

TEXAS

The Lone Star State has a long-standing hedge fund pedigree and its appealing tax regime makes it a big draw as an onshore jurisdiction. *HFMWeek* spoke to two of the Texas fund industry's leading players about how the region is adjusting to the current economic climate



Scott Houdek is head of **BNP Paribas** south-west region prime brokerage business based in Dallas, Texas. He leads a team of ten prime brokerage professionals providing a full-service offering to the hedge fund market.



Steven Menna is a principal in the **Rothstein Kass** Dallas office. He works with domestic and international clients within the hedge fund and private equity sectors, and has extensive experience with fair valuation of various derivative products.

Texas, America's third largest fund domicile, is perfectly-placed to serve clients touching base between US fund market leaders California and New York. Scott Houdek of BNP Paribas and Steven Menna of Rothstein Kass, however, offer more than the domicile's benefits as reasons for its success. In a discussion that contrasts modern-day challenges with Texas' rich hedge fund history, they provide a rounded view of one of America's most vibrant jurisdictions.

HFMWeek: What are Texas' key strengths as a funds domicile? Why would a hedge fund manager choose to set up in Texas over other onshore funds jurisdictions?

Steven Menna (SM): Texas' strengths lie in its geographical location as opposed to it being a strong place for a domestic hedge fund domicile. Most onshore hedge funds nationally are domiciled in Delaware to take advantage of benefits received from a tax perspective. A hedge fund manager may decide to set-up shop in Texas as opposed to other jurisdictions due to cheaper overhead costs in comparison to New York or California, as well as the ease of travel between those two other aforementioned hedge fund locations.

Texas also offers advantages to the individual as there is no state income tax to individual taxpayers. It may also be a choice for a jurisdiction due to the many already existing hedge fund complex relationships that exist in the area including significant high-net-worth

family hedge funds (which spawned many other complexes in the 1990s) as well as the oil and gas money that is rich in the area.

Scott Houdek (SH): Similar to hedge funds in other parts of the country, many Texas funds choose to organise their onshore funds in Delaware versus their home state. However, there are many benefits Texas-based hedge funds experience by being based in the Lone Star State. One of these is the relatively low cost of running a business in Texas compared to New York, Greenwich or San Francisco. For example, things like rent, personnel costs, and service provider fees are often less than in other states. Other significant benefits for Texas hedge funds include lower personal income taxes (Texas has no state income tax), affordable living, as well as the fact that Texas is centrally located. This geographic advantage saves time and money for managers who travel across the country to research companies.

HFMWeek: In terms of assets under management, Texas has the third largest share in the US behind New York and California. To what do you attribute this to?

SH: Many factors contribute to Texas being such a significant hedge fund community, one being the fact that Texas is home to many hedge fund pioneers. None is probably more significant than the Bass Brothers from Fort Worth. The Basses began trading arbitrage strategies in the late 1970s and their enterprise has produced a

number of successful investors including well-known names such as Richard Rainwater, Geoff Raynor, Clint Carlson and the late Tommy Taylor, to name a few. You can trace over 15 current Texas hedge funds with lineage originating from the Bass operations. Additionally, Texas' strong oil and gas industry has produced many natural resource analysts, traders, and investment bankers that have started energy-focused funds.

SM: As mentioned previously, the birth of some of the earlier hedge funds in the region was as a result of the high-net-worth families and the oil and gas money that was prevalent in the late 1980s and 1990s. Many hedge funds spawned from those organisations as certain managers left to form their own organisations. The Texas hedge fund industry experienced significant growth through the years as hedge funds nationally grew in substantial assets under management and complexes.

HFMWeek: What are the greatest challenges currently facing the Texas hedge fund industry and how should they be overcome?

SH: Texas managers haven't been immune to the unprecedented market moves during the second half of this year. Both performance and retention of assets continue to be top concerns. We're seeing year-end redemptions in the 15-25% range for Texas funds. One advantage for the small and mid-sized funds in Texas is that many have a high percentage of high-net-worth money, and we've seen evidence that these investors may be more patient than their FoHF counterparts. Another challenge being discussed in the community is the issue of how to retain key talent. Ideas being discussed include modifying ownership structures to give more equity to key employees, paying employee bonuses out of partners' personal wealth, and renegotiating fee structures with investors to help retain team members as they work to recover their high watermarks.

SM: Some of the greatest challenges facing the hedge fund industry are not necessarily Texas challenges but global challenges. As hedge funds continue to see significant deterioration, continued bank/brokerage struggles and investor redemptions, survival is at the forefront of the mind of many hedge fund managers.



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Disregarding the current market conditions, Texas has had some trouble obtaining talent in the front, middle and back offices as personnel with significant hedge fund experience still resides primarily in New York and California. Many hedge fund shops in the area have talent that has been grown locally. Recruiting talent from other locations isn't always an easy endeavor.

Another challenge is the lack of administrators based in the area. The hedge fund complexes in the area that utilise an administrator are typically dealing with providers that are outside the state and thus don't get the benefit of reaching their providers in person on a routine basis.

When and if the market turns around many of these challenges will diminish as the overall market and the service providers that operate in it will gain strength in the area.

HFMWeek: What are the changes you expect to see in the coming year in the Texas hedge fund community?

SM: Clearly the market continues to be the biggest challenge facing the industry. Hedge fund complexes will need to operate leaner and make intelligent choices on how they trade and operate in order to survive. Liquidity will be a concern as investors look to move money and hedge fund managers struggle with illiquid investments.

SH: We expect Texas hedge fund assets to be approximately 40-50% less than the start of the year. Hedge fund investors are rebalancing their portfolios and increasing liquidity, negatively impacting hedge fund assets. These redemptions, along with poor performance, will lead to a number of changes in 2009. We expect a number of fund closures, downsizing of firms (we've already seen this at a few of the larger firms in Dallas), and a restructuring of terms to retain assets and talent.

On a positive note, the dislocation is causing some Texas managers to look at setting up opportunistic funds in areas such as high-yield bonds, distressed loans, mortgage related securities and converts. While the changes will surely be meaningful, Texans are resilient and will make the necessary changes to their businesses to be prepared to take advantage of the opportunities that will arise out of this challenging period. ■