REPRINTED FROM

MARHEDGE

WWW.MARHEDGE.COM DECEMBER 19, 2005 ISSUE 8

Hedge Funds in a Mediocre Market

Hiring, firing and retention issues

By Adam Herz

As more firms and capital continue to move into the alternative asset management space in search of premium returns, all of the low hanging fruit seem to have vanished. A majority of hedge fund managers now face an obstacle they have never before encountered: an environment of mediocre returns.

More than ever, funds' management of their human capital will be as important as the management of their investment capital.

With over $1 trillion of capital invested, aggregate hedge fund returns are 5.7% for the year, according to news reports, and 484 hedge funds have been liquidated this year alone. Compared with the heyday of the late 1990s, when managers could deliver returns of 30% or higher, current numbers appear weak, reducing available revenue for compensation. Combine these statistics with the proliferation of funds, the flood of investable capital and overcrowded markets in most strategies, and the result is a real squeeze on compensation.

This new environment requires hedge fund managers to make more than pure investment decisions; they must make business decisions that focus on human capital.

Many managers, from multibillion dollar hedge funds to funds with only a few million under management, are now facing crucial, "make-or-break" business decisions concerning their employees. The choices are:

- Reduce staff and cut spending because of reduced fees and returns;
- Add more talent to either bolster current strategies or diversify into new strategies; or
- Restructure existing payout schemes and implement creative compensation models to address issues in the new environment.

Adding value

Here, generally, is some advice that I give hedge fund managers considering these options:

For funds seeking to navigate in this current environment, I advise that a careful, detailed analysis be carried out concerning which employees add the most value. Funds today cannot afford to retain mediocre employees; they need superstars who can generate alpha.

In determining an employee's value, you need to look beyond raw statistics to separate the superstars from those who were in the right place at the right time. In most firms, portfolio managers make the final decisions about which investments get made, but good managers acknowledge when the underlying genesis and work behind an idea stems from someone on their team.

Those that add this kind of value need to be identified, retained and rewarded. Analysts who only "process" ideas should be compensated accordingly or let go.

Cutting employees has its benefits as well. Terminations open up cash resources and show stars you can differentiate between them and the pack. Managers can use such savings to reward revenue-producing superstars, invest in other business ventures or hire productive replacement staff.

As it takes time and money to train new employees, and firings can engender ill will within the fund, you must be selective and fire only those who do not or cannot contribute to the productivity of the firm.

Carrots

Once you know who your superstars are, you need to do whatever it takes to retain them. To do this, it is paramount that managers communicate the fund's criteria for determining compensation. How compensation is structured must be transparent.

This is especially important for hedge funds when communicating their philosophy regarding compensation in different return environments (ie, the volatility of their compensation models). Funds that have less volatility in compensation between good years and bad ones will significantly benefit in this environment, as compared with "outlier" funds, those that pay at top range in boom times and at the low end in busts.

Both styles are legitimate and reasonable strategies and are determined by the culture of the firm. If they are communicated effectively, the right candidates will be attracted and retained.

Funds need to retain top talent when there isn't as much money to go around. If they produce, superstars expect to get paid; if they aren't, they will leave for funds willing to do so. This makes funds, especially in this environment, willing to explore many untraditional compensation models.

These include approaches such as offering a percentage of profits, more aggressive measures such as offering equity within the funds, or commitments to seed autonomous funds down the road. More and more funds are even offering slices of management fees. Many of the more nontraditional models involve creative positive incentives to stay.

Whatever the carrot, we've found that creative compensation structures go a long way toward retaining key employees. However, as funds continue to toy with different forms of restricted covenants and compensation issues such as noncompetes and vesting, they need to keep in mind the negative ramifications such measures have on employee morale and future hiring.

Firms that choose to use incentives such as retained bonuses and matching plans tend to get

REPRINTED BY PERMISSION
© 2006 by Managed Account Reports LLC. All rights reserved.

more out of their employees.

Many funds are also using the current mediocre market as an opportunity to expand the fund with new talent, investing in the future. Hiring new blood has its benefits, but it does require an investment of both time and resources.

Junior level hires tend to have the least risk, thanks to the lower cost, lower expectation and relatively quick leverage they provide the existing team members. They do, however, require more attention and training without providing new ideas or capabilities to the firm, and there is a risk of losing them to competitors willing to pay them a premium for the investment you made.

For senior level employees, the most important characteristic they offer is the ability to add new capabilities to the firm. They pose a higher risk as they cost more and may be more difficult to manage than a junior analyst, but if you can find and attract the right people, you can add tremendous value to your business on many levels.

> Whatever the carrot, we've found that creative compensation structures go a long way toward retaining key employees.

When it comes to human capital issues, hedge fund managers in the current environment have a difficult task ahead of them. Those that understand the business side of running a hedge fund and the importance of hiring and retaining key talent will certainly have an big advantage over those that impulsively pursue short-term cost savings rather than long-term business strategies.

Adam Herz is the president of Hunter Advisors, www.hunterac.com, an executive search firm that specializes in recruitment of investment professionals for clients within the hedge fund and alternative asset management industries.

The reports on investment managers published in MAR/Hedge are based solely on information and data supplied by the respective investment manager. The accuracy and completeness of such information and data have not been verified by the publisher, and therefore we do not and cannot guarantee the accuracy or completeness of such information. Further, any statement non-factual in nature and any statements of opinion constitute only current opinions of the authors, which are subject to change and not necessarily the opinions of the publisher. No information in this newsletter constitutes or should be interpreted as a solicitation for investment in any of the investments reported on. A prospective client should independently investigate an investment manager before engaging the services of that manager, and should consult with independent qualified sources of investment advice and other legal and tax professionals before using the services of an investment manager. Due to, among other things, the volatile nature of the markets in which the investments and investment managers reported in this publication are involved, the investments written about in this newsletter may only be suitable for certain qualified investors, and may be subject to other requirements and/or restrictions enacted and/or enforced by regulatory agencies including but not limited to the Securities and Exchange Commission and the Commodity Futures Trading Commission, and/or other state and federal regulatory agencies. Past performance records as reported should not be considered indicative of future results.

© 2006 by Managed Account Reports LLC
Reproduction in any form forbidden without permission.

MARHEDGE

EDITORIAL

Editor-in-Chief
Randall S. Devere
rdevere@marhedge.com

Managing Editor
Michael Fischer
mfischer@marhedge.com

European Bureau Chief
Patricia Ward
pward@marhedge.com

Conference Editorial Director
Mindy Rosenthal
mrosenthal@marhedge.com

Associate Editors
M. Corey Goldman
cgoldman@marhedge.com

Martin Steward (Europe)
msteward@marhedge.com

Hung Tran
htran@marhedge.com

Phyllis Feinberg
pfeinberg@marhedge.com

Database Manager
Indira Peters-DiDio
ipeters@marhedge.com

Contributors
Fred Gehm (Chicago)
Rupert Lee (Sydney)
Ben Warwick (Denver)

GLOBAL HEADQUARTERS

President & Publisher
Gary Lynch
glynch@marhedge.com

Senior Vice President, Sales
Mark Salameh
msalameh@marhedge.com

Director of Marketing
Lisa McErlane Yao
lmcerlane@marhedge.com

Account Manager, Subscriptions
Richard Robinson
rrobinson@marhedge.com

Account Manager
Alana Ezderman
aezderman@marhedge.com

Junior Account Manager
Corinne Termini
ctermini@marhedge.com

Subscription Manager - Customer Service, Reprints
Keisha Morgan
kmorgan@marhedge.com

Production Manager
Brooke Abrams
babrams@marhedge.com

Manager, Conference Operations
Jill Hoffman
jhoffman@marhedge.com

Associate, Conference Operations
Patrick Brady
pbrady@marhedge.com

Conference Officer
Jeannie Lee
jlee@marhedge.com

MANAGED ACCOUNT REPORTS LLC

Founded in 1979
1250 Broadway, 26th Floor
New York, NY 10001
Tel: 212-213-6202
Fax: 212-213-1870
www.marhedge.com

EUROPEAN OPERATIONS

111 Westminister Bridge Road
London SE1 7UL
United Kingdom
Tel: +44-(0)20-7827-9977
Fax: +44-(0)20-7827-6413

Founders
Leon & Joy Rose
Publisher Emeritus
Greg Newton

SUBSCRIPTION RATES

*One Year - $1195 US/Canada**
One Year - $1295 ROW
**(in Canada, please add GST tax)*
Call +1-646-274-6224