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Locked up

Top hedge funds tying up investors' money for longer

By Alistair Barr, MarketWatch
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SAN FRANCISCO (MarketWatch) -- Access to top hedge funds is increasingly coming at a new price for investors: not getting their money back for years.

The trend is bad news for investors, according to some in the industry who say it means investors could get stuck losing money if the performance of managers heads south. However managers love the development because they don't have to worry about investors leaving in droves if performance slips.

Hedge fund "lock-ups" traditionally prevented investors redeeming their money for a month or a quarter. However, new managers with gilt-edged reputations and more established funds with impressive track records have begun asking for - and getting -- lock-ups of up to five years.

And, while wealthy individuals and funds of funds are traditionally the majority of hedge fund investors, now institutions such as pension funds and endowments, with longer investment horizons are piling into the sector in search of outsize returns.

Eaton Park Capital, run by former Goldman Sachs (GS: news, chart, profile) trading star Eric Mindich, Icahn Partners, the hedge fund of corporate raider Carl Icahn, and Lee Ainslie's Maverick Capital have introduced lengthy lock-ups in recent years.

Other firms, including EagleRock, Spinnaker Capital and Monsoon Capital, have lock-ups of at least two years on some of their hedge funds.

"Hedge funds have sold themselves on the idea that there's some liquidity allowing you to move in and out," said Greg Kulka, director of alternative investments for the State of New Mexico. "Anything that lengthens lock-up periods makes investors feel that the game is kind of being changed on them. They might be resistant."

Kulka, who helps oversee about $12 billion, said the state hasn't invested directly in any hedge funds. Instead, it's put a portion of its assets into funds of hedge funds, which allocate money to a range of different underlying managers.

"We like liquidity," Kulka explained. "The funds of funds we deal with have quarterly or semi-annual lock-ups."

A Deutsche Bank survey of hedge-fund investors published in July found that 77% would only allocate money to managers with lock-ups of one year or less. Last year, the same survey found 68% of investors shunned lock-ups of more than 12 months.

Chasing top talent

However, the lure of big returns from top hedge-fund managers has been too strong for some investors.

As billions of dollars flows into the industry in search of the best managers, top firms have discovered they command longer lock-ups because demand is so strong for their skills.

Indeed, the July Deutsche Bank (DB: news, chart, profile) survey noted that some hedge funds with "extraordinarily high and consistent returns" can impose longer lock-ups.

"All this capital is chasing the top talent," said Jared Herman, co-founder of Hedgebay, which allows investors to buy and sell stakes in sought-after hedge funds. "That means the best of the best can command the toughest terms, such as longer lock-ups, higher fees, and other bells and whistles that make it painful for investors to get out."

Eaton Park raised more than $3 billion when it started in 2004, despite effectively locking up

investors' money for three years, according to a person familiar with the firm.

Investors in the fund's Class-A shares can't get any of their money back for two years and can only redeem a third of their assets during the third year, according to industry publication Alternative Investment News.

Those investing in Eaton Park's Class-B shares can redeem after the first year, but have to pay a 6% redemption fee for the first three and a half years, AIN said. Eaton Park declined to comment.

Hedgebay volume has increased strongly since it started in 1999, partly because longer lock-ups mean more investors are looking to sell hedge-fund stakes early, Herman said.

The average seller on Hedgebay gets their money back about two months earlier than they normally would for a fund without a lock-up, he claimed. For funds with longer lock-ups, the time saved is substantially greater. (see full story).

Mis-match

The increase in lock-ups is causing problems for some funds of hedge funds, which usually offer their investors the chance to cash out monthly or quarterly.

One manager, who didn't want to be identified, said that when top hedge funds introduce longer lock-ups, these managers automatically become off limits.

That's because the firm wants to avoid a mis-match between the liquidity it offers its own investors and the more limited terms of its underlying managers.

If the fund of funds invested in too many managers with three-year lock-ups, the firm may not be able to pay back its own investors if a lot of redemptions come in during a particular quarter, he explained.

"Funds of funds are particularly concerned that they might have a mis-match of liquidity between the lock-up terms their managers impose versus those they give their own investors," Deutsche Bank noted in its July survey.

This also concerns New Mexico's Kulka.

"If fund of hedge fund performance isn't up to scratch and redemptions come in, it may be difficult to get money quickly out of some underlying managers with longer lock-ups," he said. "There's potential for this mis-match to cause some fallout, but it's not really clear how broad this problem might be."

In order not to miss out on top talent, some funds of hedge funds, including New York-based Optima Fund Management and Switzerland's Gottex Fund Management, are considering longer lock-ups of their own.

Lock-up love

Hedge fund managers love longer lock-ups.

Nader Tavakoli, founder of EagleRock Capital Management, said the New York-based credit hedge-fund firm garnered new investments earlier this year from institutional shareholders who were happy to have their money locked up for three years.

EagleRock's funds usually have quarterly and annual lock-ups, Tavakoli added.

Because EagleRock won't have to worry as much about redemptions, it can use strategies that can take longer to generate returns and can capitalize on periods of market disruption when other hedge funds with shorter lock-ups may be forced to sell, Tavakoli explained.

"These investors want the comfort and security of knowing that they're in an investment vehicle that can take a longer-term view," he said. "They're looking for higher returns for submitting to a longer lock-up."

Stability

Longer lock-ups also make hedge-fund businesses more stable.

If a firm introduces a three-year lock-up and raises $1 billion, management fees of between 1% and 2% ensure that the business will generate annual revenue of at least $10 million. That's before lucrative performance fees, which are usually 20% of annual gains.

"This is on the lips of every hedge fund manager. They would all love to have a longer lock-up if they could get it because it makes their capital base more stable," Hedgebay's Herman said. "You'd think that a $1 billion fund is pretty stable, but without longer lock-ups, these businesses

can have the carpet pulled out from underneath them in the space of a few months."

With a certain amount of annual revenue guaranteed by lock-ups, hedge funds can hire the most talented traders by promising big pay packages, Herman added.

"Lock-ups are a mechanism for the best of the best to compete for top talent," he explained. "If you're just a run-of-the-mill hedge fund, there's no way you can do that. Most funds have to offer something else, such as equity in the business, which can get very expensive."

The allure of stable assets was strong enough for Maverick Capital. The Dallas-based hedge-fund firm introduced three new funds last year that offered to charge investors lower fees if they submitted to lock-ups of as long as five years, according to Alternative Investment News. The company declined to comment.

Spinnaker Capital, a $2.5 billion London-based hedge fund group, opened a new fund at the start of 2004 with an initial three-year lock-up, according to the firm's web site.

Monsoon Capital, a $70 million hedge fund that focuses on small-cap Indian stocks, has a two-year lock-up, after which investors can redeem annually, founder Gautam Prakash said.

While the longer lock-up has made raising money more difficult, Prakash said it's needed because the fund invests in less-liquid stocks and expects positions to bare fruit over multiple years, rather than weeks or months.

Institutional horizons

EagleRock's experience points to another trend that's lengthening lock-ups.

"A lot of the money flowing into longer lock-up hedge funds is institutional," Robert Picard, chief investment officer at Optima Fund Management, said.

These new types of hedge-fund investors are more willing to submit to longer lock-ups because they typically have longer investment horizons, Picard added.

Deutsche Bank's July survey found pensions, endowments and foundations to be the most willing to accept two- and three-year lock-ups, while funds of funds and wealthy individuals were less keen.

Still, even among those pension, endowment and foundation investors, more than 60% said they'd only invest in hedge funds with lock-ups of a year or less, Deutsche added.

Private-equity evolution

While most investors remain resistant to longer lock-ups, some hedge funds argue that they're needed because the types of investments they're making can't be sold quickly and take a long time to bare fruit.

This is especially true of hedge funds that are becoming more involved in private equity.

Hedge funds have typically used short-term trading strategies and invested in large, liquid markets such as equities and fixed-income. However, some managers have recently been branching out into less-liquid strategies, including private equity, in search of higher returns.

"Distinctions between private-equity funds and hedge funds will probably disappear over time," Optima's Picard said. "Private equity funds tie up money between five and 12 years. That's driving longer lock-ups at some hedge funds."

Part of the reason Eaton Park locked up investors' money for three years was because the firm planned to allocate almost a third of its assets to private-equity investments, Alternative Investment News reported in 2004.

Carl Icahn's hedge fund, which uses activist, private-equity-type strategies such as buying large stakes in companies and taking board seats to influence management, has stringent lock-up terms.

The fund, Icahn Partners, has a one-year hard lock-up and investors wishing to leave in their second year have to pay an 8% penalty, according to Alternative Investment News. In the third year, a 4% penalty is levied on redemptions. The firm declined to comment.

SEC registration

Some industry experts said there are less-convincing reasons for longer hedge fund lock-ups.

If managers invest in liquid markets such as equities and fixed-income, longer lock-ups shouldn't be needed, they said.

"Among managers asking for longer lock-ups, there are those where it's warranted and they will see money flowing into their funds," Optima's Picard said. "Those where it's not warranted, they'll just have to bow to market pressures and may see an investor shake-out."

Some hedge funds are mulling lock-ups of more than two years to avoid registering with the Securities and Exchange Commission in February, said John Van, chief operations officer at industry consultant Van Hedge Fund Advisors International.

The new SEC rules require most hedge fund managers to register as investment advisers by February 2006, a move that's been criticized as too onerous by some in the industry.

The agency included the two-year exception after private-equity and venture capital funds complained that they might be forced into registering too.

"While this rule was brought in mainly to distinguish hedge funds from venture capital and private equity, I've heard that some hedge funds are moving to lock-ups of more than two years," Van said.

That's probably not a good enough reason for a long lock-up, some experts said.

"If hedge funds want to be taken seriously and compete for the big money, they're going to have to register with the SEC," said Vladimir Belinksy, president of Hermitage Advisors, a San Francisco-based firm that advises wealthy people on investments including hedge funds.

Supply and demand

Fittingly for the hedge fund industry, Belinsky, Picard and Herman agreed that the recent increase in lock-ups really comes down to two issues: supply and demand.

"The more successful hedge funds with enough assets and a good track record have no problem raising capital, so they can negotiate terms that are more restrictive," Belinsky said. "That's just the way of the world."

In future, the industry may diverge, with elite managers commanding long lock-ups from mainly institutional investors, and other managers sticking with shorter lock-ups and more traditional wealthy individual clients, one fund of hedge funds manager said.

Optima's Picard said this scenario will likely also be vulnerable to efficient-market forces.

"There could be a big blow-up in one of these top hedge funds and institutional investors will be stuck losing money," he said.

Institutions may then move back to hedge-fund investments with shorter lock-ups again, he added.

Locked up

Seven hedge-fund firms with lock-ups of at least two years

Fund Group	Lock-up
Eaton Park	Up to three years
Icahn Partners	Up to three years
Maverick Capital	Up to five years (with fee incentives)
EagleRock Capital	Three years
Spinnaker Capital	Two years (for latest fund)
Monsoon Capital	Two years

Sources: Alternative Investment News, MarketWatch research, firm Web sites.

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