Client Alert: Hedge Funds Tackle New Communication Challenges

Key investor relations trends for alternative asset managers.

We were honored to serve on a recent discussion panel for the *Texas Hedge Fund Association* concerning new challenges (and opportunities) for hedge funds seeking to define and differentiate their Funds in the marketplace. The topic is timely, to be sure: amid intense competition, skeptical investors and an underperforming equity market, the scramble for capital among alternative asset managers has never been more intense. This environment has served as a catalyst for a paradigm shift in how these managers think about investor relations and communication with key stakeholders. The black box era is over. Consider that eight years ago, KKR employed exactly two professionals in its investor relations department. That number today? 37. The same trend holds true for the hedge fund industry, where investors are demanding a <u>relationship</u>, not merely a transaction. These developments highlight a couple of key trends, which we believe are of interest for our clients and Friends of the Firm:

- It is well-known that the overall characteristics of the hedge fund investor base are changing. Whereas the industry's roots lie in wealthy individuals and family offices, ***institutional*** **investors now represent a growing percentage of the pie**. According to The Boston Consulting Group, at the end of 2010 the institutional segment held 60% of global AUM. This trend should continue, as pension funds and (increasingly) sovereign governments seek potentially higher returns from hedge fund investments. Importantly, these institutional investors are beholden, in their own right, to stakeholders (retirees, public pensioners) that demand transparency and accountability. From an investor relations perspective, this mandates that hedge funds implement institutional-quality protocols designed to instill both confidence and a thorough understanding of risk and return strategies.
- A second trend of note is the growing concern that "key man" dilemma at hedge funds poses real risk. As Bloomberg recently characterized it, this means "….**managing succession in a business where success is built on the founders' trading skill and reputation**." Several of the star managers so closely affiliated with their funds have announced plans to step aside – and not always with success. When Chris Shumway of Shumway Capital announced he was retiring earlier this year, investors pulled $3B in assets despite the appointment of a successor. Shumway eventually closed the fund in its entirety. Legendary investor Stanley Druckenmiller also closed his Fund upon his announced retirement. This succession dilemma will no doubt become more prominent in the coming years as increasing numbers of key managers choose retirement over a future of enhanced regulation and a tougher return environment.
- The third development is more abstract, but no less relevant. The industry is **transitioning (perhaps already has) from a purely transactional-based model to one grounded in relationships**. So while performance was once the ONLY thing that mattered, it is now coupled with investor demands for information as to HOW returns were derived, what the investment process looks like, what the risk management systems are, who is performing valuation work, etc. This "returns +" model is predicated on thoughtful, diligent

communication materials and open channels of communication that provide transparency into the Fund's operations.

These developments call for a review to ensure the following communications and investor relations tactics are in place:

1. **Build / Nurture the Brand:** We sympathize with the skepticism in the hedge fund community for "brand-building," but we are in a new era. Recent surveys of U.S. and European institutional investors find *reputation* has become a primary consideration when choosing a hedge fund manager, and it follows that sophisticated investors want to know that their capital is being invested by an entity that: (1) knows its values and priorities; (2) has invested in building a culture to support those values; and (3) has internalized them from Founder all the way down the chain. A strong brand identity, which transmits a fund's unique value proposition in a clear, concise, and compelling way, will help it capture and retain assets.
2. **Tell Them, Tell Them What You Told Them, And Then Tell Them Again:** All materials that describe the Firm and investing strategies must – in a clear, concise, and compelling manner – reflect the brand and the Firm's priorities. The same key message strategy deployed so effectively in the political (and, increasingly, corporate) realm are applicable to alternative asset investors.
3. **Media – Less is Often More:** Importantly, the development and nurturing of a hedge fund brand should not be confused with media relations. The media can be a high-risk medium through which to communicate your message, and should be deployed judiciously and only in support of a specific business objective. There are myriad, "controlled" communication tactics that can be deployed to support a Fund without being subject to the often-unreliable filter of the media.
4. **Crisis / Contingency Planning:** In today's 24/7/365 media environment, hedge funds are highly vulnerable to the kind of rumor and innuendo that can destroy a hard-earned reputation. We believe this is particularly true as the Government plays a larger role in the economy: Phil Falcone, to cite one recent example, is under intense political heat for his investment in LightSquared and its relationship with regulators. Acute sensitivity to – and planning for – a range of external vulnerabilities should be hard-baked into a Fund's communications planning.

Looking Ahead

There is an old saying (to paraphrase) that "…no one ever got fired for hiring IBM." Does it follow, *ipso facto*, that IBM always does a better job than its peers? Of course not (and it is certainly more expensive than most). What matters is that IBM stands for enduring values that resonate with corporate decision makers – values that have been refined, honed, and relentlessly invested in for decades. We believe the hedge fund industry is on the precipice of a similar dynamic: those funds that couple strong returns with a commitment to a strong brand and reputation will thrive.