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HEDGE FUNDS

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FACING SCRUTINY FROM REGULATORS AND INVESTORS ALIKE, FUNDS HERE AND ELSEWHERE ARE OPENING UP ABOUT WHERE AND HOW THEY DO BUSINESS.



FOR NORTH TEXAS HEDGE FUND MANAGERS, IT MAY not necessarily be the best of times or the worst of times. But one thing's for sure: the times they are a-changin'.

Hedge funds are loosely regulated investment vehicles for wealthy individuals and organizations that can put money to work in almost anything. As such, they've operated in relative secrecy since Fort Worth's Bass brothers helped launch the industry in these parts in the 1970s.

Now, though, hedge funds are facing unprecedented demands from investors and regulators alike to be more open about how they conduct

their business. Investors, in particular, want better market-beating returns for lower fees, along with more openness from managers on where they've invested their capital. Oh, and investors also want easier access to their money, rather than having it tied up for months or years at a time.

Meanwhile, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act has forced many hedge fund managers to register as advisers with the Securities and Exchange Commission.

And so, like their counterparts across the country, Dallas-Fort Worth hedge fund managers are having to change how they operate. "We've seen capital flow within the hedge fund space where you have more transparency, liquidity, and lower fees," says Mark Okada, chief investment officer and co-founder of Dallas-based Highland Capital Management LP, a multibillion-dollar player in the hedge fund arena.

As hedge fund managers face pressure to cut their fees, more will likely choose areas like Dallas to set up shop, according to Okada, who launched Highland Capital in 1993 with North Texas businessman James Dondero.

"Dallas is a lower-cost place to do business," Okada says. "It's very business-friendly. And that's a big reason why places like Texas that have lower costs, taxes, and regulatory burdens are going to be a growth area for activities like this. ... Capital



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BILLION-DOLLAR STARS

A look at some of the largest managers on the DFW hedge fund scene, listed alphabetically. Dollar amounts represents all assets under management. Some firms do more than hedge funds, meaning the amount of hedge funds under management may be less. Numbers are per the firms' most recent disclosures with the Securities and Exchange Commission.

NAME	CITY	ASSETS UNDER MANAGEMENT
Amalgamated Gadget LP	Fort Worth	\$3.9 billion
BP Capital	Dallas	\$1 billion-plus
Carlson Capital LP	Dallas	\$15.9 billion
Crestline Management LP	Fort Worth	\$6.23 billion
Frontier Investment Management	Dallas	\$999.2 million
Hayman Capital Management	Dallas	\$1.49 billion
HBK Investments LP	Dallas	\$13.8 billion
Highland Capital Management	Dallas	\$17.7 billion
Hodges Capital Management	Dallas	\$1.14 billion
Maverick Capital Ltd.	Dallas	\$13.5 billion
Ranger Investment Management	Dallas	\$1.9 billion
Smith Group Asset Management	Dallas	\$2.27 billion

SOURCE: D CEO RESEARCH

will flow where it's best served."

If capital does indeed go to the managers who use it to the best effect, hedge funds overall must be doing something right. Hedge funds worldwide saw their capital hit \$2.51 trillion in the third quarter of 2013, up \$94 billion over the previous quarter, according to Chicago-based Hedge Fund Research Inc.

Locally, the roughly 100 or so hedge fund managers that call DFW home have more than \$20 billion under management, according to estimates from John McColskey, a board member of the Texas Hedge Fund Association who also is president of the Austin hedge fund firm Meritage Capital LLC.

'TWO AND TWENTY' MODEL UNDER FIRE

Twenty billion dollars is a significant amount, and a reflection of the confidence that investors have in managers and in the performance of the funds that the managers run. After peaking at \$2.6 trillion in 2007, for instance, hedge funds saw their collective global assets fall to \$1.83 trillion in 2008, as the value of their investments shrank and as investors yanked out capital, according to HFR data.

From a more bottom-line perspective, the amount of money that managers run helps dictate how much money those managers earn. Similar to their brethren in other "alternative" asset classes like private equity and venture capital, hedge fund managers generally get paid with what's known as the "Two and Twenty" model. That means they take 2 percent of the total asset value, along with 20 percent of any profits their funds generate. If the values of their funds fall, that's simply less money in the managers' pockets for administrative costs.

And, if they lose money (rather than gain) in a particular year, they must make up the losses the following year before they can share in any profits or charge additional fees.

The "Two and Twenty" model isn't universal, with some fund managers charging less, some more. What is becoming universal, though, is a distaste for high fees when fewer hedge funds are out-performing the markets in which they operate.

"It's simple economics," says Scott D. Cheskie-wicz, an Austin-based partner at Jackson Walker LLP whose practice includes representing large institutional investors in hedge funds. "As more managers get in the space, as the collective wisdom gets better on equities, the opportunities for arbitrage and market mis-pricings become less and less. They must act quicker. It's harder to outperform the market for hedge fund managers."

That certainly was the case in 2013, when the S&P 500—the broadest gauge of the stock performance of big public companies—rose about 29 percent. By all accounts, many hedge funds that were focused on public equities failed to keep pace.

But, as with most things in life, hedge funds' 2013 stock performance is open to debate. That's because hedge funds, by definition, are intended to provide a protection against downside risk. In stocks, for example, that commonly takes the form of what's called a "long-short" strategy, meaning that the fund manager places bets both on certain stocks going up and that various other equities will go down.

Using such a strategy may not necessarily beat a bull market, but it also means that the fund could make money when the bear is on the prowl, or at least not lose as much. Over the long term, long-short funds—which make up the lion's share of DFW hedge funds—could provide better risk-adjusted returns than just buying a big basket of stocks and hoping they go up ... and without such sharp ups and downs in the value of the investments, to boot. Beyond that, hedge funds

Hedge fund managers that call DFW home have more than \$20 billion under management, according to estimates.

have a wide range of possible investment avenues they can pursue, whether that's putting money in currencies, derivatives, or something else entirely. That means their returns don't necessarily march

in lockstep with the public stock and bond markets, and often may go in different directions entirely.

"Hedge funds aren't supposed to beat the S&P every year," says Okada of Highland Capital Management. "They're supposed to provide better risk-adjusted returns over the long term."

That indeed is how hedge funds are supposed to work. But the theory ran into trouble during



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the 2008-09 financial crisis, when many hedge funds suffered steep losses.

The turmoil of that period “clarified that although hedge funds had claimed they were hedged—meaning delivering positive returns regardless of whether the market goes up or down—it was clear during the crisis that this claim was bogus,” says Kumar Venkataraman, chair of the finance department at Southern Methodist University’s Cox School of Business. “To some extent, for investors in hedge funds, this was a wake-up call.”

Venkataraman notes that when economic times were good, the hedge field became populated with individuals who simply didn’t belong in it. “The industry grew so quickly that a lot of marginal people with questionable talent were managing money,” he says. “Marginal players saw their shops go down [in the crisis]. It just cleaned up the industry.”

The crisis and resulting scandals did more than remove less-skilled players from the ranks of hedge fund managers, experts say. It also shifted power away from managers and back to their investors.

That happened largely because the entire industry became tainted by the likes of Bernard L.

Madoff, whose asset management firm turned out to be a \$50 billion Ponzi scheme. Other big hedge funds shaken or destroyed by scandal include the Galleon Group and SAC Capital Advisors LP, both of which were hit with allegations of insider trading.

Although these offenders were based in other parts of the country, the shock waves have been felt in North Texas as well. “Picking managers who aren’t crooks is a big issue” to investors, says Cheskiewicz. “You’re increasingly seeing back-office due diligence. They will run background checks on the key people. It’s on everyone’s mind: ‘We don’t want to be the one that gets nailed by the SEC.’”

Because of the heightened scrutiny from regulators and investors alike, it’s getting tougher for small, less-known hedge funds to raise money. Large investors in particular want to entrust their money to people who have proven records in making money and doing so in an ethical manner. “There’s a lot of competition for capital,” says Evan C. Williams, an associate in the Dallas office of Hunton & Williams LLP.

All of which brings us back to the changes that DFW hedge funds are experiencing. One wave

of the future might be taking shape locally at Highland Capital, which increasingly is taking investment strategies once reserved solely for hedge funds and using them in mutual funds. (For a description of the similarities and differences between hedge funds and mutual funds, see accompanying story.)

Highland mutual funds invest in everything from floating-rate bank loans to master limited partnerships in the energy industry, and use techniques such as applying proprietary models that seek to profit from rising and falling prices for high-yield debt.

“If you ask me the most important thing we’re doing in the hedge fund space, it’s growing our mutual funds, and providing hedge fund strategies to investors in that space,” Okada says. “Our investors there [range from] individuals to institutions who use our mutual fund products as their hedge fund exposure. ... Over the next 10 to 20 years, there will be huge growth in hedge fund managers offering their services through regulated, transparent, liquid, lower-fee mutual fund offerings, versus the private structures we see today.” **D**

MUM’S THE WORD

Traditionally, hedge funds have been big—and secretive.

IF YOU HAVE MONEY IN A MUTUAL FUND for retirement or a child’s education, you probably have a basic understanding of how hedge funds work. Just like with mutual funds, a group of individuals or organizations provide money to a hedge fund manager, who invests the dough on their behalf in, say, the stock market or corporate bonds. But that’s where the similarities with mutual funds end.

While the government tightly regulates mutual funds, hedge funds historically have operated with relatively little oversight by federal or state authorities.

Whereas most anybody can put money into a mutual fund, investors in hedge funds are limited to institutions or wealthy individuals or families, who in theory are better able to understand the risk of certain investments and have stronger financial cushions to absorb losses.

Most importantly, the scope of what a given mutual fund can invest in has historically been very limited. If a given fund sets out to make money in large publicly traded health care companies in the United States, it can’t shift gears and invest in privately held oil fields in Russia.

Hedge funds can do that, though, and do dabble in everything from stocks and bonds to currencies, commodities and various types of derivatives.

They can invest “long” (meaning betting a financial security will rise in value) or “short” (using borrowed financial securities to place a bet on a downward plunge in value.) They can invest in private companies alongside venture capitalists, private equity backers, or even the oc-

casional wealthy individuals.

What’s striking about hedge funds is both how big they can get and the relative secrecy with which many operate.

Ever heard of HBK Capital Management? The 180-employee Dallas firm had more than \$13.8 billion in assets under management as of a March 2013 filing with the Securities and Exchange Commission.

Carlson Capital LP? The Dallas shop had more than \$15.9 billion in assets under management as of early December 2013. Or there’s Crestline Management LP, a Fort Worth “fund of funds,” with more than \$6 billion in assets overseen. (A fund of funds invests in other funds, rather than directly in stocks, bonds, or other financial securities.)

And yet these firms, like most in their industry, make little information about themselves available to the public. The

firms’ web sites feature images of things such as the buildings they operate in and one or two sentences about the companies themselves, with hardly anything about the identities of the people who run them or their investment strategies. Representatives of HBK, Carlson, and Crestline did not respond to requests for comment.

Why are they so private? The answer may lie partly in their DNA. Hedge funds have traditionally received loose government regulation in return for avoiding publicly sharing much information about themselves.

That’s a hard habit to break, even if, as is the case with the recently enacted Jumpstart Our Business Startups Act, the U.S. government has dropped its bans on hedge fund advertising and other solicitation measures.