

## Smoothing the Path to Change

**By Chidem Kurdas, New York Bureau Chief**  
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NEW YORK (HedgeWorld.com)—Different kinds of convergence are in evidence in money management. A few large hedge fund firms are starting to resemble conventional asset managers, while others are taking long-dated bets in private equity. But there are barriers to change.

Roger Fenningdorf, partner at institutional consultant Rocaton Investment Advisors, expects the lines of demarcation between private equity, real estate and hedge funds to continue to blur.

In the future, clients might invest in the broad category of alternatives instead of investing separately in private equity or hedge funds or real estate, Mr. Fenningdorf said.

Multi-asset class managers that allocate across different alternatives to make the most of market opportunities could very well have a competitive advantage in extracting returns and attracting institutional money.

Such groups already exist. For instance, Citigroup Alternatives manages investment vehicles in private equity, hedge funds, real estate, structured products and managed futures, with US\$37.6 billion of client assets. It also invests the bank's own money.

Will the most successful hedge fund and private equity shops come to resemble Citigroup Alternatives? Because of their internal diversity, such businesses can manage more assets, and of course institutional investors tend to favor large asset managers with the full organizational structure.

"In the next two to three years, expect hedge funds to morph into mutual fund-like organizations," says Russ Gerson, a long-time Wall Street recruiter who formed Gerson Group in October 2005. He and his partners left A.T. Kearney to start the business, which offers a combination of strategic advice and head hunting.

He expects that there will be a lot of consolidation in the next couple of years, especially with low returns taking a toll. Right now, his focus is on the intersection between hedge funds and private equity.

"Where we add value is to help a hedge fund develop private equity capacity and a private equity manager develop hedge fund capacity," he said. This can take the form of finding people to recruit or finding a firm to acquire.

Moving an individual has its difficulties, but moving an entire team and fitting it into another organization is even harder. Successfully transplanting across sectors adds more complexity.

Mr. Gerson said his group works to understand what the clients do, in order to tailor the hire or acquisition to their strategy. In integrating a person from private equity into a hedge fund group, he sees the difference in mentalities as the biggest challenge.

In private equity, assets are raised for and investing is geared to the long term, whereas hedge fund money and trading is relatively short-term. The mindsets of the professionals are adapted to these different horizons.

The time frame also has an impact on compensation, a difference that must be worked out. Fee rates tend to be similar in the two kinds of investment: around 2% of assets for management and 20% of profits for performance.

But hedge fund people are used to annual bonuses, while private equity payoffs are delayed; it can take three or five years or longer for the investment gains to be realized. In the meantime, the team has to live on management fees.

By contrast, some hedge funds don't even charge management fees, instead relying on high performance payments.

But if you can make the combination work, it is a good way to deal with cyclical fluctuations in revenue, said Mr. Gerson. For instance, at times when short-term trading opportunities for the hedge fund are scarce, there may be long-term profits to be made in private equity.

That over-used term, synergy, may really apply to such blends. Mr. Gerson finds that the two sides can help each other, with private equity knowledge informing hedge fund trades and vice versa. Large hedge funds like Soros Fund Management have long been active in private equity deals.

But as in any marriage, personalities and the chemistry determine whether the integration is successful.

These issues are separate from hurdles on the investor side to the meshing of hedge fund and private equity strategies. In particular, institutions currently allocate assets either to liquid public markets, where hedge funds tend to be, or illiquid private investments. The separate buckets may make it more difficult for hybrids to get pension money.

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