The rise of new fund structures

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Investors are embracing risk again and the hedge fund sector has bounced back to life. But things are not quite the same as they once were, and perhaps never will be. For a start, the wave of restructurings and liquidations is not yet over. In addition, the difficulties suffered by managers and investors alike have accelerated the trend towards new fund structures.

As Neal Lomax, a partner at law firm Mourant du Feu & Jeune, says: “We are in uncharted territory; the hedge fund industry has never been in a comparable situation.”

The restructuring which started last year and is still ongoing at some funds, is largely due to a vicious spiral of redemptions followed by distressed asset sales, leading to a fall in NAV and further redemptions. Law firms such as Mourant du Feu & Jeune have been called on to give advice on suspending redemptions and NAVs, on gates and lock-ups, on side pockets and restructurings and liquidations.

“A fund may be restructured into a liquidating entity to hold and dispose of illiquid investments or as an ongoing entity in which the manager continues to manage the portfolio on behalf of investors who elect to remain invested,” says Lomax. “Alternatively, it may be converted into a listed closed-ended vehicle.” Investors in such a vehicle might benefit from greater certainty on pricing, transparency and the ability to exit the fund by selling in the market, he adds.

Investors have also needed to protect their assets, and some of the larger ones have engaged law firms to obtain freezing and disclosure orders. Directors, too, concerned about their positions, have sought advice on their duties and on regulatory and compliance issues. Some have even brought claims against their own managers for breach of duty.
However, while a relatively small number of claims and counter-claims are meandering their way towards courthouses, the rest of the industry is now busy launching new funds and attempting to extract returns from existing ones.

But, scarred by the liquidity problems that ruined many a fund, there has been a marked shift towards “hybrid funds”, representing a convergence of the traditionally separate asset classes of hedge and private equity. These types of fund are not new, but the trend towards them has accelerated as hedge fund managers scramble to manage liquidity by side pocketing illiquid or difficult-to-value assets, often in return for restructured upside fees that are paid only on realisation of the underlying assets.
Lomax notes: “Managers will seek to structure new funds so that the duration and liquidity of the fund matches as closely as possible the duration and liquidity of the assets in the fund’s portfolio. For example, hedge funds with a mandate to invest in less liquid assets may incorporate fund terms more traditionally associated with private equity funds. These structures are attractive both to managers seeking to lock in assets and to investors looking at fees and predictability.”

The rationale for these funds has been created by the rising chorus of criticism of the traditional hedge fund model – particularly with regard to returns and manager remuneration – combined with the increased cost of stock borrowing and higher margin requirements at brokerage houses.

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