund feature that we have built into hedge funds, particularly where a fund has performance-based compensation that is subject to a hurdle or preferred return and the sponsor is looking to avoid a cash drag. Along with longer lock-up periods and the re-emergence of the side pocket mechanism,[7] these are means for the hedge fund manager to preserve the flexibility that is considered optimal to capturing yield in a highly competitive market. Some hedge fund managers, including relatively recent launches, have used these features to particularly striking effect; capturing significant returns by making private investments alongside their public markets plays, and competing successfully for deal flows against the most

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prominent venture capital firms. In response to the COVID-19 pandemic, "commitment classes" proved to be an effective means of quickly raising additional capital to pursue opportunities arising from the dislocation. Managers are also continuing to raise springing funds/classes that will activate in the event of a new dislocation.

This blurring of the lines separating hedge fund and private equity and other closed-end product terms has led many of our clients to market "hybrid" funds designed to hold a blend of both liquid and illiquid assets. We have built these funds for managers that invest across public and private equity markets — something that has become common — and these funds are also particularly useful for strategies such as credit. Hedge fund managers developing such funds need service providers that have significant experience with both open-end and closed-end investment products, given the difficult issues that can arise, such as issues relating to taxation, trade allocations, conflicts of interest and valuations.

A related trend evident among hedge fund managers is that of established firms offering new, customized or bespoke products to investors while simultaneously continuing to manage their flagship hedge funds. This evolution or innovation can take the form of "best ideas" funds, long-only or long-biased funds, funds that offer exposure to a specific subset of a flagship fund's investment strategy, or other variations such as funds with narrower geographic mandates.

Hedge Fund Terms and the Possible Effect of Increased Sovereign Wealth Fund Allocations

Our hedge fund manager clients continue to innovate in developing fund terms. For example, we often help clients to preempt the most common investor demands and speed fundraising processes by building some investor requests directly into fund documents, sometimes including a "most favored nations" provision for the benefit of all investors. This practice mirrors a longstanding practice of private equity fund sponsors. For new launches, we also regularly work with clients to include "early bird" classes offering a fee discount and, sometimes, capacity rights (often at the same discount).

Economic Terms

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More broadly, management fees are stable, having converged (albeit somewhat strategy and size-dependent, and with many outliers) at 1.5% per annum (the mean rate for 2020 inceptions appears to be slightly lower). Incentive compensation rates are still usually between 15% — 20% (the mean rate for 2020 inceptions appears to be around 18%). This is consistent with the provision for a "rack rate" of 20% and a reduced rate for certain investors (e.g., a founders class, or investors subject to a longer lock-up period).

In some cases (e.g., long-only products), incentive compensation is subject to a hurdle rate; typically a relevant index but sometimes a fixed rate. For these products, we will question whether the manager will provide for incentive compensation based on relative outperformance of an index, even if the fund has experienced net losses. If a manager is considering this approach, certain tax complexities require discussion.

Shifting Allocations — The Growing Importance of Sovereign Wealth Funds

Interestingly, endowment plans and foundations have decreased their allocations to hedge funds (on a relative basis) in recent years, while sovereign wealth funds are allocating more than ever. Sovereign wealth funds are also the most willing of major investor types to leave their funds locked up and have the lowest return expectations.

What are the possible effects of this trend? Among them, increased sovereign wealth fund participation may lead to:

1. More requests for managed account or fund-of-one structures, as opposed to commingled products;
2. An increased focus on environmental, social and governance (ESG) issues;
3. Further standardization of due diligence questionnaires, reports and, to some degree, fund terms; and
4. An even greater need to be familiar with the requirements of, and deepen a manager's relationships with, the firms acting as consultants/gatekeepers for such capital sources.

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SRZ lawyers regularly author articles, alerts and publications, providing their updated, timely views of the market trends affecting private funds and drawing on SRZ's decades of experience as the market-leading law firm serving the alternative investment management industry. For more market insights on current and emerging trends in the private funds industry, read SRZ's Private Funds Market Trends Report for June 2021.

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[1] *See Preqin's* 2021 Global Hedge Fund Report, available to subscribers here.

[2] *See*, for example, *PivotalPath's* commentary, available here. *PivotalPath's* March report indicates that 62% of the managers it tracks posted positive returns in March and three fourths were up for the first quarter.

[3] The number of new hedge fund launches was outpaced by the number of fund liquidations in 2020. However, some such closings reflect a natural evolution within a maturing industry — a number of well established firms were "closed" in 2020 as founders determined to convert to family offices. *See*, for example, "John Paulson to convert hedge fund firm to family office," *Pensions & Investments*, available here, or "Hedge Fund Closings Were Up in 2020 — But It's Not What You Think," *Institutional Investor*, available here.

[4] *See*, for example, *PivotalPath's* commentary, available here. *PivotalPath's* March report indicates that 62% of the managers it tracks posted positive returns in March and three fourths were up for the first quarter.

[5] *See,* for example, "After GameStop Backlash, Citron Research Will Stop Publishing Short-Seller Reports," *The Wall Street Journal*, available here.

[6] *See*, for example, "The New Stock Influencers Have Huge — and Devoted — Followings," *The Wall Street Journal*, available here.

[7] One recent survey reported that approximately one fifth of surveyed hedge fund managers were either offering funds with side-pocket mechanics, or planning to offer funds with side-pocket mechanics in the next two years.

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