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## Hedge Fund Monthly

### Hedge Funds vs Private Equity Firms in the Alternative Investment Community

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Hedge funds have led the charge in the alternative investment community as a viable and growing segment of the buy side/asset gathering industry. Some of the brightest and smartest people from the industry have not only started hedge funds, but lately have started large "institutional", multi-strategy funds that span the globe looking for opportunities in which to trade. However, lately, as a technology provider to this industry, we at Gravitas are noticing with increasing frequency, private equity firms "spinning out" of larger institutions and establishing their own identities. Furthermore, many "hybrids" have followed in their own rite. Under the structure of a fund, the "hybrids" trade multi-strategies which combine traditional hedge fund investments and private equity investments. Many traditional hedge funds are finding it difficult to produce attractive alpha (delta between the performance of the index and their fund returns), and therefore are looking for other instruments/vehicles in which to trade. Hence they are selectively exploring both the private equity and real estate sectors.

#### **What is the Difference?**

Most hedge funds have portfolio managers that will actively allocate the funds amongst different securities, primarily in public companies or securities that are traded through some liquid or over the counter marketplace. Hence they rely on real-time market data, to market their holdings on a daily or even on an intra-day basis, and have to first gather the assets which are "domiciled" with the custodian or the prime broker. The typical hedge fund will charge 1-2% management fee and anywhere from 20% or more incentive or profit-sharing fee. Many hedge funds, especially the larger and more successful ones, may ask their clients to "lock up" assets for up to a period of three years. However, the gains and losses in the funds are reported monthly and tracked daily by the funds' management.

Private equity firms may charge fees on a similar basis, ie a management fee and a performance fee. Generally these firms will have commitments on assets from their investors on which they can call, as and when they are required. An investor typically does not have to transfer funds into the private equity firm until the funds are "called" based upon the investments the firm is making. These firms invest in private firms (hence private equity), or take a private stake in public firms (PIPES), and do not mark to market their holdings as there may not be a public valuation of them until an exit or sale is occurred. It is then that they realise their profits. These firms have much longer life-cycles (typically) in the investments they make as opposed to hedge funds, and do not require real-time market data-feeds. The lock-up for private equity firms is frequently seven years or more. These firms are trading illiquid assets and need a much longer period to identify, invest and then exit the companies. Generally, the managers participate in the upscale profits on a cumulative basis whereas profits

are offset by any losses.

Another difference is in risk management. While hedge funds use metrics like VaR and look at alpha and beta (market and absolute correlation), the private equity firms have a more bottom-up approach to risk management based upon research and the management team of the companies in which they take a stake.

The types of investors these institutions attract also vary. While hedge funds predominantly have had traditionally high net worth investors, and recently more and more institutional investors, they also have been more accessible to individual investors. Private equity firms, on the other hand, are generally less accessible to individual high net worth investors and attract more ultra-high net worth investors and institutional investors. This may be a function of the typically longer lock-up periods in the private equity firms, and the less liquid nature of their investments.

Examples of some of the larger hedge funds are ESL, Eton Park, Farallon Capital, Moore Capital, Och-Ziff, and TPG-Axon while examples of private equity firms are The BlackStone Group, The Carlyle Group, JP Morgan Capital Partners, TowerBrook Capital and the Texas Pacific Group.

Besides their business models, these firms also differ in their needs and consumption of technology. Hedge funds tend to require a much more robust and fault intolerant technology implementation as they have various applications like an order management system, portfolio accounting system, risk management system and various market data vendor feeds like Bloomberg, Reuters and so on. Private equity firms primarily need a good and reliable phone system, email and ability to share MS Word, Excel and PowerPoint files. Hence they need much simpler network infrastructures. Both, however, have a demanding end-user community that demands top-notch service and timely response to their respective requirements. Hedge funds typically use one or multiple prime brokers and fund administrators, whereas private equity firms typically do not require any.

To summarise, while hedge funds lead the charge in being the first to create an alternative to traditional investment vehicles for (high net worth) individuals and institutions, private equity shops are also beginning to proliferate and grow, and spin out of larger institutions. Both types of businesses are similar in many ways, but also have certain distinct characteristics with regards to the investors they attract, the kind of operations they need to set up and the technology they need to support them, both internal and that provided by third parties.

#### *About Gravitast*

*Gravitast Technology, with its "white glove" services approach and multiple legs of offering where we view technology holistically, has been providing a broad range of integrated IT services including consulting, software development and infrastructure integration since 1996. Our customers include an impressive portfolio of financial services firms, including hedge funds, brokerage firms, investment banks and asset management firms.*

*We have expanded our delivery capacity and enriched our offerings with best-of-breed delivery partners including: Constatin/Walsh-Lowe, Globix Corporation, and MTM Technologies. Gravitast continues to be the preferred provider of IT services to the hedge fund industry, having secured the launches of over 25 funds, including some of the largest and most complicated hedge fund clients over the last 12 months.*

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