

## Clock Ticking on Fee Structures?

By Riley McDermid, Deputy Editor

There can be no doubt that the last two years have fundamentally changed the landscape of global capital markets, most experts say, after months of both tanking valuations and widespread scandals forced investors to question even the most basic of due diligence done during the boom times earlier this decade.

Fund of funds and hedge funds appear to have suffered the most from this suspicion in the wake of billion dollar Ponzi schemes and tanking pension funds losses.

“The myth of [fund of funds] being better able to withstand fat tail events and being your ‘eyes and ears’ was obliterated in the fourth quarter of 2008,” says Randy Cass, a Canadian hedge fund manager and former institutional portfolio manager, and founder of financial data firm First Coverage. “Between massive draw-downs, fat-tail correlations and Madoff-like scandals, they will never be able to claim that mantel again. That being said, the same tarnish has rubbed off on to the quants and the market-neutral strategies as well.

The bad news continued to roll in even after the credit markets began a tentative rally right before Christmas, further spooking investors.

“No one was really able to come out of this with their reputation as ‘uncorrelated’ intact so I agree that fund of funds are being bypassed but I’m not sure the money is heading into the active single managers like some think,” Cass adds. “Before investors used to come to market-neutral quants and fund of funds for the ‘peace of mind’ and a good night’s sleep. That’s not going to happen anymore.”

Michael Jaliman, a senior adviser at Boston-based advisory firm Vantage Partners, says that he agreed with that, because a year of crushing losses has many people wondering “why they are paying so much money” in fees for funds that neither met their return targets this year nor avoided multiple scandals resulting in billions in losses.

“Some fund of funds use complicated math strategies, and in that case, if it is verifiably a better strategy, it may be worth the money,” says Jaliman. “But some people got very wary after the scandals showed that some fund of funds weren’t doing the due diligence, and that makes them reluctant to pay more.”

That sort of reluctance will ultimately lead to many funds charging much lower fees, as they try to woo back big players with stressed bottom lines and an aversion to risk.

“This isn't just likely, but inevitable,” says Cass. “The funds have their hands tied right now. Either they agree to redeem their investors or they agree to bite the bullet on the fees that they are being asked to by some of their largest investors.”

“There will still be the odd exception who is able to charge above market for a premium product, but there is no way that this hedge fund industry reverts back to the days of 2 and 20 for institutional investors,” he says. “It was a misalignment of goals and compensation that ended with sophisticated institutional investors paying performance fees on returns that were obliterated. They won't line up to do that again anytime soon.”

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