Innovation and imagination applied to hedge fund performance payments

How does the controversy and debate about bank bonuses affect the hedge fund industry? What will be the repercussions for remuneration in the industry, particularly the performance fee model?

Everyone agrees the current controversy over bonus payments has so far had little impact on hedge funds – mainly as a result of a startling lack of interest by the media in fees paid to fund managers. Nevertheless, it would be naive to believe the industry will not come in for attention, if only by investors keen to see a system that is linked more to their concerns than to rewarding the manager regardless of true performance. Various innovations are already being seen throughout the industry as individual hedge funds decide to implement new models. While the demise of the 2-and-20 model may be somewhat exaggerated at this point, it is clear its days are numbered.

As regulators continue to focus attention on hedge funds it is likely remuneration will pop onto the agenda at some stage, unless short-term memory loss kicks in as the immediacy of the financial crisis recedes.

Mark Barker, Hermes BPK Partners

With the controversy and debate shifting from the financial stability of institutions to that of individual bankers' excessive risk taking (and their resulting bonuses), we have to be careful that the policy/regulatory response does not create the all-too-often outcome of unintended consequence. Hedge funds rely on many of the highly skilled resources that exist within banks to support, and in some cases, perform many of their functions. Any actions that lead to talent migration could have a negative impact on the quality of infrastructure that supports the industry. On the performance fee question, we believe there is a growing recognition within the industry that a closer alignment of interests between managers and investors is required. We have been taking steps to address this at the fund of hedge fund level through a three-year deferred performance fee structure. We are also actively encouraging managers to institute structures that discourage short-term behaviour and reduce the probability of managers earning high fees on returns that may be transitory.

Ira Kustin, Akin Gump Strauss Hauer & Feld

The strengthened negotiating position of investors in hedge funds over the last nine months has led to unprecedented requests for changes to the traditional hedge fund manager compensation (HFMC) model. While the basic elements of HFMC (ie, the management fee and some form of incentive or performance compensation) still exist, investors have demanded changes to the amount or method of calculation of such compensation. Requests for management fee changes have typically taken the form of a simple request for lower fees, especially with respect to any special liquidating vehicles a fund may be using. Management fees may also be tiered and adjusted reflecting AUM. Requested changes to incentive or performance compensation have been much more complicated and have included multi-year performance calculation periods, hurdle rates that must be met prior to managers being paid and the use of escrow accounts or private-equity style clawback provisions which provide investors with some level of comfort. These provisions all give rise to significant tax complications.

Owen Watkins, Kaye Scholer

The UK FSA's code of practice on remuneration is restricted to large banks, building societies and broker-dealers. The FSA will shortly announce the extent to which the code will be extended to other FSA-regulated companies and a wide extension is on the cards. This would be consistent with developments elsewhere but it is not clear how a code of practice developed for banks and other entities that pose systemic risk could be sensibly applied to hedge fund managers. It is hoped that the FSA will take proper account of the differences between hedge fund managers and banks. Unlike bank employees, the interests of hedge fund managers are aligned with those of investors: they are co-investors in the fund and so share in the losses as well as the profits. And hedge funds themselves are increasingly enforcing internal holdback and sometimes clawback from their portfolio managers. However, if regulators do adopt a 'one-size-fits-all' model, this could have serious adverse consequences: eg, any deferral in receiving a performance fee could lead to managers facing the prospect of unfunded tax liabilities.

Alastair Barrie, Martin Currie

The controversy over bank bonuses arose because globally banks rewarded short-term risk taking at the expense of managing for the longer term. In the highly competitive hedge fund industry, the importance of aligning the policies, procedures and culture of a company with the interests of its clients has always been recognised. What has changed is that investors now demand more than just excellent performance. They also want evidence of strong business management, clear talent retention, operational quality, full transparency and product integrity. Within this, performance fees remain the appropriate model. This structure recognises skill is rare and capacity limited. It enables clear alignment of interest and reflects the cost of running a complex product. At Martin Currie our remuneration is focused on rewarding the delivery of what our clients expect of us. Managers share the performance fees earned with the company but they must invest 50% back into our funds. All of our managers are shareholders in the company – the ultimate alignment of our interests with those of our clients.

Lendell Porterfield and Andrew Lowenthal, Porterfield, Lowenthal & Fettig

The Treasury, Federal Reserve and G20 are proposing many changes to systemically significant financial institutions: higher-quality capital and more-stringent liquidity requirements; improved risk management practices; and compensation structures that provide "appropriate performance and risk-taking incentives". Hedge funds do not receive federal benefits, do not sell to the retail population and no hedge fund has received even one dollar from the taxpayer. The justifications policymakers are using to curb compensation at regulated SSFI simply do not exist for the hedge fund industry. The current political environment is very risky. Future actions are far from certain (think Chrysler secured creditors). The hedge fund industry is vulnerable to headline risk and is never really more than one bad actor away from additional regulation and oversight. The industry's regulatory future is not unrelated to the worst managed hedge fund and that is a risk that must be managed.

Christopher Clarke, Crystal Clear Capital Management

There is no sound reason why the current controversy over bank bonuses should affect the rewards for successful hedge fund managers. Bonuses paid to senior bank executives are, in effect, excessive rewards for continuing the implementation of flawed policies through the support of governments terrified by the prospect of further bank failures. These governments, rejecting the free market for pseudo-socialist control, seem to be frozen by the fear of public reaction but unable to act in case they are seen to kill the geese that have consistently laid the golden eggs. Hedge fund managers, in contrast, will continue to operate in the arena of survival of the fittest. True, those under-talented 'long-only clones' will certainly struggle for survival and will eventually become extinct, despite their lowering of fees. Managers capable of consistently achieving high levels of absolute return should, however, be able to double or even triple their fees in future as talented managers with a long history of out-performance will remain in short supply.

Gray Smith, Appleby

Hedge funds are clearly different from banks in that performance is more direct and measurable. So many of the arguments on bank bonuses are not relevant to the industry. Nevertheless, we are seeing moves to tie managers in with ongoing performance. We are starting to see fees paid by way of the issue of a separate class of shares to the manager with their fees at risk in the fund for a minimum period. It also has the benefit, if structured correctly, to lead to the manager making a capital gain, particularly important now for UK-based managers. We have also seen this approach taken further, with managers issuing shares to key employees. One manager is promoting a fund where investors take the first 18% and the manager gets any surplus. It is imaginative and addresses concerns over fees for poor or mediocre performance. Many say 2-and-20 is dead but people tend to have very short memories. With the radical improvement in performance already this year, I suspect fees will settle back to somewhere near their old levels in the medium term. The proliferation of side letters in this area is likely to continue.

Holly Miller, Stone House Consulting

We see a convergence between hedge fund compensation and traditional investment management compensation. The two-part fee model for hedge funds, where there is a base fee and a separate performance fee, is likely to remain in place, although 2-and-20 is changing. Performance fees may rise beyond the 20% level. We think they will become part of the traditional manager fee model over time. Hedge fund managers will increasingly be forced to build a robust infrastructure similar to their traditional counterparts against the backdrop of a lower base fee and will find themselves looking to the traditional model for guidance. Salaries and bonuses are likely to be cut most, bringing them more into line with traditional managers. As fee pressures squeeze margins across the industry, traditional and alternative managers alike will be forced to manage their businesses while also managing their portfolios. The result will be greater alignment between portfolio returns, firm profitability and employee compensation for both hedge funds and their traditional counterparts.

Jason Butwick, Dechert

The FSA has said remuneration policies and practices need to be considered as part of a company's overall commitment to effective risk management. It has identified a number of good and bad practices. A few of these suggest that aspects of the performance fee model may involve poor risk management, including providing all or most significant bonuses in cash, with no deferment. A growing number of companies are now deferring payment of cash bonuses. Some are also investing a proportion of deferred bonus in their fund(s), thereby helping align remuneration with risk. Another is insufficient weight given to non-financial measures of performance. Bonuses calculated purely on performance fees ignore the relative volatility of the strategies deployed. Finally, determining bonus pools by reference to net revenue, as opposed to profit. Given the FSA's stance, companies will have to review their remuneration structures going forward to ensure that they do not encourage excessive risk taking.