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Expecting a leaner year

With only a few strategies in demand, funds find new ways to motivate employees

By Josh Friedlander
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If anyone suspects that the allure of hedge funds has dimmed given this year's sluggish performance, don't tell that to Robert Chapman, the corporate-activist investor who plans to relaunch Chapman Capital next year. For the ten positions now open at his firm, Chapman says he has received 14,000 resumes.

"The dream of working for a hedge fund, I think on its own, will attract lots of treasure hunters," says Chapman. "And activists are considered the modern-day pirates on whose ships one should serve."

Chapman likes to be outrageous, but his point also speaks to the state of the hedge fund employment market today. The veteran hedge fund pros applying to work for him tend to be "mercenary employees with high-watermark issues at their current employer," says Chapman, referring to funds whose poor performance makes it impossible for them to charge their incentive fees and thus pay their employees as much as they desire, or perhaps deserve. No doubt some of these folks are looking to make a switch because Chapman is willing to offer a more advantageous structure. "I decided to give up to 49% of my incentive pool to my team," says Chapman, who doesn't plan to pay himself a base salary. "It keeps me extremely motivated."

Chapman's situation speaks to the seemingly contradictory trends at work in the hedge fund world today. While industry returns this year have been lackluster, there's still strong demand for specific talent in hot strategies, from energy and emerging markets to private equity and activism, and for certain administrative functions that are accompanying the growth and institutionalization of the industry. In fact, compensation is expected to be up 20% for senior-level executives in these high demand areas, according to a new report by global search firm Russell Reynolds Associates.

Indeed, institutionalization, the term now in use to describe the ongoing bureaucratization of this once chiefly entrepreneurial industry, might also augur a growing egalitarianism in compensation of the type Chapman plans. Institutionalization addresses the concerns of, well, institutions, meaning the biggest pension funds, which would prefer to deal with those whom they perceive as safer bets: established players with full and mature operations. Part of satisfying the maturity component would be lower staff turnover, a problem that - until now - the hedge fund industry had not considered significant enough to merit much attention.

Whether there's more equality or not, this year doesn't look to be such a good one for most. Executive recruiters are predicting lower salary levels than last year, and the high correlation among hedge funds - especially in long/short, convertibles and other arbitrage strategies - means bad news for some is bad news for many more. The average portfolio manager with more than ten years' experience earned $406,000 to $1.35 million in total salary last year, absent profits from an equity stake and depending on the performance of his fund, according to search firm Glocap Partners. And even though average base salaries for the high end of this group have increased to $220,000 in 2005, up from $211,000 in 2004, says Glocap, the vast majority of total comp came from bonuses - a variation dependent, to an unfortunate degree, on the market, resulting in a wide range of payouts.

As Michael Goodman, a managing partner at recruiting firm Long Ridge Partners, noted succinctly: "For the first time in a while, we're flying into the year blind," noting that by this time last year, the post-election rally had already assured healthy bonuses.

"If there's no year-end rally, á la last year, a lot of people will be looking to move shops," notes one investor. As the vast number of those looking to work for Chapman Capital attests, not all will be able to.

In the past, a disappointed hedge fund employee could start his own shop, but that's less likely this year, investors and recruiters say. "It's harder and harder for people to raise funds," notes Adam Herz, a founding partner with recruiter Hunter Advisors. In the next six to 18 months there will be a decreasing number of individuals thinking they can spin off, he argues.

Again, blame it on institutionalization. The larger hedge funds continue to grow at a faster rate than smaller funds in terms of sheer head count, recruiters say, and institutional investors are cautiously placing their bets with larger, more stable-seeming institutions. The old adage for nonconformists is to "get in a line or start your own." Without the capital to support small spin-offs, that latter option has become much less viable.

The rise in uncertainty is presenting an opportunity for savvy managers interested in retaining talent, limiting churn, and building scalable enterprises capable of maintaining the trust of institutional investors.

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A leading proponent of this movement is Frank Brosens, founder of the $1.3 billion Taconic Partners and an alumnus of the Goldman Sachs proprietary training desk - where he was a disciple of Robert Rubin. His notions of the hedge fund as a more egalitarian partnership of owners, employees, and investors is still mostly alien to the industry (see profile below).

But the trend is gaining some traction, especially as Wall Street's revival presents an employment alternative. "Prop desks are as attractive as hedge funds," says Robert Olman, founder and managing partner of Alpha Search Advisory Partners. "Two years ago, 'I want to go to a hedge fund' is all we heard all day long. Now we ask, 'How do you feel about a prop desk at a bank?' and we hear 'fine.'"

Wall Street prop desks can't compete against the salaries earned by hedge fund founders, he adds, but for portfolio managers living in eat-what-you-kill environments, prop desks are starting to look more attractive. They offer stability or at least a perceived sense of stability - an irony considering that the earnings limitation concomitant with this stability is the catalyst that first led so many prop desk traders into the waiting arms of the hedge funds.

And despite potentially lower salaries, and even in a year when recruiters say Wall Street bonuses could be up as much as 20% on average, hedge funds still hold sway. "Overwhelmingly the 'net talent inflows' are still to the hedge fund community," says Olman. And not merely for money's sake either, he thinks, citing hedge funds' entrepreneurial dynamics, intellectual challenges and "the creative outlets inherent in complex strategies."

Nonetheless, all-in packages will be greater than $1.4 million for senior staffers with three-year or longer track records of profitability, according to estimates provided by Olman. Many will make more than $2.5 million, he noted. As usual, at the top funds, owners will continue to pull down total compensation into the tens to hundreds of millions of dollars.

Even if skittishness marks the feelings of the hedge fund rank and file, the long-term forecast for growth is good. The hedge fund industry plans to increase its own staffing levels 10.6% by year-end 2006, according to Morgan Stanley, which recently polled 180 funds. "On an average percentage growth basis by firm, the smaller shops are predicting faster percentage growth," says Heather Evans, a managing director in Morgan Stanley's prime brokerage group. "But that is because they are already small, so adding one to three people makes a big difference. Overall, the bulk of the growth will come from multistrategy shops, particularly those between $1 billion and $3 billion."

As more hedge funds pile into the game, the search for alpha drives them into ever more complicated strategies, many of which require experience in derivatives - in both the front and back offices. This is truer at the larger shops, where multistrategy funds require hefty support for their various maneuvers. "We do find a strong relationship between the size of a fund's staff and the use of over-the-counter derivatives," says Morgan Stanley's Evans. There is very little automation around over-the-counter derivatives, she reasons, requiring employee-intensive operational processes the likes of which the market-traded securities industry hasn't witnessed in a decade.

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Other areas that will continue to experience growth are energy and emerging markets, say recruiters. In energy, the consensus among hedge funds is that oil prices will continue to rise, and the related areas of natural gas and power are also becoming bigger plays, with power commanding the most esoteric skill set of the trio. Those firms that can't fill positions by recruiting from their competitors will likely continue to look to energy companies, says recruiter Deborah Rivera, founder of the Succession Group. They'll target energy companies in part because Wall Street has become too expensive. "All the major investment banks have expanded their energy desks in the past year. By this point, the guys at the banks are too expensive because they would require hefty guarantees, which the hedge funds are reluctant to pay," she adds.

India, China and Latin America are expected to remain dominant areas of interest. "We anticipate that with emerging markets performance outpacing allocations to the sector ... demand for senior-level talent will be white-hot by the time bonus season rolls around," says Olman.

As hedge funds veer closer to private equity strategies in the search for alpha, they are expected to continue to raid private equity firms like the Blackstone Group and Warburg Pincus. Earlier this year, Och-Ziff Capital Management nabbed David Stonehill from Blackstone Group, while this summer Eton Park Capital hit another blow to Blackstone by hiring principal Joshua Astrof. Eton later lured Oliver Goldstein from Warburg Pincus, where he had served as a managing director for six years.

Private equity isn't the only area likely to suffer from hedge fund recruiting muscle. Law firms and compliance shops should also watch out. Most headhunters mentioned an increase in the number of positions on the so-called "cost side." There was a big wave of compliance hires in 2005, as funds staffed up to meet the new requirements of the Securities and Exchange Commission. The SEC has mandated that managers with assets at or greater than $30 million serving more than 14 clients register as investment advisors by February 2006 - a process requiring managers to employ a chief compliance officer.

This hiring has occurred even at many of the larger firms that are skirting the SEC rules via a loophole whereby funds with lockups of two years or more and those closed to new capital can avoid registration.

Plenty of this hiring has already occurred at the top levels. In September, Third Point Management created a chief operating officer position and named James Kelly, a former Moore Capital executive, to the

role. He oversees day-to-day operations and focuses on business development, risk management, and client services. FrontPoint Partners created a COO position this June, filling the slot with Joanne Pace, who had been managing director and global head of human resources at Credit Suisse First Boston. Halcyon Asset Management did likewise in April, creating a COO role and plugging in Tom Hirschfeld, who had been COO for investments and head of venture capital at J. & W. Seligman.

"The big story is that there's a continued increase in the ratio of support staff to investment professionals," said Adam Zoia, founder and managing partner at Glocap. The industry will continue to add more noninvestment professionals in 2006, he said, with the greatest number of hires in those strategies, like distressed or credit, that tend to involve a higher percentage of separately negotiated transactions - and therefore require more back office support - than, for instance, long/short equity.

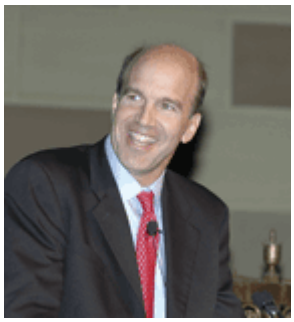
Marketing staff will also be in high demand, according to recruiter Tom Kellerhals, cofounder of the Westminster Group. These aren't sexy positions, he notes, but increasingly essential. "Institutions are used to being handheld in a certain way." From a recruiting point of view, that means there will be a new demand to supply the necessary accoutrements in terms of marketing and client services personnel.

Since hedge funds would far prefer to hire from other hedge funds, he says, staff to fill these slots can be "harder to find than hen's teeth in a graveyard."

The Brosens approach

When Frank Brosens, founder of the $1.3 billion Taconic Partners and an alumnus of the Goldman Sachs proprietary training desk, spoke at the recent Absolute Return symposium, his comments were followed by an awkward silence. Finally, a member of the crowed called for the mike. "We're stunned by what you're talking about," he said. "It seems to be antithetical in our industry and refreshing, and hopefully many more people will appreciate what you're talking about and follow suit."

What Brosens was talking about is the need for hedge funds to make the goal of good management a core component of their operations. The benefits would be enhanced performance and the stability to effectively grow and maintain an organization to thrive beyond even its founders. Some of his suggestions are radical, like keeping equity at the firm when partners leave or creating a fund to cover expenses when the high water mark isn't met.



Frank Brosens

To start with, new employees need to be given proper training, he says, as compensation is not the biggest issue in the first three years. "You want to include senior people in the process and you want to review them and compensate them based on how well they can bring junior people along," explains Brosens. He also believes in giving professionals responsibility early on. "You want to encourage them to think commercially and creatively starting day one," he says, adding that it's also important to manage the risk appropriately.

Brosens' philosophy is to focus on the process of decision making rather than the decision itself, encouraging newcomers to try new ideas without any fear of being second-guessed or criticized. "A fear of criticism very quickly leads to having a view that is not dissimilar from the rest of the Street," he points out.

After employees have been at the organization three years, economics become more important, according to Brosens, who believes merit should determine pay. Then a firm "should look to compensate people based on what they contribute to the organization rather than what the organization needs to pay to keep them," he said. To that end, he recommends that funds offer a broad distribution of the equity of the partnership, creating a commonality of interest and purpose among the best employees.

Most radically, he believes there shouldn't be a disproportionate share of that equity allocated to the founders, whose equity share should correlate to their own value, as well.

In their senior years, employees' potential contributions, but also their expectations, are perhaps the greatest, and the risk of their departure increases. As a result, he suggests that firms shoot for an appropriate parceling out of the organization's equity shares, offering employees an economic incentive to stay or, at least, making the economics of their situation comparable to the alternatives but with far less risk.

"We've done this at Taconic," notes Brosens. "Make it clear that when the founders leave, their equity share will get redistributed among the remaining partners. And while that precludes the sale of the firm, the IPO of the firm, or any other way to monetize the assets, it sends a very loud message to the senior professionals there that they will always be treated equitably."

Brosens also talks about the importance of building the value of the franchise, which includes building both a strong culture and an appropriate infrastructure for a professional atmosphere.

"If you can create an entity where people enjoy coming to work, it can have incredible retentive value," he says. To that end, he suggests that firms find explicit ways for everyone to benefit from the success of the organization. "Communicate as much as possible the progress of the organization and your vision of it going forward." Other imperatives: Avoid separate profit and loss statements, thereby encouraging work toward a common goal, and include employees in decision making. Be sensitive to each individual's needs. "Allow people as much as possible to do the things that they really enjoy doing, and give them as much responsibility and authority as they're capable of handling," he says, adding that employees should be given visibility and credit.

Choosing the right investors - those who have a long-term focus and really understand your business - will make all the above easier. "Make decisions to optimize their economics. In the end it will optimize yours as well." Aligning asset growth with an organization's capabilities is also critical. Growing too fast risks dilution of the expected returns, but growing too slowly might make employees disinclined to stay.

Brosens also recommends that firms avoid being too greedy. "The way we think about it at Taconic is to have management fees essentially cover expenses on an annual basis, and that anything really beyond that will dilute returns to investors unnecessarily," he says. Finally, don't be stymied by the high water mark: "Something we're considering at Taconic is to build an internal reserve that's able to compensate your people when the high water mark would otherwise not allow you to without hitting the investors."