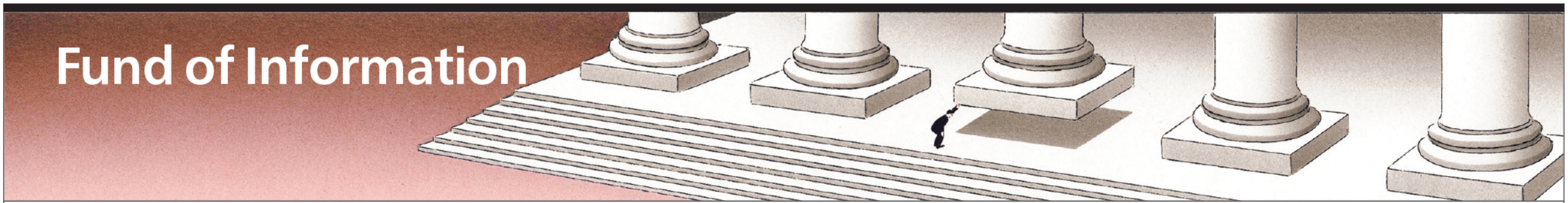


Hedge Fund Shares: A Little Goes a Long Way

by Eric Uhlfelder

THE BIG GRIPE ABOUT HEDGE FUNDS IS THEIR FEES. WHILE THESE levies show signs of coming down, many funds still charge 2% in annual management fees and then take a hefty 20% of annual profits.

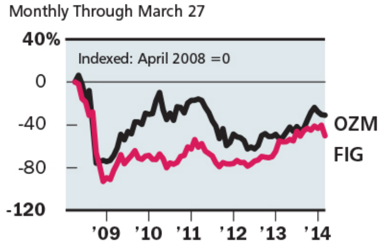
But there is a way for investors to get on the right side of these expenses: buy the shares of publicly traded hedge managers who funnel most of their fee-generated profits into dividends. Their number is limited, and it's sometimes hard to figure out what a publicly traded hedge fund stock is. For instance, **Blackstone Group** (ticker: BX) oversees $56 billion in assorted hedge fund vehicles, but this business actually accounts for only 10% of the firm's revenue and profits.

A few well-established names, however, including London-based **Man Group** (EMG.UK), **Och-Ziff Capital Management Group** (OZM), and **Fortress Investment Group** (FIG), better fit the bill.

Volatile Stocks

Performance of Och-Ziff and Fortress

Monthly Through March 27



Source: Thomson Reuters

The case for buying their shares seems compelling at first glance. These are big, well-known managers with billions of dollars in assets that rack up fees in good markets and bad. They don't necessarily need to be world-beating investors to attract capital. Institutions such as pension funds now provide the majority of industry assets (which approached an all-time high of $2.5 trillion at the end of last year), and they seem satisfied to stick with funds that generate high single-digit returns so long as they aren't too volatile.

At the same time, these funds typically pay out 75%-85% of their earnings as dividends, which translates into annual yields north of 4%. Och-Ziff shareholders saw their dividend yield top 13.4% for 2013 on earnings-per-share growth that soared by more than 58% over 2012 levels, to $1.87.

A quick look at performance numbers indicates that when times are good at a publicly traded hedge fund, its shares do even better—often as much as 50% to 100% or more. In 2012, for example, the flagship Och-Ziff Master fund gained 11.6%, but the firm's stock jumped 17.2%.

Cash Track, page M39

Unfortunately, as JPMorgan Chase asset-management analyst Ken Worthington notes, the market tends to punish hedge fund stocks more in bad times than it rewards them in good times. Case in point: Shares of Man, Och-Ziff, and Fortress are all still trading below where they were just before the bad times last hit, toward the end of 2007.

Making hedge fund stock investing especially tricky is that much of the firm's revenue, about a third at Fortress in 2013, comes from the performance fees. A good chunk of these so-called incentive fees were derived from its credit funds. The manager's total performance fees increased 77%, to $493 million in 2013, which helped propel its shares up 95%. Over the same time, Och-Ziff's performance fees rose by $483 million to top $1 billion; its shares gained 56%.

That means a hedge fund's balance sheet relies not only on growing assets in rising stock or bond markets, but also on whether the manager is well positioned to exploit the gains. That makes for very volatile earnings.

Man, which has had to weather merger issues, euro-zone debt problems, and impairment charges, barely saw its stock price budge last year. It posted a small profit in 2013 after a loss of $748 million in 2012. Its net performance fees more than doubled in the past year, to $122 million.

Because markets are fickle and hedge fund returns so variable, analysts tend to put a much lower price/earnings value—five to seven times—on performance earnings than on the more stable management fees the funds collect. The latter fees are awarded a multiple of 16 times, closer to what a mutual fund operator enjoys.

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Perhaps because of their swashbuckling reputation, hedge funds are also subject to other sorts of risk discounts. U.S. regulators are currently looking into whether Och-Ziff violated bribery laws in receiving an allocation from Libya's sovereign wealth fund. In public filings, the firm has said it can't be sure how the investigation will be resolved or how it will affect the firm.

Fortress shares recently lost more than 10% of their value in three days. That came after the firm announced it was issuing more than 28 million new shares to allow fund principals to cash out of their positions. One of the main ideas behind taking a hedge fund public is to give key internal shareholders a way to liquidate their interests without affecting management continuity. Investors, however, were worried about dilution.

Hedge fund stocks are clearly "risk on" plays that aren't for most investors. Their performance depends on markets behaving well and on managers delivering consistently positive returns. Hedge fund consultant Jonathan Kanterman thinks that such shares could be an effective way for savvy hedge-fund investors to hedge their own exposure. That would mean selling the stock short. ■

ERIC UHLFELDER covers global capital markets from New York.