A Global Perspectives White Paper

Global Perspectives

Hedge Funds - end of the "Gilded Age"?

By Shane Brett,
Managing Director
Global Perspectives

www.globalperspective.co.uk

Date 21th March 2013

Contents

Introduction

"America's top 25 hedge fund managers make more than all the CEOs of the S&P 500 combined"

The Economist, October 2012

Hedge Funds have had an incredible run over the last 2 decades. The annual salaries and bonuses of the most successful managers have been amongst the highest paid to anyone, anywhere, ever.

Astronomical wealth has kept everything from top end international property to luxury goods to private yachts afloat for many years.

This is starting to change.

Multiple headwinds of lackluster performance, increasing competition and invasive regulation are starting to bite.

This White Paper examines these trends and asks the question - have hedge funds reached the end of their "Gilded Age"?

Background

Many of the very highest earning hedge funds and private equity managers earned annual income a dozen times higher than the CEO of Goldman Sachs (e.g. Blackstone).

It is amazing that hedge fund managers have escaped the public vitriol reserved for the investment banking community. This is primarily because no hedge fund has ever been bailed out with public money and their remuneration has remained below the public radar.

This is now changing, most prominently in Europe.

1. New Remuneration Regulation

The Alternative Investment Managers Fund Directive (AIFMD) was finalized in December 2012 and it contains some very specific rules relating to future hedge fund manager remuneration. These rules will apply from July 2013.

All hedge funds managed or marketed in the 27 European countries of the European Union will have to pay their employees at least 50% of their remuneration package in the form of shares in their funds. Cash payouts are limited to half employee's annual income.

Furthermore, the same shares cannot be divested for at least 3 (and preferably 5) years. There is no leeway here. The rules are written in such a way that they must be directly transposed into the law of each European member state 'as is'.

The fund remuneration policy must be made known to investors in the fund. Further details will be required by their local regulator. Details of payments to staff will be out in the open and transparent for the first time. It is a sea change for the industry.

Another crucial point is that these rules apply to any fund marketed in Europe. This point has yet to be fully understood in other international locations (like the US). In future to even try to seek investor capital from Europe, your fund must be fully compliant with the wide-ranging AIFMD regulations - of which the remuneration rules are only one small part.

The Directive makes this 'third country' compliance process a gradual process but by 2018 non-European managers active in Europe will be forced to introduce compliant remuneration policies - or forsake capital investment from the world's largest trading block.

To make matters worse the EU wants to extend their recently agreed banking bonus rules to cover hedge funds, effectively limiting annual bonuses to one time salary (or two times with 75% shareholder approval).

These regulatory changes will all have a negative impact on remuneration throughout the industry.

2. Lackluster Performance

Compounding this new proscriptive regulation is the lackluster performance of many hedge funds over the last 5 years. For this they have only themselves to blame.

Once again in 2012 many of the largest funds saw disappointing gains in a largely positive general market. Poor performance translates into far lower incentive fees and also effects potential future capital allocations.

It also gives investors the upper hand in fee negotiations and will also apply downward pressure on both future performance and management fees.

The difficult for many hedge funds in out-performing the market is a reflection of their huge success in recent decades. How can hedge funds outperform the market (and earn large performance fees) when to a large extent they are the market?

3. Convergence of Mutual and Hedge Funds.

A wider trend taking place cross the global asset management industry is the gradual convergence between mutual and alternative funds. Mutual investors want access to hedge fund strategies and hedge fund investors want the liquidity and transparency of mutual funds.

This trend has been widely noted but less has been said about the likely effect it will have on funds profits. This will exert downward pressure on both performance and management fees.

Salaries and bonuses have always been far lower in the traditional mutual fund industry, primarily due to the lack of performance fees. This convergence is set to continue and will further threaten the old “2 & 20” model.

4. Competition from Exchange Traded Funds

In addition to mutual funds adopting hedge fund strategies, an increasing threat to hedge fund revenue comes from the rapid growth of Exchange Traded Funds (ETFs).

Since they exploded onto the investment scene over a decade ago the growth of ETFs has been stunning. Where they initially tracked indices or stock exchanges, they now offer far more diverse investments in a huge variety of specific sectors. Many of these strategies are specifically designed to mimic hedge funds and – crucially – they are far cheaper for investors.

The growth of ETFs is set to continue and will prove a challenge to many hedge fund managers who will be under pressure to differentiate themselves from these low cost funds, as well as justify their own high fees.

Conclusion

It now looks likely that the golden era of widespread immense hedge fund profits finished with the global financial crisis.

A new set of pressures from investors, regulators and competitors has put the existing hedge fund revenue model under considerable stress.

Nonetheless, for many managers that perform, hedge funds will still be a very lucrative business.

Many wider trends also point to long term industry growth.

The 2012 “Fiscal Cliff” agreement in the US left the favourable “carried interest” rules for hedge funds and private equity intact.

The on-going global hunt for yield will continue in a zero interest rate / QE infused world.

The years ahead will see a worldwide surge in asset management investment as governments and companies back away from pensions and people need to save more for their retirement.

All this will be underpinned by continued economic expansion in global emerging markets.

The challenge for hedge funds will be to preserve their revenue model, while delivering value to their investors.

Global Perspectives
www.globalperspective.co.uk
Email: Shane@globalperspective.co.uk
Phone: +44 (0) 20 3239 2843

The “Future of Hedge Funds” also examines the current and future global economic environment and what this will mean for Hedge Funds in the years ahead.

Available from Amazon in paperback here-

www.amazon.com/Future-Hedge-Funds-Trends-industry/dp/1481130226/

And for Kindle here-

www.amazon.com/The-Future-Hedge-Funds-ebook/dp/B00AHACY8Y

Global Perspectives

Global Perspectives
www.globalperspective.co.uk
Email: Shane@globalperspective.co.uk
Phone: +44 (0) 20 3239 2843