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At Hedge Funds, Bigger Is Better This Year

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Pay disparities spawned by 2007's spotty hedge fund returns are prompting analysts and portfolio managers to migrate from smaller to larger fund groups early in the new year.

"The smaller funds are losing their people in mediocre years, because they can't afford to pay them well" when modest returns crimp fee income, says Claude Schwab, founder and chief executive of Schwab Enterprise LLC, a hedge fund recruiting and capital raising firm.

On the other hand, large diversified fund groups are using their greater resources to keep payouts high, even if their average offering returned in the mid-single digits last year. Those titans are now swooping in and hiring away the talented analysts, senior analysts and portfolio managers from smaller shops - generally those with less than $600 million under management, whose funds returned 5 percent or less in 2007. Schwab declined to cite specific instances, because his clients believe that publicizing their activity would make it still costlier for them to recruit.

Multi-billion dollar fund firms with multiple strategies can transfer fee revenue they earn from better-performing strategies to bolster payouts for employees in strategies that didn't perform well, observes hedge fund recruiter Sandy Gross, managing partner and founder of retained search firm Pinetum Partners.

Smaller, Focused Operators at a Disadvantage

Hedge fund operators get most of their revenue from performance fees, usually computed as a set fraction of the positive returns generated by each fund over the course of a year. That means a fund group that focuses on a handful of similar strategies will earn little or no performance fees for years when their strategy is out of favor. But a group with diverse offerings is likely to have some winners even if its overall menu produces an average or median return no better than the narrowly focused fund company.

Compounding the problem for smaller fund companies, Gross says that institutional investors – a fast-growing share of the fund industry's customer base – prefer to entrust their assets to companies that resemble themselves. As a result, smaller fund shops have a harder time raising capital. To remedy this problem, she says some smaller fund operators are seeking to partner with larger ones.

Schwab Enterprises last month published a book of compensation data covering hedge fund analysts and traders, stratified by firm size and fund performance. An important trend he observed is that front-office pay at the larger employers (more than $1 billion under management) has become steadier in recent years.

Getting a Handle on Compensation

Within a large fund company, Schwab says the median discretionary bonus for an analyst or portfolio manager that has a poor year now shrinks 40 – 60 percent compared with a strong year. Prior to 2003, the compensation discount for poor years ranged from 60 – 80 percent. That degree of volatility persists today at smaller fund companies, but not bigger ones, he says.

The gap looms large after a year when an unusually high proportion of funds posted single-digit returns. Schwab says most of his clients, who tend to be established firms with $1 billion – $20 billion under management, returned between 3 percent and 10 percent in 2007.

He says larger fund companies tend to make analysts' bonuses fully discretionary. Formulas that tie an analyst's bonus to fund returns are more found at smaller funds, to aid recruiting and retention.

For hedge fund analysts completing their third year in 2007, Schwab found bonuses ranged from $250,000 to $1.1 million, on top of a $ 150,000 median base. For firms with weak returns, payouts were 40 - 60 percent below those with strong returns.

Beyond the third year, compensation can quickly soar. Schwab says he found an analyst with four years' experience whose discretionary bonus was about $10 million. That analyst, who worked at a well-known firm that performed strongly last year, had generated a winning investment idea in which the portfolio manager took a large position that made a major contribution to the fund's return.