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For Asset Managers, The Risk is in The Return

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In any valuation, it is necessary to understand the benefits associated with an ownership interest (returns), and the risks associated with achieving those returns in future periods. After all, value is a function of perceived risk and return expectation. This article is intended to help identify the returns and risks unique to asset managers; principally hedge fund and private equity fund managers.

First, a distinction between hedge funds and private equity funds is necessary. ***Hedge funds*** are investment vehicles that seek to achieve stable returns that are not correlated with market indices or other "traditional" investments in stocks, bonds, real estate or commodities (whereas mutual funds are often correlated with indexes). Many times they attempt to do this by taking advantage of public market anomalies or inefficiencies. Each hedge fund typically has a specific trading style or strategy such as equity (stocks), fixed income (bond yields, interest rates), geographic (Europe, Latin America, Asia), industry specific (technology, healthcare, financial), or event driven (bankruptcy, mergers, acquisitions, activism), to name a few. ***Private Equity Funds*** are typically characterized by pools of capital, many times in successive funds bearing the same name (***tranches***), that are invested by a fund manager in private companies (hedge funds typically invest in more liquid and often publicly traded securities). Private equity fund managers seek to generate returns by selling the private companies to existing enterprises (by merger or acquisition), via a public offering (IPO), or to existing management; in each case often after restructuring capital, operations, or both. Like hedge funds, private equity funds are many times specialized in terms of strategy and style (venture capital funds, industry specific funds, geographic funds, etc.). In both cases, hedge funds and private equity funds, active management is the key to generating returns, whereas mutual funds are more likely to generate passive, market based returns.

Sources of Income

Both hedge fund and private equity fund managers typically derive income from two sources: management fees based upon a fixed percentage (typically 1% to 2%) of ***assets under management (AUM)***, and performance fees derived from fund returns (typically 10% to 20%). In the hedge fund world these are typically referred to as ***incentive fees*** or ***incentive allocations***, whereas private equity managers refer to these as ***carried interests*** or ***promotes***. In both cases, the management fee income stream bears less risk, since the fee is calculated as a percentage of assets under management, whereas performance fees are predicated entirely upon a fund manager's ability to produce returns, and the magnitude of the performance fee is often much greater. To illustrate this, consider the following scenarios:

A fund manager has $1 billion in AUM.

Scenario 1: The manager achieves a 10% return in a year. The 10% return might increase AUM to $1.1 billion, which would yield $11 million in management fees in the ensuing year (assuming a 1% management fee and a 10% increase in AUM). The return might also generate a performance fee of $20 million, assuming a 20% allocation to the fund manager.

Scenario 2: The fund suffered a 10% loss. There would be no performance fee, but the fund would still generate a management fee of $9 million (more than 80% of the fee realized with a 10% gain under scenario 1).

Lock-Ups

What the scenarios above do not reflect, is the impact that performance has on a manager's ability to retain and attract capital. Traditionally, investors in these types of alternative investment vehicles are very sensitive to performance. Consequently, poor performance would likely result in capital flight (withdrawals), reducing AUM and thereby have a greater impact on management fee income than what is illustrated in the example. However, the risk of significant capital withdrawals for both private equity and hedge fund managers is typically mitigated to a degree by the existence of ***lock-up*** restrictions, periods (usually 1 to 5 years), during which investors agree to have their capital "locked up", preventing withdrawal.

Hurdle Rates, Clawbacks and High Water Marks

As mentioned previously, to the extent a manager is unable to generate a return in a particular period (or on a particular investment in the case of private equity funds), a performance fee will not be earned. In most cases, both with regard to private equity funds and hedge funds, this penalty is compounded by ***clawback*** provisions that allow investors to recover losses before the asset manager can earn additional performance fees. Private equity fund provisions many times extend beyond just investor loss recovery, and establish minimum rates of return that the fund must generate for investors before a carried interest is earned by the manager. These minimum rates of return are referred to as ***hurdle rates***. Private equity investors may recover carried interests to the extent of previous distributions to the asset manager when subsequent transactions fail to produce returns, or result in losses that pull the investor below the promised hurdle rate. As a result, a fund manger's carried interests may not be safe from clawback until the fund is liquidated.

Similarly, where a hedge fund experiences losses, not only is there no performance fee for the asset manager, but the investors must be brought back to their individual ***high water marks*** before further incentive fees can be earned. Each investor's high water mark is set at the value of their investment each time an incentive fee is earned (***crystallized***) and allocated to the asset manager, typically annually. Only to the extent that the last established high water market is exceeded at the end of an incentive fee period, can the asset manager earn a new incentive fee. Consequently, incentive fees may only be *earned* (crystallize) at the end of an incentive fee period since gains realized part way through a year may be erased by losses during the balance of a year and vice versa.

Size Matters

Cliché, I know, but it's true when it comes to asset management at least. Employee compensation is by far the most significant expense of asset managers. One of the most critical factors for success in asset management is the ability to attract and retain talent. Hedge fund managers' inability to do so is the leading cause for the demise and liquidation of hedge funds. Typically, asset managers compensate employees through a combination of salary (from management fee income) and bonus (customarily from performance fees). In the absence of performance fees, bonuses must be paid from management fees. This is where size (in terms of AUM) is important. For funds to endure prolonged periods of losses, there must be sufficient AUM to generate management fees necessary to cover not only the salary component of employee compensation, but also bonuses (since there are no performance fees). This is one reason larger asset managers in terms of AUM are generally viewed as less risky.

Lack of Liquidity

Because of the nature of their investments (private companies for which there is no ready public market), private equity fund managers generally have limited liquidity, even in terms of the carried interests already earned (due to the potential for clawbacks), until the underlying fund is liquidated. Hedge fund managers, depending on the investment strategy/style, many times face liquidity restrictions as well. Hedge fund assets may be comprised of derivative securities that are not easily or readily unwound due, in part, to the presence of third party intermediaries in many transactions, commonly referred to as ***counterparties*** and ***prime brokers***. Furthermore, hedge funds may be highly leveraged. Finally, when investors invest in private equity funds and hedge funds, they are investing in the asset manager and the return that manager is expected to achieve. Accordingly, investors expect to see that the asset manager's capital is invested along side theirs, often referred to as having ***skin in the game***. Investors will also demand that there are contractual restrictions against the asset manager's withdrawal of capital.

To properly appraise an interest in an asset management company, one must possess a solid understanding of the unique attributes described above (among many others not addressed here, including fund structure, taxation, etc.), and the associated risks and returns.

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