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# Hedge Fund Riches Reshape Buy-Side Pay

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### The returns-based compensation that took hold among hedge fund managers a few years ago is exerting a tidal-like pull on the rest of the asset management world.

In a candidate-driven job market, recruiters and consultants see both alternative and traditional investment managers under growing pressure to share a greater portion of fee income with their staffs. The sight of hedge fund leaders reaping nine- and even 10-figure paydays is the latest impetus for spreading the wealth.

The potential for huge rewards pegged directly to fund performance is dimming the appeal of the formerly dominant discretionary bonus.

"Those less satisfied with their compensation tend to be those who get paid based on a discretionary bonus," says Sandy Gross, managing partner and founder of Pinetum Partners LLC, a Greenwich, Conn., retained-search firm that specializes in hedge funds, investment banks and other securities firms. "There seem to be more negotiations at the end of the year with those types."

**How the Formulas Work**

At most hedge fund operations, fees collected from investors are closely tied to how well their portfolios perform. One widely used fee formula is "2-and-20," or two percent of assets plus 20 percent of each portfolio's yearly investment return.

Many of the senior investment professionals who manage hedge fund portfolios have succeeded in tying their own compensation to their employer's income stream. That can create huge, if uncertain and potentially volatile, payouts for individual managers of top-performing funds.

Even among hedge funds, use of returns-based compensation has been spotty, and is largely confined to portfolio managers. But the arrangements are starting to move down the alternative assets food chain, sources say, reaching analysts and even back-office support staff.

Meanwhile, portfolio managers and others toiling at long-only firms are scrambling to get in on the action. That's creating a dilemma, especially for institutional asset managers who might like to add hedge fund-like offerings to their menus. They fear staff turmoil if they continue to pay one group of portfolio managers the old-fashioned way, while promising another group an uncapped share of the returns they generate.

That may explain why such well-regarded investment managers as T. Rowe Price, Franklin-Templeton and Nuveen have elected to stay in the long-only camp, even while others, like AllianceBernstein and Lazard Asset Management, built up successful hedge fund businesses.

**'If the Numbers Go Through The Roof…'**

When thinking about diversifying into hedge fund products, asset managers are "very nervous about compensation issues," says Eric Weber, chief operating officer of Freeman & Co., a boutique investment bank for the financial services sector. He says executives fear combining dual compensation schemes under one corporate roof would open a "Pandora's box" - a stampede by the firm's long-only investment staff to transfer to the hedge fund side.

Here's why: At a hedge fund firm that keeps 20 percent of its portfolios' returns as a performance fee, a portfolio manager might be guaranteed one-fourth of the firm's take, or 5 percent of the return on the funds he runs. If the fund gained $200 million before fees, the performance fee would come to $40 million, and the portfolio manager would keep $10 million of that.

"So if the numbers go through the roof, you're going to be paid through the roof," observes Weber.

On the other hand, total compensation for a portfolio manager of a long-only fund with the same returns might fall in a range of $3 million to $5 million, according to one buy-side recruiter.

To be sure, many long-only firms reward fund managers for strong performance. A 2006 survey by London-based PRPi Consulting found that more than 70 percent of fund management houses shared performance fee revenues with investment professionals, up from just 29 percent three years earlier.

The problem is that the fee rates for long-only managers are far below those of hedge funds. When they do include performance in a portfolio manager's pay package, Weber says it's likely to be part of a complex formula that takes account of how a fund performed against its peers and how much new cash is flowing into the fund.

**Rewarding Analysts, Operations Staff**

Meanwhile, the lure of performance-fee riches is influencing the design of pay packages for staffers who don't manage portfolios, at both hedge funds and traditional buy-side firms.

Gross sees alternative investment firms awarding "phantom stock" - synthetic, non-tradable shares that vest over a period of time and eventually pay off based on a fund firm's revenues or profits.

Another trend she notes is providing analysts with verifiable tools for documenting how their ideas contribute to portfolio performance. In the performance-obsessed fund world, having a "portable track record" is vital to marketability. So although it doesn't qualify as "compensation" in the monetary sense, Gross says analysts are asking for and getting this element.