

Convergence: Exploring Infrastructural Needs When Forming Hybrid Funds

Joseph Patellaro and Steven Alecia, Citi's private equity services

Convergence is a word that journalists and industry pundits liberally apply to trends, most of which turn out to be nothing more than hype. In previous decades, financial services convergence and media convergence were hot topics. Today, the press is full of articles about convergence in the alternative investments space, mainly the convergence of hedge and private equity funds.

The problem with overusing the word convergence is that we apply it to any two sectors approaching an intersection. Real convergence requires a solid infrastructure to be successful. Private equity and hedge funds are indeed converging into hybrid funds, but these new funds will have to recognize and resolve the tremendous challenges that lie ahead.

To some degree, the convergence of hedge funds and private equity investing is old news. Hedge funds have evolved from classic long/short strategies and merger arbitrage to distressed debt, shareholder activism and private investments. In fact, a recent survey by Freeman & Co. showed that private equity-type investing represented 7% of total hedge fund investments in 2005

and is expected to increase this year. Typically, these investments have taken the form of side pockets, where a portion of the hedge fund is segregated from the rest of the assets for illiquid investments.

The real news is the birth of true hybrid funds that do not have side pockets but rather two distinct pockets of capital: one devoted to liquid investments and the other devoted to illiquid investments. These new funds are targeting middle market investments and are attracting between \$250 million and \$500 million each. Many are focused on a particular industry, hoping to leverage a core competency and find a comfortable balance between short-term trading in public securities and long-term investing in private equity.

Typically, hybrid funds are started by individuals with a hedge fund background rather than a private equity background. Today, hedge funds number approximately 6,000 with \$1.3 trillion under management while private equity funds total about 1,000 with \$200 billion in assets. Hedge funds' greater flexibility in terms of where and how they can invest has undoubtedly played a role in their greater willingness to expand into other alternative investments.

Hybrid funds are a great vehicle for alternative asset managers looking to extend their brand by offering more products. Firms can leverage the reputation and past performance of a fund manager, take advantage of an increasingly overlapping investor base, and use industry knowledge and due diligence to source deals. Also, they can attract new types of investors – entrepreneurial individuals with deep analytical and financial engineering skills.

In alternative investing, hedge funds and private equity have superficially similar structures – lightly regulated pools of private capital, and overlapping institutional investors – and both feel the pressure to outperform increasing numbers of competitors. However, hedge funds and private equity have two very different economic models and supporting infrastructures.

The time horizon of private equity investing is much longer than in hedge fund investing, and the skills required to execute the investments are very different. Hedge funds attract people who thrive in a trading environment; private equity attracts people focused on research and analysis. Private equity firms



drive change from the bottom up by reconfiguring business fundamentals, while hedge funds drive change from the top down by altering management, dividend or financial policy and board membership.

The difference in time horizons and types of investments has a major impact on liquidity. Hedge funds are used to providing monthly or quarterly liquidity to their investors, based on a calculation of net asset values. Net asset values are easily determined when the underlying assets are publicly traded securities. However, private equity investments are carried at cost since there is no market price for the asset until some realization event, usually several years after the initial investment.

In terms of compensation, hedge fund managers take an annual performance fee based on current net asset values of liquid investments; private equity managers take out a management fee based on the total amount of capital committed during the investment period and actively invested capital thereafter (they also

receive about 20% in carried interest after the investments are realized). The calculation of management fees under a hybrid fund structure requires a robust and transparent tracking and reporting system, and the basis for the calculations needs to be agreed upon upfront.

Hybrid funds with two different economic streams are also going to need two different tracking and reporting systems. Hedge fund assets are typically marked to market on at least a monthly basis. Private equity assets are carried at cost until realization. Hedge funds require daily reconciliations to support their trading activities while private equity funds may not revalue assets until an IPO, sale or another round of financing. Coming into a hybrid fund, CFOs, controllers and their staff will need to be aware of what they don't know and fill the knowledge gaps, either internally or using outside help.

Two different economic models also give rise to different tax liabilities coming from both the difference between capital gains and trading

income as well as where investors are domiciled and whether investors are taxable or tax exempt. Typically, private equity funds are structured as limited partnerships while hedge funds are structured as open-ended investment companies in a tax haven. Hybrid funds will have to develop a legal structure that accommodates both types of investors and the tax liabilities arising from both types of investments.

In conclusion, there is no standard yet as to what a truly converged hybrid fund will look like. Convergence is still a fairly new concept in the alternatives space and different hybrid funds have dealt differently with the issues of accounting and valuation, investor liquidity preferences, timing of subscriptions and redemptions and overall allocations. In the alternative investments business, the combination in a hybrid fund of two very different asset classes with two different economic streams will require a solid infrastructure – people, processes and policies – to support true convergence.