Outliving the Founder's Participation

Succession Planning for Hedge Funds

As a generation of hedge fund founders looks ahead to retirement or plans to move on to other opportunities, the industry is wrestling with the question of succession: Can a hedge fund outlive its founder's participation?

Some fund managers have concluded that the answer is no, closing their funds and returning capital to investors. Other fund managers are looking for ways to maintain the business as they transition out, through succession, sale or other strategies. Succession also has become an increasingly important consideration for investors: 67 percent of investors in a recent Ernst & Young survey said a well-articulated succession plan is important to them when investing in more established hedge funds. Interestingly, only 38 percent of hedge funds considered a well-articulated succession plan important for retaining investors.

Unfortunately for those who do want to achieve an orderly succession, there are relatively few successful models to follow. What is clear is that succession handled poorly can drive away investors and cause the fund to close.

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What makes succession planning for a hedge fund manager so challenging? Chief among the reasons is the fact that, more than most other businesses, hedge funds are closely tied to their founders and their reputation and trading skill. Investors typically are buying into the founder's strategy and investment track record; the closer the fund is aligned with a "star" manager, the more challenging it can be to transition leadership of the fund to a successor. Without having the same confidence in the successor as they do the founder, investors are likely to view staying with the fund — and an unknown quantity — as inherently riskier.

Another thorny issue can be the ownership of the management company, which is typically owned solely or primarily by the founder. A successful leadership transition needs to both address the founder's interest in the business, allowing him or her to cash out all or a portion of that interest, and provide the long-term equity incentives to retain potential successors and other key members of senior management.

Finally, practical constraints, including the day-to-day demands of the business, can limit the ability of hedge fund founders to advance a succession plan. Succession planning takes a lot of time and effort and can create additional pressures when running the business. Furthermore, managing people and grooming successors may not necessarily be a strength of the founder.

Four transition approaches

The past several years have seen a number of hedge fund transitions. The most common approaches that hedge funds have taken when the founder is ready to move on are: closing the fund, selling a stake in the management company, identifying a successor or committee to manage the fund, and establishing investment sleeves with individual managers.

Wind down the fund

In situations where there is no credible and ready successor, funds have closed and returned investors' money. In one of the most well-known examples, George Soros announced in July 2011 that he planned to close his Quantum Fund and return $1 billion in client investments. Soros and Stanley Druckenmiller, who closed his $12 billion Duquesne Capital Management fund in August 2010, said they would focus on managing their own fortunes once the funds closed. While evolving to more of a family office structure can free fund managers from some regulatory concerns, it can require much of the same work without the benefit of the fee revenue that a hedge fund generates. However, investing in other funds can evolve into a business of its own; Blackstone Alternative Investments, for example, was started by the partners of Blackstone to invest their own money and later was expanded to take outside investors for its fund of funds.

A potentially more attractive option for hedge fund founders wanting to hand off the day-to-day investment management is to seed new funds run by other managers. O.S.S. Capital Management founder Oscar Shafer, for example, announced plans to seed as much as $50 million to a new stock fund run by two of his junior partners, Barry Lebovits and Joshua Kuntz, after closing his fund. Julian Robertson returned client money in his Tiger Management hedge fund in 2000 and then helped to finance funds established by former Tiger managers. A potential advantage of this approach is that it may enable the retiring founder to become a preferred investor in the fund or to receive an equity interest in the management company.

Sell all or part of the management company

By selling an equity interest in the management company, a founder is able to cash out all or a portion of his or her interest in the business — one of the challenges to a leadership transition at hedge funds. Several hedge fund founders have taken this approach: David Shaw, founder of D.E. Shaw & Co., sold a stake of the firm to Lehman Brothers Holdings in 2007, after handing over responsibility for running the fund to a six-person committee. Highbridge Capital Management co-founders Henry Swieca and Glenn Dubin sold their interest in the management company to JPMorgan in a staged buyout, which began in 2004 and was completed in 2010. While Swieca left in 2009, Dubin remains CEO of the multistrategy fund. As part of the succession planning for York Capital Management founder and CEO Jamie Dinan, York sold a 30 percent stake in the management company to Credit Suisse. Dinan has told investors that he has been working on a succession plan for years and will continue to fine-tune it.

Although a sale does allow the management company to spread equity beyond the founder, it is not a solution to the succession conundrum in and of itself. For a successful transition, organizational issues, particularly the role of the founder, must be addressed.

A planned succession

Examples of successful leadership transitions at hedge funds are relatively few, but there have been some. Firms have taken different approaches, including grooming a single successor, appointing co-successors or establishing a committee to manage the fund.

In one of the most-watched recent succession examples, Caxton Associates founder Bruce Kovner named Chief Investment Officer Andrew Law as his successor to run the $10 billion hedge fund. The announcement in September 2011 culminated three years of succession planning, during which Law was appointed CIO and became the main contact for investors. At other funds, such as Bridgewater Associates, the founder has eased the transition to a new generation of leadership by gradually sharing responsibilities with co-executives rather than handing them over entirely.

Certain fund strategies — for example, computer-executed trading strategies — appear to ease the leadership transition, as they tend to be very quantitative and require less judgmental input from a single person. Campbell & Company, a $3 billion hedge fund that uses computer systems to execute trades, announced in September 2011 that its president, Stephen Roussin, had been appointed to succeed retiring CEO Terri Becks. When James Simons, founder of Renaissance Technologies Corp., which also uses computer models to guide investments, stepped down in 2010, he handed over responsibility for the firm to former co-presidents Bob Mercer and Peter Brown.

One thing is clear, however, transitions that are not well-planned and -executed are likely to incur the wrath of investors. Investors in Shumway Capital Partners reacted swiftly to founder Chris Shumway's announcement in November 2010 that he had named a new CIO and was planning to step back from managing money, asking to redeem $3 billion from the fund. By the following February, Shumway announced that he would return all capital to investors.

Build out a number of investment "sleeves"

Another option for spreading the responsibility for investment decisions beyond the founder, and thus reducing the fund's dependency on a single person, is to establish multiple sleeves, each with its own investment manager. To the extent that investment decision-making is dispersed or distributed down to lower levels, it makes it much easier to transition out the founder. It also reduces the risk to the fund of becoming overly reliant on one or two successors for the success of the transition, and allows for the continued involvement of the founder.

Jeffrey Vinik, founder of Vinik Asset Management, recently recruited David Iben to manage a new value sleeve to complement the firm's traditional growth approach. SAC Capital Advisors founder Steven A. Cohen has been quoted saying he manages less than 10 percent of the firm's capital, with the rest allocated to 125 portfolio managers. The fund also has an eight-person team that oversees the running of the $14 billion hedge fund.

Planning for succession

The successful succession of a founder takes years of planning, to prepare both the organization and investors for the transition. In short, it's never too early to begin planning for succession. The key is to institutionalize the firm so that it can operate and produce solid returns without the overwhelming involvement of the founder — and to prepare investors for a future without the founder. To do this, hedge funds must address five main issues.

The management structure, especially the responsibility for investment decisions

If succession is the goal, a hedge fund founder must begin to shift investment responsibilities to other executives in the firm. It is much harder to transition leadership of the fund if the founder does not begin to relinquish control of some of the investment decisions. Firms can take different approaches: some start the process by elevating new leaders and adding new layers of management depth and structure; others appoint a co-CIO to work with the founder or establish an investment committee to share investment decisions.

Short-term and long-term scenarios

In addition to developing a thoughtful plan for the orderly transition of the founder, hedge funds also should devote attention to potential unplanned transition scenarios, such as the prolonged illness or death of the founder. For example, some firms have a board of directors with the authority to assume control over the management company and make key decisions, such as appointing a new CEO if necessary, if something were to happen to the founder.

The retention of potential successors and other key people

Succession plans can quickly fall apart if potential successors depart the company. To avoid an exodus of critical members of the team, hedge funds should put in place the incentives that align these employees with the long-term health of the firm — for example, the opportunity to acquire a truly significant equity stake in the management company.

Ownership of the management company

A leadership transition is unlikely to be successful if the hedge fund does not address the founder's ownership interest in the management company. A way needs to be found to transfer majority ownership of the firm over time to its principals. A sale or, in rare cases, a public offering also may be considered.

The perceptions of investors

If they are to be successful, succession plans need to be well-executed and well-communicated. Ideally, investors will get to know potential successors over time, getting comfortable with their style and contributions to the success of the fund. The goal is to make sure that investors do not perceive the fund as solely dependent on the involvement of founder.

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