# Hedge Funds and Private Label Funds - a Private Client's Guide

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# Overview

1. Introduction to Hedge Funds
2. Investing in Hedge Funds
3. Private Label Funds

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# An Introduction to Hedge Funds

# An Introduction to Hedge Funds

- Definition
- Principal Strategies
- Manager Remuneration
- Funds of Hedge Funds
- Typical Structures

# Hedge Funds: Defining Characteristics (1)

- A hedge fund is an actively managed investment fund whose objective is to earn an absolute and positive return independently of the return delivered by standard market indices
- A hedge fund uses a variety of investment strategies and tools: leverage, short selling and derivatives
- A hedge fund is designed for investment by a relatively small number of HNW and institutional investors, rather than a broad market of retail investors
- The manager of the hedge fund earns a percentage of upside generated by the fund

# Hedge Funds: Defining Characteristics (2)

- Objective always to generate “alpha” (“absolute”/“uncorrelated” returns)
- No investment or borrowing restrictions
- Short selling & leverage permitted
- Less liquidity (in exchange for freedom of investment strategy)
- Less transparency
- The fund‘s strategy & manager are the key sources of risk (rather than the market)
- Manager remuneration (“2 & 20”)

# Hedge Funds: Defining Characteristics (3)

Comparison with mutual ("retail"/"traditional"/"long-only") funds

| | **Hedge Funds** | **Mutual Funds** |
|---|---|---|
| **Objective** | Absolute return | Relative return |
| **Strategies** | Wide freedom, including leverage, short selling, other hedging strategies | Limitations or prohibitions on leverage, short selling, use of derivatives |
| **Primary sources of return and risk** | Strategy and manager | Market |

# Hedge Funds: Defining Characteristics (4)

| | Hedge Funds | Mutual Funds |
|---|---|---|
| **Liquidity** | Limitations on investment and redemption | Daily liquidity |
| **Marketing** | Limitations on marketing and selling | Broad access to retail market |
| **Fees** | Asset-based and performance-based | Asset-based only |
| **Taxation** | Pass-through entity, no tax at fund level | No tax at fund level if all income distributed |

# Hedge Funds: Active Management

***Less Active***

<u>The Spectrum of Active Management</u>

| | |
|---|---|
| **Pure indexing** | |
| **Enhanced indexing:** | Target return 1% over index<br>Small bets away from index |
| **Constrained active management:** | Target return 2% to 4% over index. Larger bets away from index |
| **Unconstrained active management:** | Target return more than 4% over index.<br>Largest bets away from index |
| **Hedge Funds:** | Target return not related to index at all. Manager can hold cash, use leverage, sell short, use other special strategies |

***More Active***

# Principal Investment Strategies

- Equity Hedge Funds
  - Long biased
  - Short biased
  - Opportunistic
- Relative Value
  - Long/Short Equity
  - Market Neutral
  - Bond/convertible hedging
  - Multi-strategy
- Event Driven
  - Merger arbitrage
  - Distressed Debt
  - Special Situations
  - Multi-strategy
- Global Asset Allocators
  - Managed Futures/CTAs (stocks/bonds/currencies)
  - Quantitative
  - Discretionary

# Manager Remuneration (2 & 20)

- Annual *management* fee charged as percentage of AUM: 2%
- Additional *performance* fee charged as percentage of annual upside 20%
- Performance fee sometimes subject to a *Hurdle Rate*
- Performance fee normally subject to a *high water mark*
- Investors can come in at any time during the financial year; need to avoid *free ride*:
    - Series of shares/roll up
    - Equalisation
- Performance fee incentivises manager to *actively* manage

# Funds of Hedge Funds (FoHFs)

- FoHFs (managers of managers) provide diversification, access & efficiencies
- FoHFs provide exposure to a large number of managers, sectors & strategies
- FoFHs often more widely marketed than single funds
- Repackaging of hedge fund risks by derivatives in a way that provides an different way of getting hedge fund exposure for investors who cannot invest directly
- Multiple fee layers: direct fees, underlying fees, fee sharing

# Typical Hedge Fund Structures

- Choice usually between corporate and/or limited partnership
- Some standard structures have arisen over time:
  - stand alone
  - multi class (or “umbrella”)
  - SPC/PCCs
  - master/feeder

# Stand-alone Fund: Single Share Class

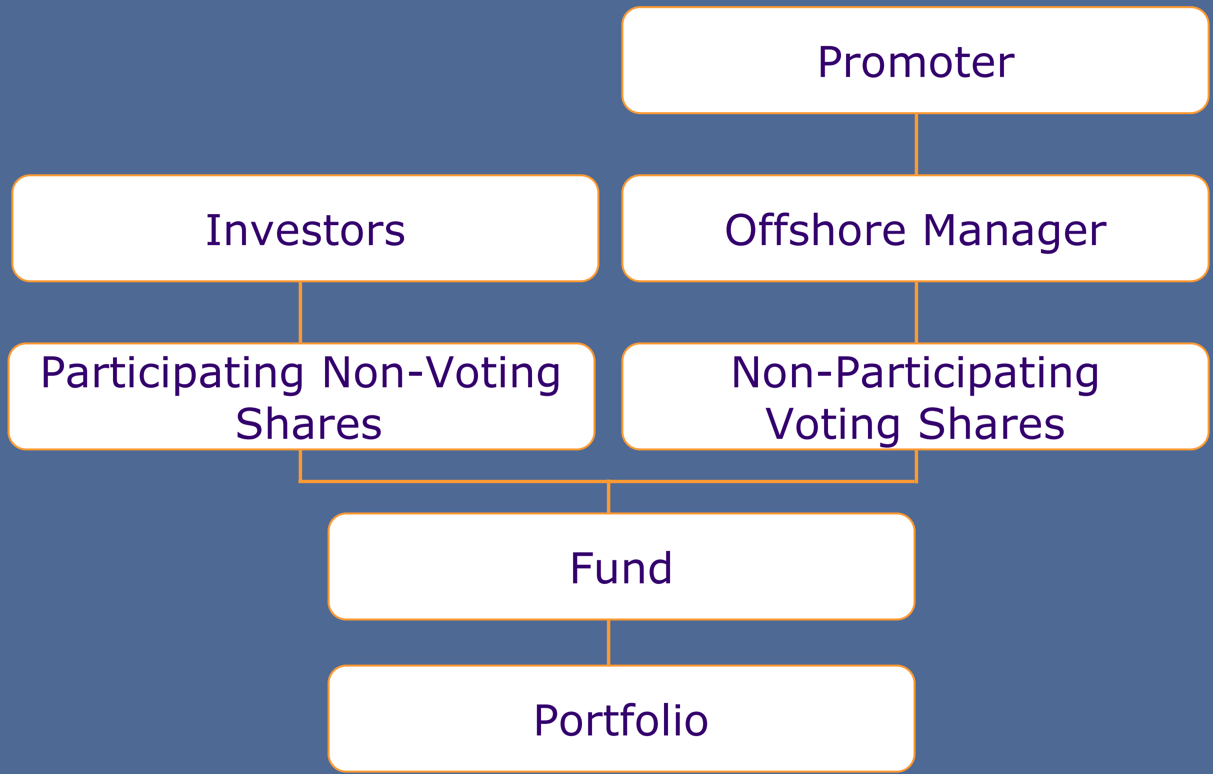
Investor

Participating and Voting Shares

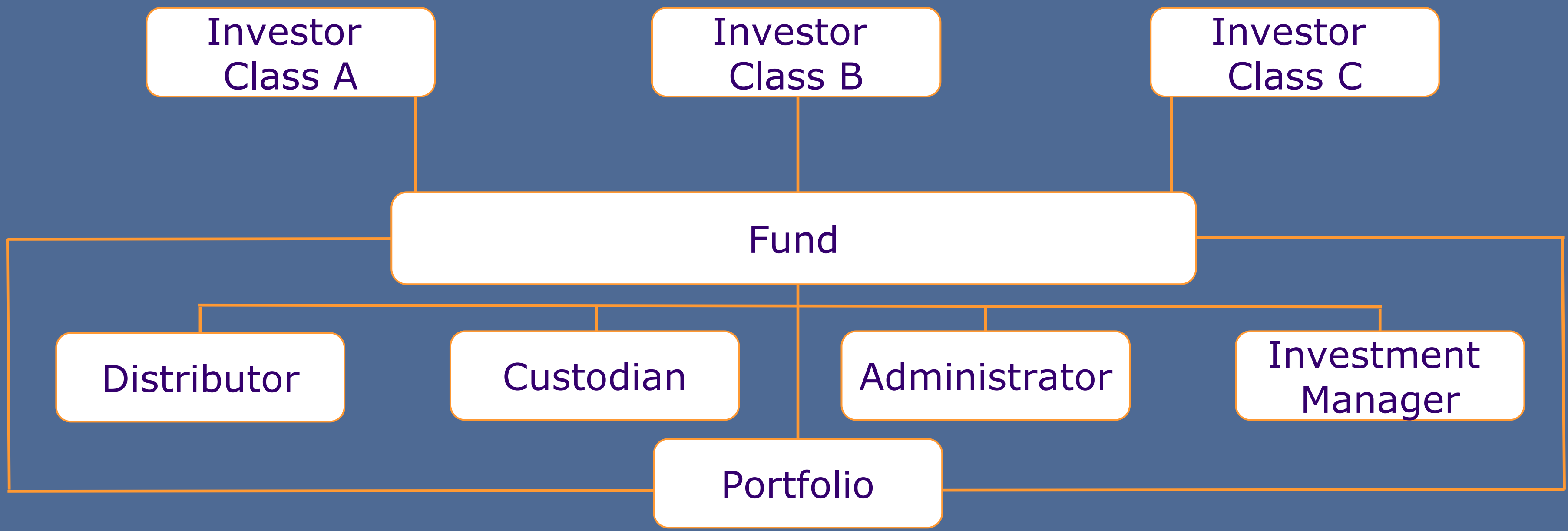
Fund

Portfolio

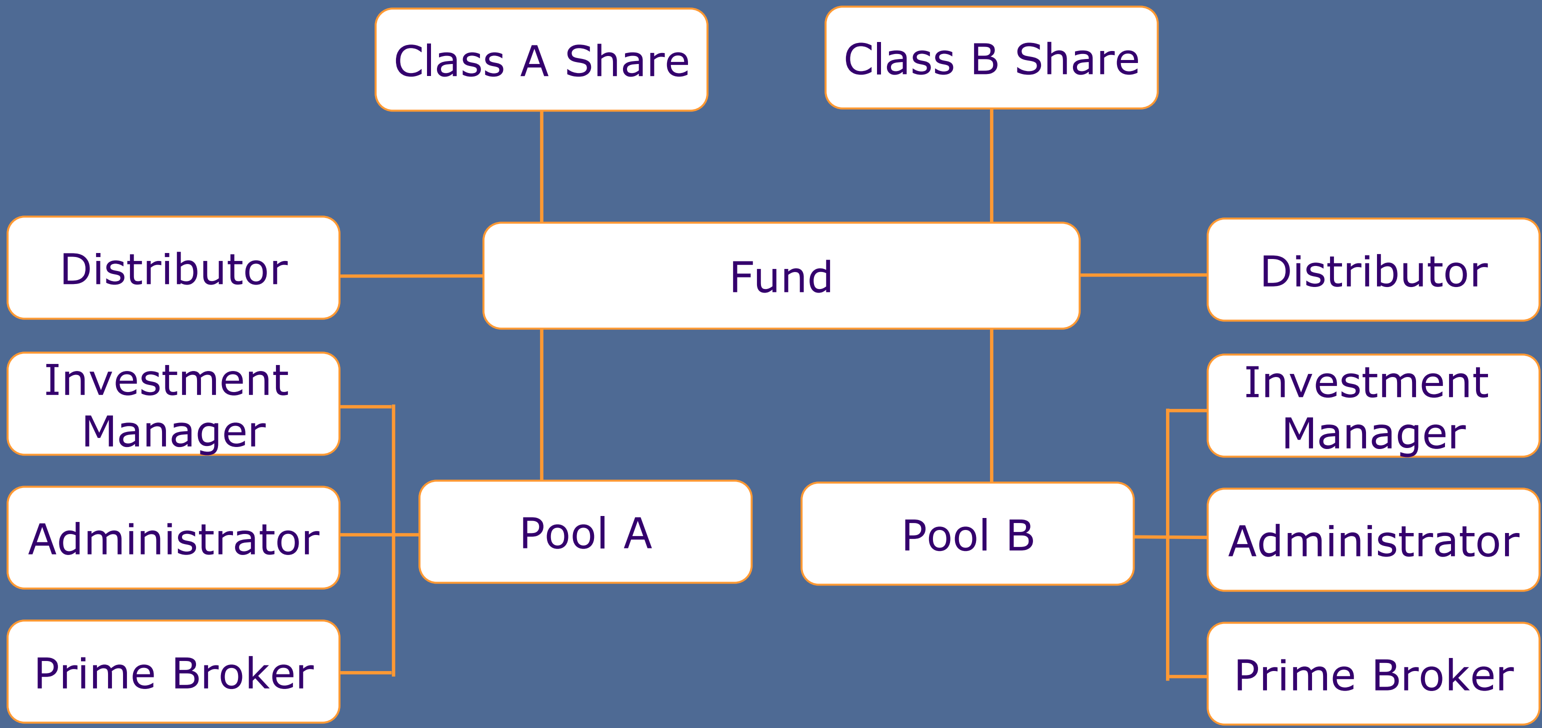
# Stand-alone Fund: Two Share Classes



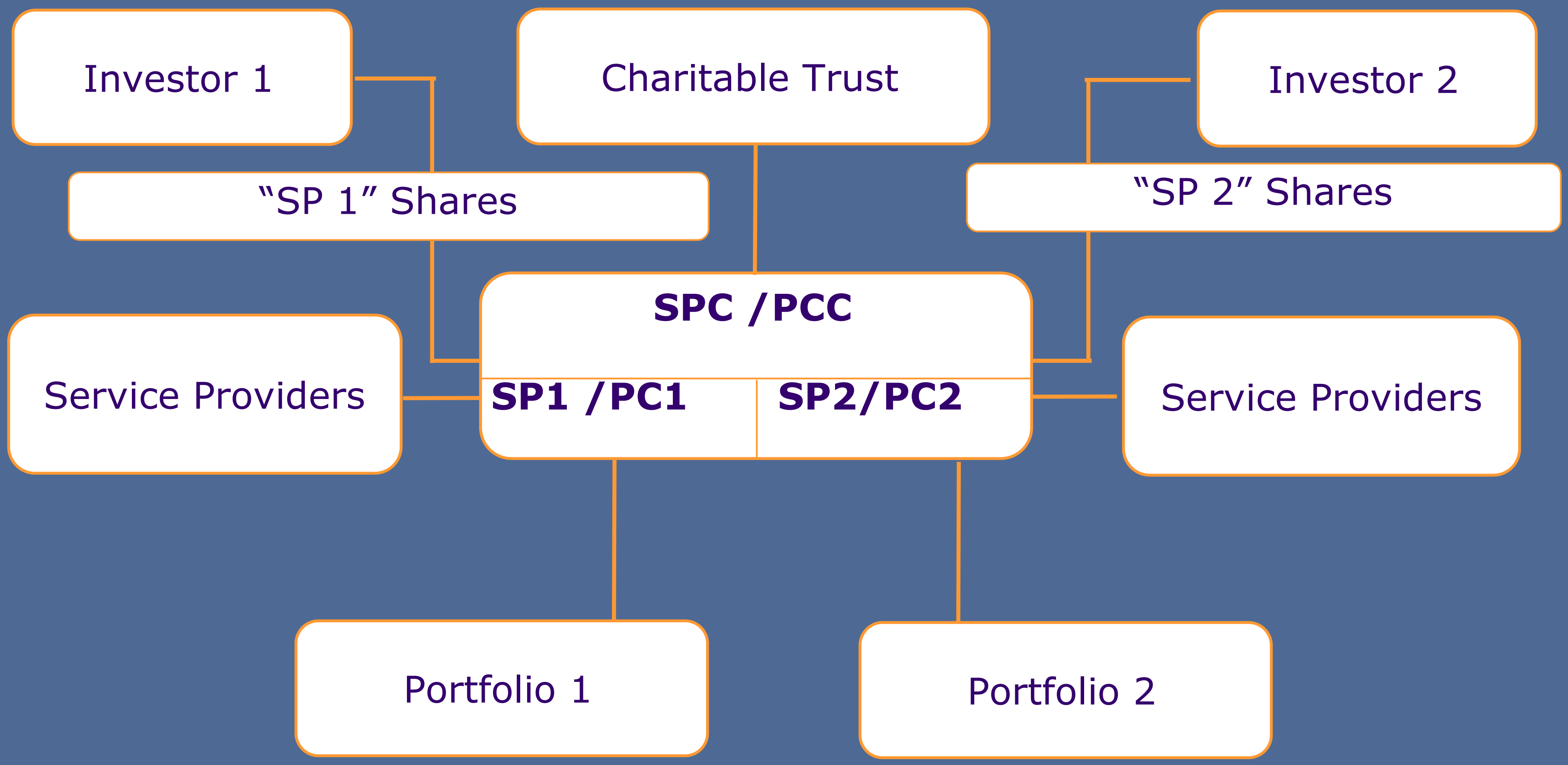
# Multi Class Fund



# Umbrella Fund



# Segregated Portfolio Company (SPC)/ Protected Cell (PCC) Structures



# Master/Feeder Structures

- Commonplace for US managers targeting:
  - Non-US investors
  - US tax-exempt investors (e.g., pension funds, charitable foundations)
  - US taxable investors
- Offshore Master fund will “check the box” for US tax purposes
- Checking the box means that the master is treated as a partnership (i.e., “tax transparent” / “look-through”) for US tax purposes
- Feeder funds (investing into the master) cater for various investor groups:
  - Non-US and US tax-exempt investors (offshore feeder)
  - US taxable investors (onshore feeder: e.g., Delaware LLC)

# 2

# Investing in Hedge Funds

# Hedge Funds: the old model

- Marked-to-market valuations
- Regular dealing days for subscriptions & redemptions
- No side pockets
- Minimal investor rights ("vote with your feet")

# Hedge Funds: the new model

- 08/09 watershed in alternatives industry
- Liquidity management becomes key
- Balance of power shifts in favour of investors
- Evolution of fund documentation (offering memorandum, constitutional documents, management agreements) to implement:
  - new fee structures
  - liquidity management tools

# Fee Structures

- Function of supply and demand: but currently "1.5 & 20" or "2 & 20" still mainstream; BUT:
- High water mark ("HWM") expected (required) by investors
- Performance hurdles: under scrutiny by investors; managers under pressure to adopt hurdle appropriate to strategy
- Lower asset-based fees on locked-up capital; incentive fees payable only at end of lock-up period
- PE-style "clawback": managers give back incentive fees earned for past performance when subsequent performance is poor; problem is that hedge fees are paid on NAV (unrealised gains, not like PE carry fees paid on realised assets after investors receive preferred return); HWM will be standard for some time to come
- Side arrangements with key investors (can cause disputes with non-preferred investors)
- Managers and investors alike expect creativity and compromise on fees

# Liquidity management

- Gates
- Lock-ups
- Redemptions in kind (*in specie*)
- Side pockets
- Suspension of NAV & redemptions

# Gates: rationale

- A gate is a liquidity management tool that permits the manager to limit aggregate withdrawals on a given dealing day
- A gate is typically defined as a percentage of the fund's NAV (usually between 10% and 20%) on each dealing day
- Redemption requests received in time order are aggregated up to level of gate
- Excess balance of requests are deferred to next dealing day and either given priority over other requests submitted for that day (a "stacked gate") or processed proportionately, subject in both cases to the gate
- Gates are intended to protect the fund and its investors from a mass exodus, fire sales of assets, and allow orderly investor liquidations. They also protect committed investors from "hot money" investors

# Gates: drawbacks

- Well connected investors can be prompted to submit redemption requests ahead of other investors: “selective disclosure”
- Problem: “rush to the exit”: investors submit big redemption requests and compete to be first in line
- Solution:
  - dispense with “stacked gate” in favour of pro-rata gate
  - set gate on a per-investor basis
  - impose cut-off limits on carried forward requests
  - discount NAV (5% - 10%) in exchange of exempting redeeming investors from gate
- Ensure gate provisions can be applied on a per-class basis

# Lock-ups: rationale

- A lock-up prohibits investors from withdrawing during a specific period (typically between 1 and 3 years)
- Hard lock: absolute prohibition on redeeming
- Soft lock: redemption possible subject to a fee (typically between 3% and 5% of NAV per share)
- Lock-up provisions often capable of waiver by manager
- Lock-ups have same advantages as gates, but avoid “selective disclosure” issues associated with gates and discourage “race to the exit”

# Lock-ups: drawbacks

- Capital locked in for years: good for manager, more problematic for investor
- Manager waiver of lock ups on a per-investor basis can lead to disputes with other investors
- Eliminates ability of investors to “vote with their feet” if manager underperforms
- Longer lock ups not always appropriate for liquid strategies
- Partial solutions:
  - Soft lock
  - Structure manager fees on locked up capital in a way favourable to investor

# Redemptions in-kind: rationale

- Cash is king
- Fund may wish to preserve cash reserves during illiquid periods
- Portfolio assets may not be capable of timely cash realisation during illiquid periods
- Investor preferred means of returning value (better than fund suspending payment of redemption proceeds)
- Fund documents should enable fund to pay redemption proceeds in non-cash assets

# Redemptions in kind: drawbacks

- Do not preserve balance of liquid and illiquid assets in portfolio
- Asset valuation can be difficult in illiquid periods; assets may depreciate between dealing day when value struck and distribution
- Some assets may be non-transferable, incapable of distribution by fund to investors
- Solution: side pockets

# Side Pockets: rationale

- Side pocket provisions enable manager to segregate illiquid/difficult-to-value assets from liquid portfolio
- Maintain stable NAV for liquid portfolio (marked-to-market assets)
- Enables fund to offer participating, redeemable shares referencing liquid portfolio and preserve potential value of side pocketed assets
- Postpone calculation of incentive fees on hard-to-value assets until those assets are liquidated

# Side Pockets: requirements

- Upon acquisition/occurrence of illiquid assets, a portion of participating shares are converted into a new class of non-redeemable shares, which can be repurchased by the fund when illiquid assets are realised over time
- To be implemented, the fund's offering document and its constitutional documents (Articles) must provide for creation of non-redeemable classes of shares and redemptions in kind (in specie)
- Manager will typically not receive incentive fees on the side pocketed assets
- Side pocket investments often valued at cost or book value (not part of NAV calculation on liquid assets)

# Side Pockets: drawbacks

- The creation of new non-redeemable shares may not be permitted by the fund's documents
- Investor consent to creation of new and/or amendment of fund's documents may not be viable
- The illiquid assets may not be transferable: have to be maintained at cost, possibly for lengthy periods, until realised

# Suspensions of NAV & redemptions

- Pre-2008: suspension of dealings (subscriptions/redemptions) often simultaneous with suspension of NAV (assumes dealings not possible because valuation of assets not possible): blanket suspension of dealings
- Post-2008: dealings suspension and NAV suspension decoupled:
  - suspension of dealings does not automatically entail suspension of NAV
  - suspension of NAV does not automatically entail suspension of redemptions
  - suspensions can be effected on per-class basis
- Suspension must be conditioned precisely by prescribed events in fund's documents and notified to affected investors prior to suspension taking effect

# Suspension of redemption payments

- Differentiate suspension of redemptions from suspension of redemption payments
- Suspension must be conditioned precisely by prescribed events in fund's documents and notified to affected investors prior to suspension taking effect
- Uncertainty as to whether redeeming, unpaid investor is member and/or creditor of the fund: suspension before or after payment day?
- Uncertainty can be mitigated by precise drafting of fund documents

# 3

# Private Label Funds

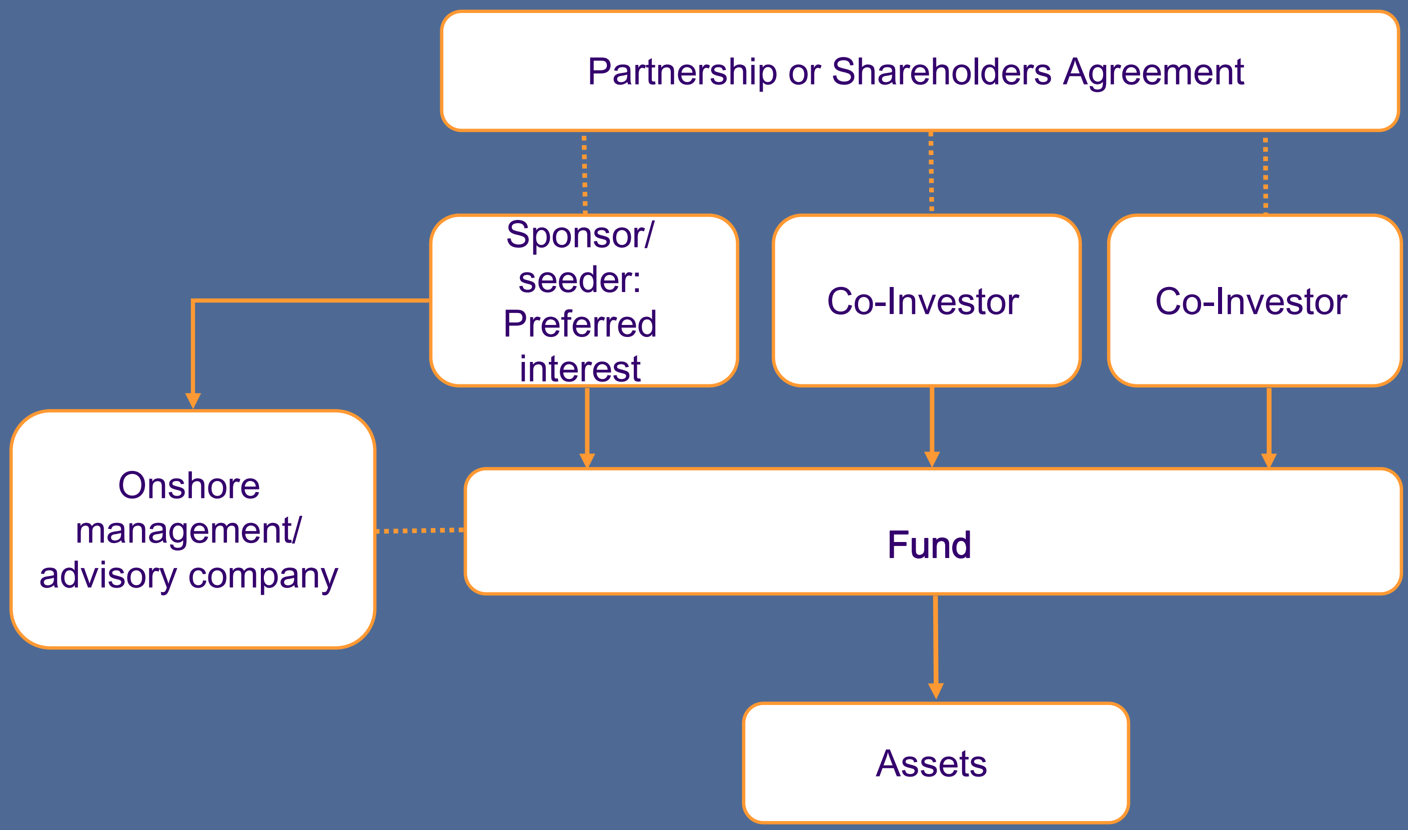
# Private Label Funds (1)

**Client Type**

- HNW/UHNW individual, or group of individuals

**Structure**

- Company or limited partnership
- Often used to hold or invest illiquid investments
- Often used as a vehicle for a shareholders' agreement between a small number of partners: closely-held, private venture (not intended for wider offering)



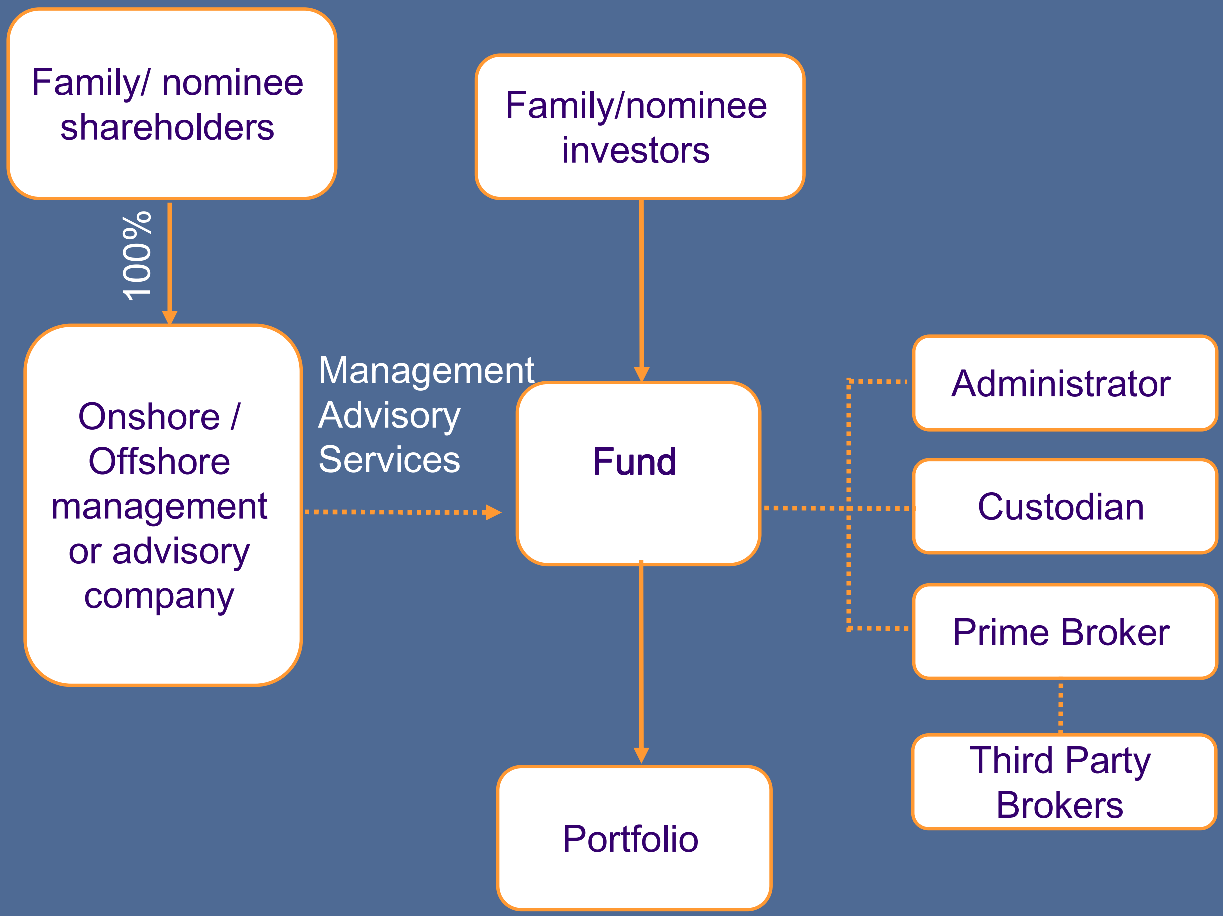
# Private Label Funds (2)

**Client Type**

- Family office
- Consolidation of wealth often key driver: pooling of assets in one vehicle
- Holdings via nominees possible
- Reporting, administrative and custodial functionality may be provided by family office or outsourced to third party service providers

**Structure**

- Family-owned entity has voting control and may invest 100%
- Family-controlled onshore or offshore management/advisory company provides active management/advisory services to the fund
- Multi-class or SPC vehicle cost effective solution for consolidating discrete assets



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## Overview

Matthew leads the firm’s Investment Funds and Asset Management practice in Europe. He advises fund managers, investors and private clients on all legal and regulatory aspects of investment funds domiciled in onshore and offshore centres.

Matthew’s practice has a dual focus: advising fund managers, their service providers and investors on the formation and operation of hedge funds, private equity funds and management companies; and advising private clients and family offices on the implementation of private investment vehicles as part of their wealth planning. He works closely with the firm’s financial services, wealth planning and commercial practice groups.

Matthew practises UK, Cayman Islands and British Virgin Islands law.

He is based in the firm's Zurich office but also visits London regularly, advising clients in both jurisdictions.

## Publications and speaking engagements

Matthew is a regular contributor of articles to hedge fund and private client publications in the UK and Switzerland, and a frequent speaker at investment management and wealth planning conferences throughout Europe.

## Memberships

Law Society of England & Wales

Lincoln’s Inn, London

## On a personal note

Matthew likes motor racing and classical music (not necessarily in combination).