REUTERS HEDGEWORLD

Section: Opinion

Opinion: The Ultimate Hedge - Protecting a Fund Owner's Greatest Asset

By Edward A. Tafaro, Exceptional Risk Advisors LLC
Monday, February 14, 2011 1:28:55 PM ET

A hedge fund's success rests squarely on the broad shoulders of its Chief Investment Officer. Larger funds may have multiple managers, but for most, the fund depends on its top managers to attract and retain both investors and key talent. This individual is the driving force, the one whom the investors count on to take it across the finish line. Names like Steve Cohen, Paul Tudor Jones, Ken Griffin, Daniel Och are inextricably linked to their fund's name and performance record.

The loss of a key investment manager due to a death or disability is certain to result in devastating redemptions, if not the total dismantling of a fund.

But even one who's seemingly invincible can be brought down. Such was the case when leading hedge fund manager Edward Petner was struck by a car while bicycling and found himself paralyzed from the waist down. For those many hedge funds founded by individuals with the ability to raise large amounts of capital, the specter of disability or death hangs ominously over them.

A recent survey of compensation practices in the hedge fund industry, conducted by the New York City firms of Grahall Partners, LLC; Kleinberg, Kaplan, Wolff & Cohen; and USB Prime Brokerage Services, revealed that more than half of the participating funds didn't have a succession plan in place.

There's only one overriding reason to invest in a hedge fund, and that's the fund's performance, which is directly linked with the Chief Investment Officer in most cases. Much like the entertainment industry, hedge fund managers are not easily replaced. In the same way "The Oprah Show" wouldn't go on if something were to happen to Oprah, SAC would have considerable difficulty managing the future without Steve Cohen.

In an *Investment Dealers Digest* article, Greg Dowling, managing principal and director of hedged strategies at the Fund Evaluation Group in Cincinnati, Ohio, summed it up well when stating, "If there tends to be one guy who is out in front at a firm, then often all of the money is there because of him. Typically, this person can have a larger-than-life personality. When that person is gone, no matter how good the underlying team might be, most investors will shoot first and ask questions later in terms of redemptions."

Sanford Crystal, executive vice president of Frank Crystal & Company, a leading insurance brokerage firm based in New York City that works with numerous hedge funds, says he feels key person insurance, including both life and disability, is paramount. "Insuring key people provides, in most cases, an infusion of working capital," says Crystal. "This cash serves to offset the lost revenue should something serious happen to a key manager or partner, whose name is also the company's name on the door."

Crystal also states, "Standard off-the-shelf insurance policies don't provide the detailed and comprehensive coverage that is required." And he's correct.

Life and disability insurance through general insurance advisors isn't the answer because of the complexity of the underwriting process when the face amount moves up into the stratosphere of $50 million or more. It's not something most insurance agents are comfortable with. Yet, the need is very real, and specialty insurance advisors must be sought out.

The problem is that most CFOs or other decision-makers don't possess a crystal ball. With fund managers being heavily engaged with what they're doing, they don't have the time to run through all the possible scenarios and do a thorough risk assessment on what the consequences would be if they go down. Even if they're aware of the implications, it's not something they want to think about. By failing to do their own planning, they are putting their funds at risk.

"Many fund managers are in their 30s and 40s," explains Sanford Crystal. "They are successful largely because they are constantly evaluating all different facets of their business, as well as the risk associated with it. But this issue is not on their radar, and it should be. If something happens to them, it may be catastrophic to the business. In short, they can't separate themselves from the business, as they are the business."

Rothstein Kass of New York City surveyed 349 hedge fund managers to find out if the industry was prepared to deal with handling major changes due to a variety of scenarios, including the death or disability of a key person.

Of those polled, only 30% said they were prepared, 22% stated they were not ready for such a situation, and almost 50% were uncertain. And of those surveyed, nearly 70% said they weren't in a position to handle an extended leave of absence of a key person due to disability.

"While you'd be hard-pressed to find a hedge fund senior partner who wasn't well versed on the tax issues impacting operations," said Rick Flynn, principal-in-charge of the Family Office Group at Rothstein Kass, "we were somewhat surprised to learn that nearly 25% of the respondents admitted they were unprepared to handle the death of an owner in the management company."

A good example of this is Ochs-Ziff Management Group, LLC, based in New York City, one of only a handful of publicly traded hedge funds. The company stated in its 2010 10-K filing that the fund "does not carry 'key man' insurance that would provide us with proceeds in the event of a death or disability to any of our key partners."

The filing further stated, "The success of our business depends on the efforts, judgment and personal reputation of our key partners, and the loss of these individuals could harm our business and jeopardize our relationship with our fund investors and members of the business community...which could result in a loss of substantially all of our revenue and earnings."

So why would a hedge fund willingly put itself so directly in harm's way? As Sanford Crystal sees it: "While many hedge funds are aware of the need for key man life insurance, the reality is that disability, not death, is the far more likely event, given the young ages of most hedge fund managers. As such, disability insurance should be considered in the same vein."

Whether a hedge fund is just starting up or has been around for some time, its credibility is based on the investment manager's track record. This is why key person life and disability insurance deserve to be viewed as an essential component of the firm's business plan and risk strategy. Not only will a strong key man life and disability insurance portfolio strengthen the fund, it will provide peace of mind for the investors by letting them know there's a well-thought out plan that provides the necessary liquidity should a serious problem occur.

It's critical to look closely to identify those who are synonymous with the fund's success. Even more importantly, fund managers are like pro athletes in that they exist in a compressed window of success. It makes good business sense to make sure they, and the fund they are inherently linked to, have the maximum protection needed to help it continue to prosper and thrive should a serious bump in the road occur.

It's true that fund managers, who are linked to their hedge fund's success, deal with their individual legacy differently. Unfortunately, many deal with it by doing nothing at all.

Edward A. (Ted) Tafaro, President & CEO of Mahwah, New Jersey-based Exceptional Risk Advisors, LLC, is an expert on high-limit specialty life, accident and disability products for clients with extraordinary insurance needs, such as leading hedge fund professionals. By partnering with elite insurance advisors and Lloyd's of London, his firm has the largest binding authority available in the U.S. for its products. For more information, contact him at 866.512.0444 or via email at ted.tafaro@exceptionalriskadvisors.com.