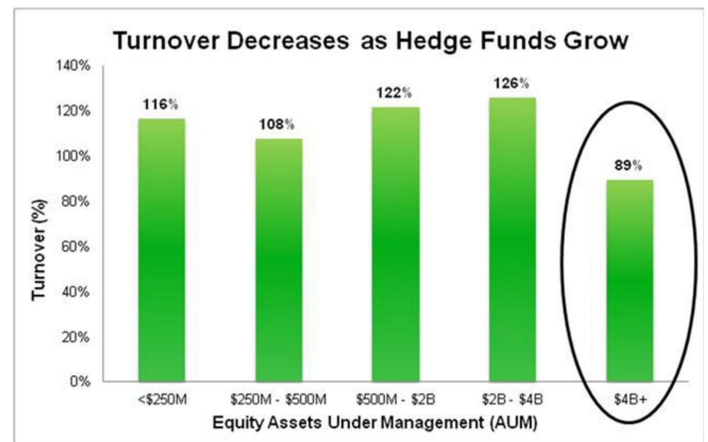
WHAT HEDGE FUNDS ARE DOING TO RAISE MORE PERMANENT CAPITAL AND WHAT IT MEANS FOR IR PROFESSIONALS

By Michael Stiller and Ted McHugh

The Holy Grail in the investment management business is patient capital. With that in mind, as we have seen over the past 15 years, one day's darling is the next day's dog, as hedge funds generating huge returns one year see tremendous inflows, but a slight flat-line or reversal in performance and assets are redeemed with impunity. The effects for Investor Relations Officers are clear: greater volatility and higher turnover in hedge fund concentrated companies.

While this has been the nature of the hedge fund business since the 90's, there is a trend afoot amongst the largest, most savvy funds to seek more permanent capital. With last Tuesday's S-1 filing from Third Point Partners, L.P of its reinsurance-arm, **Third Point Reinsurance** (TPRE), we are starting to see how these players are using insurance vehicles to lock up capital for longer periods of time. This trend has been alive for a handful of years, as evidenced by Greenlight Capital's IPO of **Greenlight Capital Re** (GLRE) in 2007 along with other hedge funds that have also adopted this structure, namely **AQR**, **S.A.C**, and **Paulson & Co**. The strategy is simple: these funds all have the ability to use their reinsurance-arm's premiums and inherent leverage to reinvest in their respective hedge funds. This leads to far more stable capital than the traditional forms of assets that come from pension funds, endowments, and high-net worth individuals. What's more, this is not a new strategy, as the world's most famous investor, Warren Buffett's **Berkshire Hathaway** (BRK'A), has been implementing it for decades. Buffett has used his stable capital source, insurance, to invest in mega cap, blue chip names while the newer players invest in various other strategies such as long/short equity, risk arbitrage, macroeconomic, event-driven, etc.

As highlighted by the chart, NASDAQ Corporate Advisory team uncovered that there is a clear correlation between the size of an individual hedge fund and its relative annual portfolio turnover. What is interesting is that portfolio turnover data is relatively unchanged for all hedge funds with equity assets under $4B. However, there is a notable percentage change in equity turnover (~30%) for funds that exceed the $4B threshold. NASDAQ estimates that there are 63 hedge funds with an equity asset base greater than $4B, a relatively small percentage of all identified buy-side firms. However, as funds continue to develop creative ways to grow and retain their capital base, as indicated above, this number is expected to grow significantly over the upcoming quarters.



Bottom Line: This trend is a double edged sword for Investor Relations Officers. As hedge funds command more stable capital, they can take larger more concentrated positions, creating less volatility in the names they like. With that said, hedge funds have historically been boisterous and commanded more of IR and senior management's time than your traditional vanilla long-only players. That trend is clearly one that won't go away with the rise of permanent capital. We suggest that when engaging with the players utilizing reinsurance strategies to remember both the positives and negatives mentioned above, but also remember names such as Greenlight and Third Point are the cream of the crop managers with outstanding track records. While some of these players do have activist-related tendencies, with that aside, they have great ability to influence the broader investment community in the positions they do decide to take. Taking that one step further, once involved, these players champion for their positions, ultimately growing awareness of company specific stories. These trends suggest hedge funds with sticky capital should be thought of like partners rather than enemies, as their influence runs deep and can be hugely beneficial.