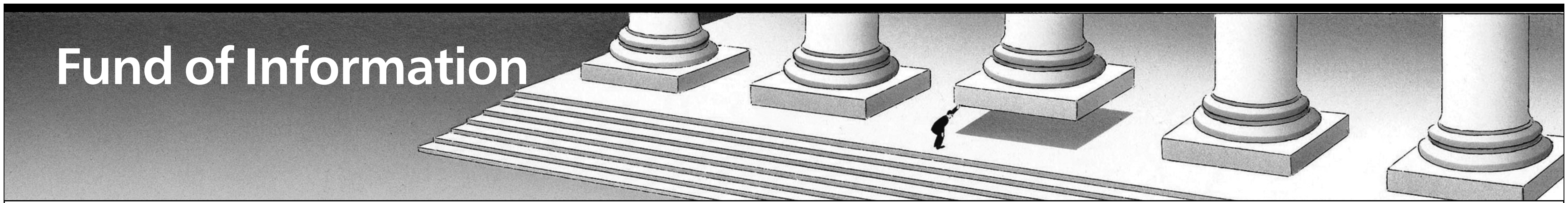

Big Investors Buying Stakes for Hedge Fund Fees

by Eric Uhlfelder

THERE HAVE BEEN HEADLINES ALMOST DAILY ABOUT HEDGE funds' poor performance and hefty fees. The funds, which typically levy a 2% management fee and take 20% of returns, have gained less than 3% in 2014, versus a 12.3% rise for the **Vanguard S&P 500** ETF (ticker: VOO), whose expense ratio is 0.05%. But a small group of sophisticated investors say they've found a different way to get dependable, income-like returns from hedge funds without relying on sometimes erratic returns. They're buying minority stakes in hedge funds' management companies and getting some of those fees.

"Our institutional investor base, sprinkled with a few high-net-worth individuals, is looking for consistent, attractive yield, which has been averaging a net 10%," says Michael Brandmeyer, co-head of the private-equity group at Goldman Sachs Asset Management, which runs Petershill Fund I, established in 2007 with $1 billion in assets. Securing a 10% rate of return in a low-rate world is no small feat.

Brandmeyer is operating in a narrow slice of the investment world, but one that's attracting a growing number of big investors, including Goldman Sachs, Affiliated Managers Group, Neuberger Berman, Blackstone, and Foundation Capital Partners. They've bought stakes in hedge fund managers, including BlueMountain Capital Management, ValueAct Capital Management, Caxton Associates, and Orchard Square Partners.

Cash Track, page M36

The big investors want long-term income. Hedge fund fees can be sizable over time, even if the funds' performance isn't always predictable. As a fund's assets grow, the fees grow; emerging-market funds, for example, have expanded by more than 9% annually since 2008, according to BarclayHedge, which tracks fund performance. Minority stakeholders get a portion of both the management and performance-based fees. About 75% to 85% of the fund's earnings in such arrangements go to stakeholders.

What's in it for the hedge funds? They can monetize some of the equity in the firm without losing control. They can also get help from the new stakeholders in managing or expanding their businesses, better technology, aid on compliance, and possibly access to broader distribution. The new money can give the fund the financial flexibility to cash out retiring partners or attract new talent.

Assembling a basket of minority stakes involves extensive due diligence to confirm performance figures, operating procedures, and regulatory compliance. Investors want a diversified portfolio, so they must become familiar with a variety of funds, from event-driven to distressed to global macro. It can take three to five years to commit all of the money.

Publicly listed funds such as **Och-Ziff Capital Management** (OZM) and **Fortress Investment Group** (FIG) haven't proved to be steady performers since the financial crisis, suggesting that a multifund, private-equity-like structure may be better at avoiding some of the pitfalls.

GSAM's Petershill Fund I says it focuses on high-quality hedge funds with at least a four-to-five-year track record and solid cash flow. It targets funds with revenue between $100 million and $1 billion, and assets ranging between $2 billion and $15 billion. Like the hedge funds they invest in, Petershill and others charge a 2% management fee and 20% of performance. Petershill must generate an average annual yield of 8% or more to collect the performance fee, says Brandmeyer.

The steep minimums exclude most retail investors, but the little guy isn't completely left out. The $80 billion New Jersey Division of Investment, representing 760,000 public employees, has put $110 million into hedge fund investor Neuberger Berman's Dyal Capital Partners' Fund I. In the 14 months ending in December 2013, New Jersey pensioners reaped a 16% return. If all goes well, New Jersey plans to commit a total of $400 million to the strategy over time, says Maneck Kotwal, co-head of alternative investments at the state fund.

One U.K. pension fund cut its hedge fund exposure, preferring this new route instead.

In a twist, the United Kingdom pension fund of Santander Bank reduced its allocations to various hedge funds in early 2013, but committed about $100 million to Dyal Capital.

These funds carry risks. They are long-term deals with little portfolio turnover and no hard-and-fast date for return of capital. Petershill Fund I, for instance, intends to wind down before 2021. New Jersey's Kotwal is OK with the lack of liquidity because of the size and quality of the yield.

The most likely exit strategy, says Brandmeyer, will be an initial public offering of the fund to investors. Or GSAM could sell the portfolio to a publicly listed private-equity manager such as the **Carlyle Group** (CG). Or it might sell to private players, including the hedge funds' original investors.

Jeffrey Willardson, managing director at the $10 billion fund of funds Paamco, sees at least one potential problem in the sale of minority stakes. "Raising capital that may support the departure of key management could detract from performance," he says. If that occurs, minority stakeholders could end up "in a spot, given their limited exit options."

Although wary of such dangers, he understands the appeal. "Investing for fees generated by some of the industry's largest players may be less risky than targeting compelling long-term performance from these funds," he says. ■

ERIC UHLFELDER writes about hedge funds and manages the *Barron's* annual Top 100 Hedge Funds.