Convergence: The Buzzword for Hedge Funds and Private Equity Funds in '06

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Overview

A frequent topic in the financial services press is the convergence of hedge funds and private equity funds. With movement into the private equity space, changes are on the horizon for hedge funds in 2006, and certain issues need to be addressed as the movement progresses.

The situation to date

The flat stock market, the drive for alpha and hedge funds' large asset base have encouraged hedge fund managers to search for investment opportunities to boost returns. While "chasing" returns is generally accepted as the motivation for the advent of hedge funds' private equity investments, the results of that pursuit, and indeed the potential for absolute returns in private equity, are not a certainty. In a *Journal of Finance* article published in August, 2005, professors Steve Kaplan of the University of Chicago and Antoinette Schoar of MIT's Sloan School of Business reported a wide discrepancy in the performance of private equity firms over a 30 year period. New funds showed the greatest underperformance. Thus, as hedge funds are now venturing into the private equity arena, they are statistically the most at-risk for underperformance.

What can we expect as the trend continues through next year?

In order to "hedge" against the historical risk of new entrants into private equity, we can expect a cross-migration of talent between hedge and private equity funds. Not only are big-name talents, such as Mark Gallogly (the partner responsible for private equity at Blackstone Group), starting hedge funds, but search firms are reporting that private equity firms are increasing pay to mid-ranking professionals to stave off the poaching efforts of hedge funds. Hedge funds need to acquire a knowledge base of analysts and operators to make private equity control-style investments, and they are paying up for it.

In addition to varying knowledge bases, a distinguishing difference between hedge funds and private equity funds is asset valuation, and its relationship to fund managers' compensation. One major attraction for private equity professionals to move to hedge funds is the opportunity to share in annual performance-based fees, instead of having to wait for a realization event as they generally do at private equity shops.

2006 and beyond will require hedge funds to reconsider their compensation structures as they relate to investing in private equity. Hedge fund managers generally receive performance-based compensation on an annual basis, which assumes the ability to regularly calculate the profit or loss of their fund. When a hedge fund invests in private equity, however, it must either use estimates of the value of the private equity investment in order to calculate the fund's profit and its fee, or wait to reap the "carry" until the portfolio investment experiences a realization event, as traditional private equity funds do.

Dealing with valuation

One common way to reconcile the valuation issue is for hedge funds to create side pockets, each of which is treated like a private equity fund within the hedge fund. The investment is set aside and no performance-based fee is realized on the investment until it is sold. The rest of the pool of portfolio assets – consisting of more traditional hedge fund assets – generate regular compensation based upon the hedge fund's standard valuation methods.

[1] See Journal of Finance, vol. 60, issue 4, pp. 1791 - 1823, Private Equity Performance: Returns, Persistence and Capital Flows, Steven N. Kaplan and Antoinette Schoar (August, 2005).

[2] See Private Equity Bonuses Rise on Hedge Fund Threat, GlocapSearch.com (www.glocap.com/pressrelease.jsp?db=gs&prid=883) April 11, 2005.

In lieu of creating a side pocket, hedge funds may estimate the value of their private equity investment. If this option is chosen, there is a significant opportunity for error in the valuation estimates, because the investment may not experience a realization event for five to ten years. Either the manager or the investors will bear the burden of the error. As the percentage of hedge funds investing in private equity rises – along with an increase in the percentage dedicated to private equities within hedge funds – the willingness for managers to create side pockets may fall. Hedge fund managers may be resistant to postponing a correspondingly larger percentage of their performance-based fees.

Alternatively, hedge funds may estimate the valuations of their private equity investments, but in return be required to concede to a clawback. Clawbacks require managers to recalculate fees and reimburse any overpayments that resulted from estimated valuations prior to the realization event.

But what about liquidity?

Clawbacks and performance-based fees beg the question of liquidity. Hedge funds must address the competing needs of liquidity and long-term investing. Side pockets limit an investor's liquidity by tying up a portion of the investment until its realization event. Hedge funds without side pockets (that instead rely on estimates of valuation for their performance fees) risk diluting existing investors (if they value the investments – and thus the fund's net asset value – too low) or charging new investors too much for their investment (if their valuations are too high).

One possible result is pressure on exit strategies. The IPO market has calmed significantly since the technology boom of the early 21st century, and with it the classic exit strategy for private equity investors has slowed. Private equity investors, including hedge funds, have increasingly begun creating "intermediate" realization events by selling their private equity stake to other private equity investors. Thus, a secondary market is developing which may ease the liquidity concerns of hedge funds entering the private equity arena.

Conclusion: market forces will prevail

As the convergence of hedge funds and private equity funds continues in 2006 and beyond, hedge funds, and ultimately their marketplace, will need to decide how to resolve the issues related to asset valuations, compensation structures, liquidity and exit strategies.

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