

## There Is Nothing Wrong With The Hedge Fund Fees

Indeed, there is nothing wrong with the prevailing hedge fund fee structures. The current debate on fees will likely lead nowhere. Simply, the debate is rather symptomatic of the frustrated investor who allocated money into hedge funds but failed to recognize that not all hedge funds engage into “hedge fund strategies”. As well, they have failed to recognize the mechanics allowing the generation of absolute returns within the manager screening process.

Investors allocate capital to alternative investments to derive alternative returns. In the case of hedge funds this should translate into absolute returns and protection of capital in times of broad equity draw-downs. There should not be any debate on fees if the core return objectives (net of fees) are met within this industry. The debate should rather be directed at the root of the main problem that plagues the hedge fund industry: not all of them deploy hedge fund strategies.

The current issues perhaps, or at least in part, stem from the low volatility environment of 2004-2005. Investors were lured by a combination of evils in the search of returns. Such evils included: fringe markets, eclectic strategies, going down the liquidity spectrum, implied short volatility, implied short gap risk strategies, and ill-applied leverage. These evils, combined with an inexperienced (or even naïve) hedge fund talent screening process, provided the cocktail that led to much of the disappointments felt by a number of investors; and a few of them now possibly in a career risk management mode looking to unload some of the blame.

These investors are now facing a real problem, whether they are aware of it or not, and this one does in fact pertain to the fee structure. The problem relates to the fact that many of their “hedge funds” are far away from the high-water mark. At this point, there are issues on both sides of the relationship.

On the investor side, a behavior sets in. This behavior is similar to the investor holding a losing position. Will it come back? And if it does, only base management fees will be applied up to the high-water mark. The assessment of the manager is therefore no longer objective.

On the hedge fund manager side, the risk of style drift has suddenly become very real. They want to earn that performance fee and will be very tempted to tilt the risk appetite to get what they want. At this point, the interests are no longer aligned between the manager and the investor. This is where manager monitoring should be most scrutinized. To the extent possible, investors should inventory where the most significant amount of risks is being undertaken and where ensuing returns stem from. They should also refer

back to their scouting and due diligence notes on the manager to see if the strategy currently applied is the same as previously described.

Now back to the root of the problem, while using a simple analogy: If one asks a gardener for a hair cut, one shall get the hair cut he/she deserves. And going back to the gardener to re-negotiate the fee charged for the subsequent hair cuts will definitely not fix the problem.

The same is applicable to the institutional investor (and consultant) who fails to distinguish hedge fund strategies from the traditional investment strategies. And for as long as they fail to do so, they will continue to subsidize and provide a living to those who will ultimately fail them when a real hedge fund strategy is needed the most.

Let the hedge fund fees attract the real hedge fund talent. Otherwise, it may go back where it came from, i.e. the inaccessible proprietary trading desks.