Valuation of Hedge Fund Businesses

by
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At the end of 2006 there were more than 9,000 hedge funds managing $1.5 trillion of assets.[1] Recent strong growth and increasing participation by a large number of investors, together with publicity surrounding some of the results of the hedge fund investments, have promoted increased interest in these investment vehicles.

In this article, I will define hedge funds, describe how they are structured, and discuss the characteristics that make them unique relative to other types of investment vehicles. After reviewing industry-driven risks for hedge fund management companies, I present various ways to analyze their financial results, and then discuss approaches to determine the value of a hedge fund management company. Valuation issues that may arise in matrimonial cases are highlighted.

I. Background

Although there is no legal definition of a "hedge fund," they can be broadly defined as any pooled investment vehicle that is privately organized, administered by a professional investment manager, and is not widely available to the public.[2] Today, the term "hedge fund" does not reflect the investment strategy of

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1 Kevin Warsh, Testimony Before the Committee on Financial Services, U.S. House of Representatives, July 11, 2007. As noted later in this article, other estimates of the current market are even larger. *See infra* text at notes 19 - 20.

2 *Id.; See generally* Alison S. Fraser, Note, *The SEC's Ineffective Move Toward Greater Regulation of Offshore Hedge Funds: The Failure of the Hedge Fund Registration Requirement*, 92 CORNELL L. REV. 795 (2007); Dustin Hall, Note, *The Elephant in the Room: Dangers of Hedge Funds in Our Financial Markets*, 60 FLA. L. REV. 183, 188 (2008); Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225 (2007).

"hedging" but rather the hedge fund's structure of being a private unregistered investment pool.[3]

The first hedge fund originated in 1949 by Alfred Winslow Jones, who is sometimes referred to as the "Father of the Hedge Fund Industry."[4] Through his firm, A.W. Jones and Company, and together with other colleagues, Dr. Jones used long and short equity positions to hedge market risk in a private fund available to investors. The fund was structured as a limited partnership with a small number of investors and thereby avoided the registration requirements of the Securities and Exchange Commission ("SEC") that existed for mutual funds under the Investment Act of 1940 ("1940 Act").[5]

Dr. Jones referred to his investment vehicle as a "hedged fund" because of the importance he placed on hedging investments against the performance of the market. One feature of Dr. Jones' fund is that he charged 20 percent of the profit as a performance allocation fee to investors – a practice that is still widely used among hedge funds today. The term "hedge fund" was first used by *Fortune* in 1966 in an article describing Dr. Jones' investment strategy.[6]

Hedge funds typically are exempt from SEC registration as investment companies under the 1940 Act. They are also typically exempt from SEC registration under the Securities Act of 1933 and are not subject to the SEC's reporting requirements

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3 According to the U.S. Commodity Futures Trading Association, hedging can be defined as "taking a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change; or a purchase or sale of futures as a temporary substitute for a cash transaction that will occur later. One can hedge either a long cash market position (e.g., one owns the cash commodity) or a short cash market position (e.g., one plans on buying the cash commodity in the future)." http://www.cftc.gov/educationcenter/glossary/glossary_h.html

4 Numerous sources contained this information.: http://www.awjones.com; http://www.traderslog.com/alfred-winslow-jones.htm; http://www.hedgeco.net/hedgeducation/industry-overview.php.

5 *See*, for example, the discussion of the 1940 Act in the Staff Report to the Securities and Exchange Commission, *Implications of the Growth of Hedge Funds*, Sept. 2003.

6 Carol J. Loomis, *The Jones Nobody Keeps Up With*, FORTUNE, Apr. 1966, at 237, 240, 242, 247.

under the Securities Exchange Act of 1934.[7] Hedge funds are generally exempt from these requirements by making investments available only to a small number of sophisticated investors through private placements rather than public offerings, and by limiting the offering size for a fund during a set period of time.[8] Potential investors are evaluated based on their annual income, net worth, knowledge and experience in financial matters, or other criteria.

In recent years, the hedge fund industry has seen many financial scandals, including fraud at some hedge funds.[9] One example of a high profile hedge fund that lost money and ultimately closed is Long Term Capital Management L.P. ("LTCM"), founded in 1994 in Greenwich, Connecticut. The fund was started by John Meriwether, the former head of bond trading at Salomon Brothers, Nobel Prize winners Myron Scholes and Robert C. Merton, and others.

LTCM specialized in fixed income arbitrage with U.S. and foreign government bonds. It was highly successful during its first two years of operations, with annualized returns over 40 percent.[10] To generate higher returns, the fund began taking highly leveraged positions. The default of Russian government bonds in August of 1998 triggered market inefficiencies within the world bond market, leading to significant losses in capital for LTCM and many other firms as well.[11] This led to the fund sustaining massive losses, which resulted in an even higher leveraged position. Ultimately, the Federal Reserve Bank of New York organized a $3.625 billion bail-out of the fund to avoid triggering a

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7 *See* Simeon G. Mann, Note, *Too Far Over the Hedge: Why the SEC's Attempt to Further Regulate Hedge Funds Had to Fail and What, If Any, Alternative Solutions Should Be Considered*, 82 St. John's L. Rev. 315 (2008).

8 15 U.S.C. § 80b-3(b)(3) (2000).

9 Neil Weinberg & Bernard Condon, *The Sleaziest Show on Earth*, Forbes, May 24, 2004, *available at* http://www.forbes.com/business/forbes/2004/0524/110.html.

10 Report of the President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, Apr. 28, 1999, http://www.treas.gov/press/releases/reports/hedgfund.pdf.

11 *Id.*; *see also* Jim McWhinney, Massive Hedge Fund Failures, Nov. 17, 2005, http://www.investopedia.com/articles/mutualfund/05/HedgeFundFailure.asp.

collapse in the financial markets.[12] LTCM liquidated in early 2000.

Scandals such as LTCM and more recent events, such as those at Aramanth and Archeus in 2006,[13] have led to an increased perception that greater transparency in hedge fund reporting is needed so investors can adequately weigh the risks of investing in these vehicles.

In an effort to increase transparency, the SEC indicated in 2005 that it was about to require most hedge funds to register and be subject to many financial reporting requirements.[14] However, the U.S. District Court in Washington held that this proposed rule was not valid, and the SEC lost the argument on appeal.[15] In 2007, the U.S. Senate attempted to reverse this ruling when the "Hedge Fund Registration Act of 2007" was introduced, which would have required most hedge funds to register with the SEC. However, the bill has not been passed to date.[16] Therefore, at the present time, hedge funds are not required to be SEC-registered if they meet the criteria noted above.

Some hedge funds have nonetheless opted to register with the SEC. However, the perception remains that many funds provide limited information to outside investors and the public. One reason is that hedge funds are not permitted to advertise to outside investors, since they are not permitted under SEC rules to make general solicitations to the public. The SEC does permit hedge fund performance data to be posted on the internet.

It is widely anticipated, following the current market downturn and financial crisis of 2008, that more hedge fund regulation will be put into place in the future. As one source suggested re-

12 McWhinney, *supra* note 11.

13 *See, e.g.*, Jad Mouawad, *Report on Amaranth Collapse Is to Be Made Public Today*, N.Y. Times, June 25, 2007, at C2; Landon Thomas Jr., *A $700 Million Hedge Fund, Down From $3 Billion, Says It Will Close*, N.Y. Times, Oct. 31, 2006, at C3.

14 Thierry Olivier Desment, *Understanding Hedge Fund Adviser Regulation*, 4 Hastings Bus. L.J. 1, 16-18 (2008).

15 Hannah Glover, *Most Hedge Funds Remain Registered*, Jan. 19, 2007, http://www.financial-planning.com/asset/article/527952/most-hedge-funds-remain-registered.html.

16 Brendan C. Fox, *Proposed Hedge Fund Registration Act Falters in Senate,* Dechert on Point, July 2007, http://www.dechert.com/library/FS_18_07-07_Proposed_Hedge_Fund_Registration_Act.pdf.

cently, "[w]ithout doubt, the Securities and Exchange Commission (SEC) will hunt for ways to regulate hedge funds."[17]

A. *Size of the Hedge Fund Market*

It is clear that the hedge fund industry has experienced a high degree of growth, both in the number of hedge funds and in terms of total assets managed. The Hennessee Group estimated that since 2000, annualized growth has been about 25 percent.[18] Funds invested increased to the $1.5 trillion to $2.5 trillion range, up from less than $50 billion in the late 80's and early 90's.[19] One source estimated that the market could grow to $6 trillion by 2015.[20]

The number of distinct hedge funds is difficult to gauge since estimates differ among various sources, but may be in the range of about 10,000 to 15,000 currently.[21]

One study, which estimated over 15,400 distinct hedge funds, reported that many hedge funds are still small in size. PerTrac Financial Solutions estimated that over 3,000 funds manage under $25 million in Assets Under Management (AUM), with about 250 funds having AUM of over $1 billion each.[22]

Many analysts had favorable expectations of continued growth for the industry into 2007.[23] However, the outlook

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17 Scott Paul Frush, The Future of Hedge Funds: Outlook, Perspectives, and Developing Trends, Feb. 26, 2008, http://www.wealthmanagementexchange.com/articles/28/1/The-Future-of-Hedge-Funds-Outlook-Perspectives-and-Developing-Trends/Page1.html.

18 Press Release, Hennessee Group LLC Releases 13th Annual Hedge Fund Manager Survey (May 1, 2007) http://www.hennesseegroup.com/releases/release20070501.html.

19 Several sources estimate the size of the industry (http://www.hedgeco.net; http://www.investorsoffshore.com; http://www.hennesseegroup.com). While estimates differ on industry size, all seem to concur that the market has experienced considerable growth.

20 Glover, *supra* note 15.

21 *See, e.g.*, *Number of Hedge Funds Up by Two Thirds in Two Years, Concludes PerTrac Survey*, Mar. 5, 2007, http://www.thetradenews.com/hedge-funds/prime-brokerage/613; *see also* data at http://www.hennesseegroup.com.

22 *Id.*

23 *See, e.g.*, Jeff Benjamin, *Investment Outlook: Boom for Hedge Funds, Private Equity Likely to Continue*, Jan. 8, 2007, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070108/SUB/701080705/1018/TOC; Deloitte, *2008 Industry Outlook: A Look Around the Corner: Private Equity, Hedge*

changed more recently, when the financial market experienced significant difficulties and volatility, from the aftereffects of the financial crisis that started in 2007. At the present time, the outlook for the hedge fund industry has become increasingly negative. One commentator recently suggested that in the current climate, "we're going to see five hedge funds fail for every bank, maybe more."[24] Problems related to this downturn will be addressed later in this article.

Going forward, more regulation may arise through renewed efforts to require all hedge funds to be SEC-registered, greater disclosure requirements, some limits on investment techniques, and more liquidity to investors, among other things.

B. *Hedge Fund Structure*

In a *basic fund structure*, a limited partnership or limited liability company is created to make investments on behalf of U.S. investors. The general partner or managing member is the person or entity that manages the fund, receives management fees and incentive allocations based on performance, pays the salaries of the people that work for the fund, leases the office space used by the fund, and covers other overhead.

U.S. investors, other than those that are tax exempt, are required to invest in *domestic investment vehicles*, while foreign investors and U.S. tax exempt investors may invest in *offshore vehicles*. Therefore, multiple legal entities will exist if the hedge fund manager has U.S. and non U.S. investors. This is compounded if the hedge fund manager operates several types of funds, covering multiple investment strategies.

Often in this situation, a non U.S. entity may be created to make investments on behalf of offshore investors and/or U.S. tax exempt investors. Since it is not a U.S. entity, it is not a limited partnership organized under U.S. laws, so there is no general partner per se. Instead, an investment manager—which is often an LLC or a similar type of entity— receives management fees and incentive allocations based on performance.

Funds, and Mutual Funds Overview, http://www.deloitte.com/dtt/article/0,1002, cid%253D186328,00.html.

24 Barbara Shecter, *Hedge Funds May Be Next*, Sept. 18, 2008, http:// www.financialpost.com/story.html?id=798163.

A *parallel structure* may be used when both domestic and offshore investors exist. In that structure, a U.S. limited partnership or limited liability company is created to make investments on behalf of U.S. investors, and a non U.S. entity makes investments on behalf of offshore investors and/or U.S. tax exempt investors. An LLC that is both the general partner to the U.S. limited partnership and the investment manager to the offshore fund receives management fees and incentive allocations based on performance.

The use of a *master-feeder fund structure* is more complicated but is often used by hedge funds when both domestic and offshore investors exist. A master fund entity is established in a non U.S., tax-neutral jurisdiction. It accumulates funds into one entity from separate "hub" or "feeder" entities, which are themselves funded by domestic or offshore investors. The master fund then conducts all the trading activity, using the funds from the domestic and offshore vehicles. Profits then flow down to the feeders, in proportion to the amount invested.[25] The benefits of this type of structure include the ability to accumulate investable funds into one "critical mass of tradable assets, improve the economies of scale under which the fund arrangements operate and enhance operational efficiencies, thereby reducing costs."[26]

An investment strategy known as *fund of funds* is an essential source of capital for many hedge fund managers. It has been estimated that one-third or more of hedge funds are held through fund of funds.[27] These are investment vehicles consisting of a pool of several hedge funds. Investors typically pay double the management fees of a more traditional hedge fund vehicle (fees to both the firm managing the fund and to the investment company or advisor) to partake in the advantages of the fund of funds structure.

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25 *See*, Master Feeder Fund Chart at end of article.

26 Effie Vasilopoulos & Katherine Abrat, *The Benefits of Master-Feeder Fund Structures for Asian-Based Hedge Fund Managers*, HEDGE FUND MONTHLY, Apr. 2004, http://www.eurekahedge.com.

27 Chidem Kurdas, *Funds of Funds Continue as Major Gateway into Industry*, HEDGEWORLD ANNUAL GUIDE, 2004 EDITION (Hong Kong, ISI Publications Limited), Section 4-5.

Investment minimums may be much lower for a fund of funds vehicle. This enables investors that cannot invest directly in hedge funds to put money into that type of investment.

The benefits of the fund of funds include professional expertise of the hedge fund manager, reductions in barriers to entry, diversification of investment opportunities and risk reduction.[28] The fund of funds strategy reduces the minimum investment requirement by pooling several investors into one and allows investors to enter or leave the market more frequently.

II. Characteristics of Hedge Funds

Hedge funds have particular characteristics that distinguish them from other investment vehicles. For example, mutual funds, like hedge funds, comprise pools of investment capital. However, mutual funds are regulated by the SEC as registered investment companies and hedge funds are usually not. Hedge funds typically cater to sophisticated investors such as pension funds and high net worth individuals.

Open-ended mutual funds may only leverage themselves up to a 300 percent asset coverage ratio.[29] This limits the riskiness of positions they can take. Because hedge funds are unregistered investment companies, they do not have to comply with these stringent regulatory limits on the amount of leverage they can use.

Hedge fund investment techniques vary and may include hedging, short-selling, arbitrage and/or leveraging. Overall, managers attempt to expose market inefficiencies and capitalize on those positions. Hedge fund investment portfolios are often more concentrated, with a narrower investment strategy, than mutual funds.[30] Hedge funds may also invest in nonpublic securities and in privately held entities, such that their focus may converge to some extent with private equity investment vehicles.

These are important issues to understand, especially in today's investment climate. Increased use of financial leverage,

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[28] *The Latest Hedge Trend: Fund of Funds*, Feb. 1, 2002, http://www.highbeam.com.

[29] Implications of the Growth of Hedge Funds, Staff Report to the United States Securities Exchange Commission, Sept. 2003, at 38.

[30] MARK J. P. ANSON, HANDBOOK OF ALTERNATIVE ASSETS 33 (John Wiley & Sons, Inc. 2d ed. 2006) (2002).

combined with investment in more illiquid assets, can add much greater risk to an investment in a hedge fund than in other types of financial investments.

These sophisticated investment techniques differ from those used by many mutual funds with more "plain vanilla" strategies, such as managing equity investments ("long only money") without hedging. The presumption—which is not always accurate—is that by using more advanced (and often aggressive) investment techniques, the hedge fund will command a better return. In exchange, however, the investor fees for a hedge fund are typically much higher.

Another characteristic of hedge funds is that managers are generally required to commit a significant portion of their personal capital to the fund ("skin in the game") to align their interests with that of the investors. While there is no standard threshold for the amount required, investors often look to see the amount of management's skin in the game, especially if the fund is relatively new.

One commentator observed that by investing a large portion of his or her own liquid net worth in their investment pool, a hedge fund manager "will not be reckless with his or her own money. [In contrast,] it would be highly unusual for a mutual fund manager to have a significant portion of personal assets in the fund he or she manages."[31]

In this respect hedge funds are similar to private equity funds and venture capital funds. However, unlike hedge fund managers, managers of private equity funds and venture capital funds take an active role in the management of the companies in which they invest. Furthermore, investors in private equity and venture capital funds often commit to investing a certain level of funds over some time period, allowing fund managers to make capital calls when investment opportunities arise.

A. *Fee Structure*

A hedge fund's revenue consists largely of management fees and incentive allocations. The management fee is a charge investors typically must pay to cover the operating expenses of the

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31 Eric Nanes, *Hedge Funds: What Are They? Why the Attraction?*, CIC Group, Inc., CIC Research, Oct. 15, 2002.

manager. The fee generally ranges from an annual 0.5 percent to 2.0 percent of an investor's entire holdings in the fund.

In addition to receiving a fee covering administrative services, managers are rewarded with incentive allocations (also called performance fees) when they produce positive returns for their investors. Incentive allocations are typically 20 percent of profits earned during a twelve month period, but can range as high as 50 percent, especially if no management fee is charged. Therefore, a significant portion of a fund manager's compensation is performance-based.

As an example, a "1 and 20" fee structure would mean that annual management fees are 1 percent of AUM (Assets Under Management) and incentive fees are 20 percent of profits earned during the year.

Some funds have a hurdle rate (minimum annual return necessary) that must be met for the incentive fee to be earned each year.[32] In these cases, the incentive fee is based on the actual return rate less the hurdle rate. Funds may also have a preferred return or benchmark, meaning that the fund will not earn an incentive fee until a specified return is earned.

Before most hedge funds can collect an incentive fee, a high-water mark provision must be satisfied. The high-water mark provision stipulates that a manager must make up any cumulative asset losses from the time of the investor's original investment in the fund. Incentive fees are only paid if the net asset value at year-end exceeds the highest previously paid net asset value as shown below.

In year three incentive fees are based upon first raising the investor balance to the high-water mark of $124,000. In other words, $7,000 of the $18,000 gross return in period 3 is viewed as a make-up return for the prior period's loss. Therefore, only the remaining $11,000 is subject to the 20 percent incentive fee.

Beginning of Year	Investor Balance	Gross Return	Incentive Fee	Change in Investor Balance
1	100,000	30,000	6,000	24,000
2	124,000	(7,000)		(7,000)
3	117,000	18,000	2,200	15,800

32 Rick Iannucci, *Motivating the Hedge Fund Manager*, http://www.rjsinvestments.com.

Investors also need to understand the tax consequences of hedge funds. Because most of the income is ordinary income and short-term capital gains from frequent trading, there may be unfavorable tax issues with a hedge fund in comparison to mutual funds and other investments.[33]

B. *Industry Risks*

Risks abound in the hedge fund industry. The competence, experience, performance and integrity of the fund manager are some major concerns to a hedge fund investor. As discussed earlier, to mitigate these concerns, a fund manager typically has a portion of his or her own funds invested, and manager compensation is based upon the performance of the hedge fund.

Market volatility is one of the main components for most hedge fund strategies. A lack of market volatility can reduce the ability of the hedge fund to generate high returns.[34] If too many investors redeem their holdings, the fund may be jeopardized by having to sell positions at an unfavorable time.[35]

This can clearly been seen in view of the current crisis in the financial markets. Home prices and demand for residential real estate have declined, increasing the number of mortgage foreclosures. Many financial institutions that carry mortgage-related investments on their books—including hedge funds—have had to write down the value of their assets. At the same time, credit in the U.S. overall has tightened, which has not only reduced borrowing capacity for the investment companies, but resulted in more redemptions by the investor base. This has forced banks, hedge funds and the like to try to sell more of these types of assets to create liquidity. In turn, this has further depressed their value.

Hedge funds have been particularly vulnerable to these problems because so many of them have aggressively used financial leverage in their investment strategies. As of the date of this

33 Hedge Fund Myths and Realities, Bernstein Investment Research Management, Oct. 2002, at 2.

34 Christine Williamson, *Hedge Funds: Low Volatility Feeding Performance Concerns (Outlook 2005)*, PENSIONS & INVESTMENTS, Jan. 10, 2005.

35 Michael Dubes, *Convergence and Transparency: Keys to Successful Market-Neutral Performance*, HEALTHCARE FINANCIAL MGMT., Aug. 1, 2001, http://www.highbeam.com/doc/1G1-78363253.html.

writing, the hedge fund market is experiencing its worst returns in over a decade.[36] There are predictions that the hedge fund market will experience even greater problems in the months and years ahead. CNN recently reported that concerns are growing among institutional investors in hedge fund investing; this may lead to even more redemptions in the months ahead.[37]

As the *Wall Street Journal* recently stated, "Hedge funds could be among the next problem areas . . . that all makes it likely that more hedge funds will shutter in the months ahead, forcing them to sell their investments, further weighing on the market."[38]

C. *Liquidity Issues*

Investors also face certain risks because their funds may be somewhat illiquid. Prescribed subscription and redemption frequencies may be quarterly, but may be shorter or longer. This is unlike investors in mutual funds who have greater access to their capital. Liquidity issues can be a particular concern when a hedge fund is not performing well and an investor wants to make a substantial withdrawal from a fund.

There are many tools hedge fund companies use to manage liquidity. *Lock ups* are a stated period of time during which a new investor cannot pull out. *Gates* are the total percentage of the fund's AUM that can be withdrawn at any given date.

The investment manager may withhold a percentage of the investor's proceeds – called a *holdback* - upon sale. The hold-back amount would typically then be paid later, within a fixed period of time, after delivery of the fund's next audited financial statements.

An investment manager may opt to distribute an underlying interest in one of the fund's investments in lieu of making a cash distribution of profit. This is called an *in-kind distribution*, and is more common with private equity investment vehicles than with hedge funds.

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36 Reuters, *It's D-Day for Hedge Funds as Redemptions Roll In*, Sept. 30, 2008, http://www.cnbc.com [hereinafter *D-Day*].

37 Roddy Boyd, *Hedge Fund Blues Are Just Beginning*, Oct. 2, 2008, http://money.cnn.com.

38 Jon Hilsenrath, Serena Ng & Damian Paletta, *Worst Crisis Since '30s, With No End Yet in Sight*, WALL ST. J., Sept. 18, 2008.

Side letters may provide a large influential institutional investor with better investment terms than is available to others (for example, reduction in fees; more frequent or detailed disclosures; better withdrawal terms; reduced lockup period; or the guaranteed ability to make additional investments in a fund that may be ready to close.) Use of side letters by an investment manager could raise potential red flags to other investors without the same amount of influence.

Redemption fees, *suspension of withdrawals* and *resale restrictions* are other examples.

As the economy tightened in 2008, a greater awareness of the risks of these tools to the investor began to emerge. For example, the bankruptcy of Lehman Brothers in September 2008 caused liquidity problems for hedge funds associated with that entity and those that had Lehman holdings in their investment portfolio. One publication suggested that funds with any Lehman holdings of questionable value would likely need to put those assets into a "side-pocket" for assets that are not readily marketable.[39] Another publication noted that gate provisions would likely be used by some hedge funds to retain some level of investor capital.[40]

Informed investors (like pension funds) often try to learn as much as they can about these issues before investing in a new fund, to assess fund performance, fund longevity, and risks. This may involve review of the private placement memorandum, limited partnership agreement, interviews with the fund manager and/or review of the manager's responses to a "due diligence questionnaire" where numerous questions are answered.

The due diligence process can be a lengthy one for investors deciding whether to invest money in a hedge fund.[41] Note that the Alternative Investment Management Association (AIMA) publishes a generic due diligence questionnaire. While it is not available to the public, examples of completed forms for various existing hedge funds exist on the internet. The due diligence pro-

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39 Tom Cahill, *Lehman Hedge-Fund Clients Left Cold as Assets Frozen (*Update3), Oct. 1, 2008, http://www.bloomberg.com

40 D-Day, *supra* note 35.

41 Anson, *supra* note 29.

cess and an example of a checklist is also published in the second edition of Mark Anson's *Handbook of Alternative Assets*.[42]

D. *Other Risks*

One study raised concerns about investing in both relatively new and older, more established, hedge funds. The concern about the former was that the risk of fund failure was greater for new funds run by inexperienced managers. Alternatively, the risk of the latter was that poorer investment returns would be realized with older, risk-adverse fund managers.

While statistics are not widely available, it is likely that many hedge funds have a relatively short lifespan. One source reported that 1,518 hedge funds opened, and 717 closed, in 2006. During the first nine months of 2007, 863 funds opened and 408 closed.[43]

III. Analysis of Hedge Fund Management Companies

Valuation of a hedge fund management company can present analytical challenges. It is usually necessary to obtain a significant amount of information and to conduct an in-depth interview with financial personnel at the business to understand the reported results and what they mean – and, possibly, what activity is not reflected in them.

Several adjustments may be necessary to present a more accurate picture of the firm's revenue earned and expenses incurred. At a minimum, the valuation analyst would at least need to understand some of the basic underlying assumptions inherent in the reported financial results of the firm.

A. *Ownership*

One of the first questions to be answered in a valuation engagement involving a hedge fund manager in a divorce situation is what ownership interests the person holds. This is not always an easy question to answer. As previously stated, there are often

42 ANSON, *supra* note 29, at 97-134.

43 *Hedge Fund Launches, Liquidations Down in 2007*, Dec. 20, 2007, http://www.finalternatives.com/node/3150, (citing a study performed by Hedge Fund Research).

multiple legal entities that exist under one management company.

The individual may have an ownership interest in the underlying management company, or companies, that pays the bills and receives most or all of the management/incentive fees. Sometimes, more than one management company exists, covering different funds under one common umbrella. Sometimes the person may hold an outright interest; alternately, he or she may own "phantom stock" which provides the right to a share of the profits – and proceeds if the business is sold – but no ability to be involved in making management decisions.

The individual may hold an interest in the general partner of a U.S. hedge fund, which may or may not be a different legal entity from the management company discussed above.

The individual may own an interest in the underlying fund entities, especially if that individual is a highly placed employee with enough investor visibility to require some "skin in the game."

The individual may be entitled to a share of deferred fees from one or more offshore hedge funds, or may have earned part or all of a bonus paid after year end. These issues are discussed below.

B. *Sources of Cash Flow to the Hedge Fund Manager*

As discussed above the hedge fund manager generates cash flow from both management fees and incentive income. A full understanding of how these funds accrue to the hedge fund manager is a vital component of the valuation process. Some common considerations are discussed below.

As is typical for Wall Street firms, it is common for key personnel at hedge funds to be paid most of their compensation through a year end bonus. This may be received shortly after year end, or perhaps some of it may be part of the deferred incentive fees.

Depending on the organizational structure and what must be valued, it may be necessary to combine the results of more than one entity – for example, two management companies, or a general partnership and a management company.

There may be a split of revenue into multiple legal entities. For example, incentive fees may be partially recorded on the books of the general partnership(s) and partially on the books of the management company. Alternately, a portion of the incentive fees may go right to the portfolio managers or other key employees, rather than through the management company. Management companies may also allocate some of their expenses to the fund entities.

The financial statements and tax returns for the management company may be on the cash basis of accounting. In that case, major adjustments may be necessary to capture employee bonuses, deferred offshore incentive fees, and other activity. (In some cases, the hedge fund manager may maintain "economic basis" or accrual basis financial results as an analytical tool, but that is not necessarily the case). Deferred fees are an important issue discussed in detail below.

C. *Fee Deferral*

The general partner, management company or even key employees may elect to defer recognition of a significant portion of the income from an offshore hedge fund for tax purposes.

Hedge funds can defer tax recognition of a significant amount of their income from offshore funds for years. Deferral elections are required to be made prior to the beginning of the year to which they apply.[44]

The valuation professional must develop an understanding of the extent and level of fee deferral, the ability of the fund manager to repatriate those funds and tax consequences of repatriation. An understanding of the extent to which incentive fees have been deferred is an important part of understanding overall performance.

What are deferred fees to the manager of a hedge fund? And why do they matter? Consider the following:

> A lot of the hedge fund managers earning the astronomical paychecks making headlines these days are able to postpone paying taxes on much of that income for 10 years or more.
>
> The key to the hedge fund tax boon is that many managers of these lightly regulated private pools of capital have the ability to earn the

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44 Certain exemptions appear to exist under I.R.C. § 409A (1986) (amended on October 22, 2004, pursuant to final regulations issues in April 2007).

> bulk of their compensation offshore and invest it in their funds, where it grows tax-free . . .
>
> thanks to the peculiarities of the structure of hedge funds and their enormous growth, the tax-deferred sums that hedge fund managers earn may be far outpacing even the compensation of the most well-paid corporate chieftains . . .
>
> Managers have to decide ahead of time how much they will defer and they are required to follow a set formula for receiving the money. At the end of the deferral period, they pay ordinary income taxes.
>
> There are downsides to this arrangement. For one, the money cannot be spent right away, which can be unfortunate for those looking to add to, say, their antique car collection. Moreover, the money is at risk . . . If the fund goes belly up, the deferred compensation is subject to claims from creditors . . . [One consultant] estimates that 100 percent of managers do it; other investors err on the side of "most."[45]

Note that depending on their investment strategy, some hedge fund managers may take the position that the recognition of deferred fees can be treated as a capital gain rather than ordinary income.

Recently, Congress has taken an interest in this issue. Between 2007 and 2008, bills have been introduced into both houses of Congress to limit the amount that can be deferred. While no legislation has been passed on this issue to date, interest in the topic remains.[46]

Sometimes the deferral period may last several years and/or could be extended beyond the initial deferral period. This means that if incentive fees are earned on offshore hedge funds, the money earned could stay in the hedge fund for years, and not flow up to the general partner or management company. The

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45 Jenny Anderson, *Managers Use Hedge Funds as Big I.R.A.'s*, N.Y. Times, Apr. 17, 2007, at A1.

46 Proposed senate legislation can be found in the following articles, Ryan J. Donmoyer, *Senate Bill Would Cost Blackstone Group its Taxation Advantage*, June 15, 2007, http://seattletimes.nwsource.com; and *Washington, DC, USA: Senate Bill Fails on Cloture Vote for Investment Tax Credit Extension*, June 17, 2008, http://www.solarbuzz.com/News/NewsNAGO361.htm. Proposed house legislation in the Renewable Energy and Job Creation Act of 2008 is referred to in the article, Mike Godfrey, *Grassley Urges Closure of Hedge Fund Loophole in House Bill*, July 14, 2008, http://www.tax-news.com/asp/story/Grassley_Urges_Closure_Of_Hedge_Fund_Loophole_In_House_Bill_xxxx31730.html; *see also Hedge Fund Battle Threatens Tax Bill*, Sept. 30, 2008, http://www.finalternatives.com/node/5616.

funds would be subject to future investment risk but would continue earning a return if the hedge fund was profitable.

Deferred income can pose valuation issues in two respects. First, the employee's share of the deferrals may be an additional marital asset from a divorce perspective. (This may be valued net of future taxes.) Second, since the reported financial results for a hedge fund management company are often on the cash basis they do not include deferred income. That means the tax returns for a U.S. hedge fund management company would very likely exclude any deferred fees. Substantial adjustments to the reported results may be necessary during the valuation. This will be discussed again later when we address the valuation of a hedge fund manager's equity interest.

In addition, a search for marital assets may require assessing results midway through a fiscal year. Interim results for the management company may be of limited use because of significant year end adjustments, such as employee bonuses and deferred incentive fees. Deferred fees are earned based on the fund's performance for the entire year.

Finally, any valuation needs to consider the normalization of compensation to owners. As in any valuation, the goal is to separate return on labor from return on equity, and to add back any profit to the bottom line so it can be considered in the valuation of the business. There is no magic bullet or single source of information to analyze officer compensation or to make an adjustment. The valuation analyst may consider what the top non-owner employees receive as compensation (base, bonus, and so on, possibly including a share of deferred incentive fees). Other possible considerations include discussions with recruiters and industry surveys; for example, the Options Group publishes a broad analysis of compensation data for many types of financial positions in the U.S. and abroad.[47]

Dealing with the issues noted above can add many hours to the analysis of a company's performance during the course of a valuation.

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47 Global Financial Market Overview and Compensation Report; www.optionsgroup.com.

D. *Management Company Risk Analysis*

Once the valuation analyst has an understanding of how the firm reports its revenues and expenses, and the path of generated cash flow, then the valuation professional can begin to assess the reasons why the firm performed the way it did. Of course, the goal is to estimate what the management company's future performance will be, since this is part of what a buyer and seller would theoretically consider when determining a purchase price for the business.

Some issues to consider include the idea that revenue for the management company is dependent on growth of assets managed, since investors pay management fees based on a percentage of AUM and incentive fees are based on fund performance. If the fund's performance is poor for an extended period (or less), investors may leave. On the other hand, if performance is favorable, then 20 percent of every dollar of gain may come into the management company as an incentive fee. Analysis of the changes in subscriptions and redemptions and overall fund performance are useful tools in trying to understand the changes in revenue.

During the current financial crisis, many hedge funds have lost money, so there are no performance fees. *Newsweek* reported that recently, only about ten percent of hedge funds worldwide are earning these fees.[48] Hedge funds that do not earn performance fees for an extended period of time are often in financial difficulty.

The mix of products should be considered. The firm may have other investment vehicles or products in addition to hedge funds. For example, perhaps they manage a major client's equity investments. Or perhaps they offer more generic asset management services to a broad spectrum of clients. Incentive fees probably do not exist for these services.

Volatility in performance can be an important consideration. If a hedge fund's performance has not been consistent, then it may be useful to consider a longer trend of earnings in the valuation.

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48 Daniel Gross, *The End of the "BSD"*, NEWSWEEK, Sept. 26, 2008, http://www.newsweek.com/id/160943.

Employee compensation is probably the largest expense. Are year end bonuses paid in January of the year after they are earned? If the books are reported on the cash basis, is there a time lag between when the bonuses are earned and when the expense is recorded? Are year end bonuses appropriately accrued as a liability (if applicable)?

Is some of the bonus money deferred, in the same way that revenues can be deferred? Do any employees receive a share of the firm's profit through participation in a phantom stock plan?

If the business is growing rapidly – as some hedge funds are – are expenses lagging behind? In other words, will the firm have expenses in the future to fuel additional expansion – such as increased rent expense for a larger office or other offices - that may cause its profit to decline in the future? Or, conversely, are profit margins expected to increase as AUM increases with little need for additional staff or infrastructure improvements?

What is reported on the management company's balance sheet? Sometimes the balance sheet includes unique asset descriptions that can identify additional investments, significant clients, or other activities.

IV. Obtaining the Necessary Information

In addition to the information typical to any valuation – for example, financial statements for the management company, buy-in and buy-out documents, and the like - the valuation analyst may consider asking for various types of industry-specific data to gain the necessary information to help develop an understanding of the hedge fund operations. Examples include the following:

- Organizational charts, both for the top management and also by corporate entity. Given the complexity of the structure of some of these businesses, organizational charts can save the valuation analyst a lot of time in trying to gain a basic understanding of what entities exist, how they are related, and who manages them.
- Financial statements, offering memoranda, limited partnership agreements and private placement memoranda and possibly investor presentations for the underlying hedge fund entities. Keep in mind that for every fund that exists, there may be several legal entities (offshore

fund, domestic fund, master fund, general partner of domestic fund, and possibly more). Note that if these entities are not domiciled in the U.S., then U.S. tax returns will not exist for them.

- Annual and/or quarterly Assets Under Management (AUM), possibly by fund. If the firm has other types of investment vehicles – such as managing a client's long-only money – then AUM for that segment could be broken out.
- Subscriptions and redemptions by year or by quarter: This may help to explain significant changes in AUM and, by extension, the financial performance of the management company. For example, if revenues declined, was it because of a significant outflow of money from fund redemptions?
- AUM for top investors: The hedge fund probably will be unwilling to disclose the names of its clientele for confidentiality purposes, but may provide the AUM for its top clients if names are redacted. As in any valuation, this would highlight whether the business is dependent on a small number of investors to survive.
- Fee structure
- Fund performance data
- Form ADV's – for SEC registered firms. Many of these are available through the public domain by using the SEC website.[49]
- Newsletters or similar communications to investors on fund performance: These can be helpful in explaining fund performance, changes in key management personnel, and other information.
- Deferred offshore incentive fees: These can often, but not always, be identified *in total* by year from review of the underlying fund financial statements. However, this will probably not identify what an individual owner or fund manager's share of the deferrals will be. A detail of the deferrals by year is usually available from the accounting personnel at the firm.

49 http://www.adviserinfo.sec.gov.

At some firms, offshore incentive fees are deferred for several years. The decision to continue to defer this revenue may be made at the corporate level, or it may be made on an employee by employee basis.

Some of this information could possibly be cross-checked by reviewing the person's annual deferral election forms. This may show the amount of incentive fees the person wanted to defer that year. Deferral election forms are usually completed before the beginning of the year to which they apply.

- Tax treatment for deferred incentive fees: If offshore incentive fees have been deferred, then taxes have yet to be paid on them. Will the future taxes be at ordinary income tax rates? Besides asking this question of management, sometimes it is helpful to cross-check how prior deferrals that have been recognized (or "rolled off") for tax purposes were treated on the person's tax returns.

V. Valuation of Hedge Fund Management Companies

As with any business valuation, the valuation analyst considers whether the asset, income and market approaches should be used, and if so, what methodologies to employ. The asset approach would perhaps be best suited for a hedge fund business that is losing significant money or is in liquidation.

The income approach is often relevant in valuing a hedge fund management company. As with any appraisal using this approach, the valuation analyst should assess whether to use a single period model such as the capitalization of income method, or a multi period model, such as the discounted cash flow method. A single period model would be more appropriate when earnings/cash flow trends have stabilized, and a multi period model may be appropriate to reflect a different trend in profitability, growth, or other assumptions in the short term versus the longer term.

To the extent a hedge fund manager has deferred recognition of earned incentive fees for tax purposes, often for years at a time); deferred funds generally remain at risk during the period of deferral, and are generally taxed as ordinary income when recognized, regardless of the length of the deferral period.[50]

Some valuation analysts believe that it is appropriate to apply two different multiples to the hedge fund revenue streams: a lower multiple for management fees, and a higher multiple for incentive fees. However, this may lose sight of the fact that they are not two independent revenue streams, but are closely related. If a hedge fund loses money – and therefore its only revenue is from management fees – then investors are likely to pull their money out of the fund, and those management fees are not likely to continue at the same rate. In addition, using two multiples would necessitate allocation of expenses between the two revenue streams, which would pose difficulties.

The market approach may involve transactions at the subject company itself, or the valuation analyst may look to the outside marketplace. Sales of asset management firms (including hedge funds) may provide market multiples that can be used to determine a value for the subject company. Sometimes, information on industry transactions can be found through press releases and transactional databases such as SNL Financial.[51]

Hedge funds exist within some public companies. For example, the Man Group plc is a UK-based alternative investments firm. The Blackstone Group and the Fortress Group both went public in 2007 in the U.S., and MW Tops had its IPO in the UK in late 2006. After some delays, Och-Ziff Capital Management Group LLC also went public in the US in late 2007. These firms are very large, and their businesses are considerably more diversified than many hedge funds. For example, hedge funds are only one type of investment offering for these companies. Therefore, consideration of their market multiples may be of limited use in valuing many hedge funds.

VI. Conclusion

The number of hedge funds continues to grow, and the industry appears to be poised to further increase in size in the coming years. Valuation of hedge fund management companies can pose many difficulties. Risks inherent in this type of business

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50 *See, e.g.*, Anderson, *supra* note 44.

51 http://www.snl.com.

abound, and reported financial data can sometimes require several adjustments in order for the valuation analyst to gain a meaningful understanding of historical trends. More market data is available now than in years past on companies with hedge fund operations, but their applicability as a point of comparison to much smaller businesses is an open question.