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By Buying Prisma, KKR Bolsters Its Alternative-Assets Lineup

BY JAN ALEXANDER

Henry Kravis knows a thing or two about acquisitions, but the deal that KKR & Co. engineered in October 2012 promised to be particularly delicate. The buyer was an established company seeking new revenue sources. The target's capital came from investors nervous about changing anything. The principals of both companies had to see eye to eye; if the target's executives walked because the buyer wanted to impose its own ideas, the transaction might fail. So although Kravis; his longtime partner, George Roberts; and other KKR executives might normally advise an acquirer to cut costs, eliminate jobs and rethink the business, in this case they had to tread carefully.

The reason: The buyer was KKR. And the target, New York fund-of-hedge-funds firm Prisma Capital Partners, was KKR's first acquisition for itself — that is, not as a participant in a buyout.

Today, Kravis can say, "It's been a great marriage," despite the long and anxious courtship. It is a marriage, however, in which the two parties live apart and operate autonomously; that was part of the deal. Kravis and his KKR colleagues work out of the firm's elegant headquarters at 9 West 57th Street, just off Fifth Avenue and a short stroll from Central Park. The CEO of what's now called KKR Prisma, Girish Reddy, runs his firm from offices at One Penn Plaza, a new building that is one of the few examples of gentrification in a shabby, if bustling, part of Midtown near Penn Station and Madison Square Garden. Whereas Kravis has hung his own art collection at KKR, featuring work by Cindy Sherman and Edward Ruscha, Reddy's Prisma displays pieces by emerging artists, including almost-large-as-life photos of Mongolia by John Delaney, a former master printer for Richard Avedon.


Photograph by Dorothy Hong

KKR Prisma co-founder and CEO Girish Reddy

Reddy co-founded Prisma ten years ago with two former colleagues from Goldman Sachs Group: Gavyn Davies and Thomas Healey, who remain advisers to the firm. KKR Prisma is a sizable business now, with $10.1 billion in assets — No. 16 on the Fund of Funds 50, Institutional Investor's Alpha's ranking of the world's largest fund-of-hedge-fund firms. But KKR expects much more.

Funds of funds gained prominence in the 1990s, mostly for high-net-worth individuals and smaller institutions that wanted to invest in hedge funds. A fund of funds allocates its capital to multiple hedge funds, offering clients less risk than in betting on a few single-fund managers, and allowing investments in otherwise inaccessible funds. When Reddy and his partners started Prisma in 2003, they thought the future lay with institutional clients and customized portfolios; they were right.

The largest private equity firms have long been attracted to hedge funds. Blackstone Group — KKR's biggest rival — started a fund of hedge funds with partner capital in 1990, 17 years before the firm's public offering, then expanded it under J. Tomilson Hill, a former Lehman Brothers Holdings investment banker and executive. Hill is now CEO of Blackstone Alternative Asset Management, the largest provider of funds of hedge funds in the world, with $55 billion in assets.

Today all the publicly listed private equity firms — Apollo Global Management, Blackstone, Carlyle Group, Fortress Investment Group, KKR, Oaktree Capital Management — have diversified into other alternative assets, including hedge funds. Goldman Sachs senior analyst Marc Irizarry says total assets in publicly traded alternative-asset managers have doubled, from $420 billion in 2009 to $835 billion in 2013, while capital from non-private-equity businesses has grown from 56 percent to almost 70 percent. KKR remains more dependent on buyouts than its publicly traded peers: 60 percent of its $102 billion in assets comes from private equity.

These firms pursued diversification for a variety of reasons. There are natural limits in private equity, so to maintain growth these firms seek new asset classes. As private equity matures, firms focus on leveraging their brands. Younger managers clamor to expand to build their careers, while share prices get a boost from assets that run countercyclically to private equity. And most buyout firms want to offer investors more products, in some cases broadening offerings into liquid alternatives in hopes of cracking the retail investor market.

But getting hedge funds right isn't easy. In June, KKR liquidated its KKR Equities Strategies fund, a hedge fund it had formed in 2011 with a team from Goldman Sachs' proprietary trading desk. The fund had $500 million in assets; sources at KKR say it never achieved the scale they hoped for and that the firm wants to concentrate on Prisma, its credit hedge funds and seeding new hedge funds. In 2009, KKR wound down a credit hedge fund, the KKR Strategic Capital Fund, after assets fell from $1.35 billion in 2007 to a little more than $400 million, hurt, like many funds at the time, by investor redemptions. KKR still runs about $800 million in two credit strategies and owns a 24.9 percent stake in Nephila Capital, a $10 billion reinsurance hedge fund based in Bermuda. And it owns 100 percent of Prisma.

A fund of hedge funds can fit well into an alternative-asset structure. To some extent, a fund of funds removes a firm's vulnerability to the performance of an individual fund manager. Because clients in funds of funds are generally smaller or less sophisticated institutions than those in private equity, a firm can expand its base without the risk of scaring off core investors if things don't work out. Certainly, a fund of funds can go awry. Apollo Global Management bought a stake in a fund of hedge funds, Lighthouse Investment Partners, in December 2010 but reportedly is now trying to cash out after disappointing performance and disagreements over strategy.

Small wonder that KKR took its time over the Prisma acquisition — about two years. A fund of hedge funds is a complicated business that must cope with new complexities when it becomes part of a large, more diversified alternative-asset firm. Throughout the acquisition process both KKR, which has a long history of buying out hundreds of companies of all kinds, and Prisma, which specializes in carefully designing and constructing portfolios of hedge funds, clearly understood the special nature of the relationship. Now, after two years, the honeymoon and the adjustment period are both over, and the story of Prisma and KKR has truly begun.

PRISMA CEO REDDY SPEAKS of portfolios as precision instruments. "You should test the risk factors before you put the pieces together," he says. "When you add a new manager, how does his or her risk complement other managers'? You should test the portfolio at that stage, not after you make a 5 percent allocation."

Such exactitude is not accidental: Reddy studied engineering before he considered a finance career. Now 59, he was born and raised in Hyderabad, India, and earned a BS in electrical engineering at the prestigious Indian Institute of Technology Madras. He came to the U.S. to work on a graduate degree in engineering at Cornell University. Cornell had just started a three-year engineering and MBA program, which Reddy joined. He says the program opened up a new view of the world.

"One of my favorite courses was in derivatives, primarily focused on options and futures," he says. "At the time, derivatives and investment management were a big focus at Cornell, with two leading professors in the area, Andrew Rudd and Robert Jarrow, so it was a natural fit for me, and I ended up doing my MBA in finance." Rudd had co-founded analytic research firm Barra (now MSCI Barra), and Jarrow developed a number of derivatives models and techniques.

In 1990, Reddy went to work for Goldman Sachs in London, where he eventually co-headed the equity derivatives group; he became a partner six years later. Davies was in the London office too, as chief economist. Reddy considered the Zimbabwe-born, Cambridge University–educated Davies a "thoughtful policy guy." Healey was a partner in Goldman's New York office, where he was chairman of the pension services group and led institutional marketing. He saw that pension managers were starting to consider alternative assets. "Pension funds had large pools of capital and interesting investment ideas, and we perceived that there would be a growing interest in hedge funds," says Healey, who served as assistant secretary of the Treasury for domestic finance under Ronald Reagan.

The trio were at Goldman when the bank went public in 1999, a move that gave partners a share of the IPO profits but reportedly with a three-year lockup. Reddy elected to leave in 2002, at the age of 47. He declined to comment on any financial incentives but says, "I thought it was time to try something more entrepreneurial." He moved with his family to Summit, New Jersey, and began to explore new ventures. He became a director at his former professor's firm, Barra, in 2003. (MSCI acquired the firm the next year.)

Healey and Davies also left Goldman. "All of us had run our course at Goldman, and we all left within a six- to 12-month period, for different reasons," says Healey, who began teaching at Harvard Business School and participating in various investment partnerships. Davies, who had been interested in the economics of the media industry, became chairman of the BBC in 2001. He brought in ideas for funding and adapting to the web, satellite and other changing media technologies, but his tenure ended under a cloud in January 2004, after a U.K. judicial inquiry criticized the BBC for what even the broadcaster called "sexing up" a report on Iraq's capability for producing weapons of mass destruction.

The three former Goldman colleagues began talking. "We'd become business and personal friends, and we thought it would be interesting to do something together," Healey says. "It's always easier to start a business with friends who come from a professional background than with friends you've never worked with." They agreed it was time for a fund of funds that could tap into pension funds and other institutions that they knew wanted hedge fund exposure.

And Reddy had other ideas. "We felt there were a few gaping holes in the business at the time," he says. "Fund-of-funds managers took pride in their practice of not disclosing the names of the managers they invested with. We could never understand why." He wanted to show investors the moving parts of his fund. "I wanted to call the business Prism because it was transparent, solid and clear — you can see everything we do. But unfortunately, that name was taken. So we used a name that sounded as much like 'prism' as possible." Thus, Prisma.

At the time, neither hedge funds nor funds of hedge funds were required to register with the Securities and Exchange Commission or the U.K.'s Financial Services Authority. "But because of our institutional client base, we registered with the SEC and FSA well before it was required," Reddy says.

The three men launched Prisma Capital Partners in 2003, trading mostly their own capital, then expanded in 2004 through a joint venture with Aegon USA Investment Management, the money management unit of Dutch insurer Aegon, which acquired about half of Prisma and became the biggest investor in its portfolios. The venture opened with about $1 billion under management. Prisma's approach was attractive to insurance companies from the beginning. "Because we make the portfolio very transparent, the insurance rating agencies will often be better able to monitor risk, and therefore they'll require lower capital levels," notes Healey.

Prisma wasn't a full-time job for Davies and Healy, as it was for Reddy. But they made a lot of decisions together, including the need to emphasize risk management. At that time, most hedge funds and funds of hedge funds didn't devote much time or resources to risk. But Prisma's co-founders believed institutions would want a firm with a heavyweight in-house risk analyst. And they knew where to find one: South African–¬born Emanuel Derman, former head of Goldman's quantitative risk strategies group. A particle-physicist--turned-quantitative-analyst, Derman, who has taught financial engineering at Columbia University since 2003, is best known for his work with Fischer Black on the Black-Derman-Toy model used in pricing bond options and other interest rate derivatives, as well as for his books, My Life as a Quant: Reflections on Physics and Finance and Models.Behaving.Badly: Why Confusing Illusion with Reality Can Lead to Disaster, on Wall Street and in Life.

"We thought if we were going to do something industrial-strength, having Emanuel Derman as our risk architect would be the way to make sure we had something with strength and sophistication," Healey says. Derman joined Prisma as a senior adviser and, with Shankar Nagarajan, is now co-head of risk management.

The business grew slowly, says Reddy, but by 2006 hedge fund managers were recognizing that institutions tended to make longer commitments. By early 2008, Prisma had a respectable $5 billion in assets and opened a London office — just in time for the financial crisis. In spite of investor redemptions, the crisis proved a boon for Prisma, whose assets began to rise again in 2009. Unlike many hedge funds, the firm had the liquidity to return investor funds. And investors throughout the industry started demanding the transparency Reddy had long advocated. "Fortunately, by that time we had built a strong five-year track record," he says. At the end of 2008, he moved the firm from Morristown, New Jersey, to Manhattan.

Even as Prisma recovered from the crisis, the three founders understood that to attract major investors, which often demanded hefty discounts, they had to grow. Healey recalls that they decided to approach KKR about setting up a partnership. He had been a mentor at Goldman to Suzanne Donohoe, who had become global head of KKR's client and partner group. Meanwhile, KKR was starting to talk to fund-of-funds managers, and Donohoe suggested the firm meet the Prisma team. They went to lunch and chatted about trends in alternative assets.

In fact, KKR was quite serious about developing a stronger presence in hedge funds. Scott Nuttall, head of KKR's global capital and asset management group, traces that decision to the years after the dot-com bust — well before KKR listed in 2010 — and a growing realization that there were many investment opportunities beyond private equity. The 41-year-old Nuttall, who is viewed as a contender to lead the firm when Kravis and co-founder Roberts step down, says he was one of many who advocated getting into other alternative assets; private equity, he points out, has changed since he joined KKR in 1996.

"The amount of resources required to execute a private equity investment has gone up dramatically even in the past ten years," he says. "And now there's more competition, so you need to evolve to stay ahead of where the industry is going. What happened in terms of our growth strategy was really an unintended consequence. We were just trying to stay best in class in private equity. But as you do that, you build all these relationships with companies, and they start to call you and ask for your help with other things they're doing."

KKR, he notes, had mandates to put its investors' money into private equity. But in 2000 firm executives began keeping a spreadsheet of opportunities they could have invested in if they'd had the ability to say yes. "It became really depressing," Nuttall says. The pivotal moment came in 2002. KKR was about to finalize a deal to take Williams Cos., an energy infrastructure company based in Tulsa, Oklahoma, private. The company, which had an energy-trading unit, had suffered a loss at the hands of a rival named Enron Corp. and was undergoing a liquidity crisis. "The CEO called us on a Friday and said they needed a $900 million loan by Wednesday and that in return they'd give us $2 billion in securities on their proven natural-gas reserves and sell us a secured note plus a whole lot of warrants," recalls Nuttall. "It was a no-brainer as an investment, but our investors weren't paying us to invest in secured notes and gas reserves. In the end, Warren Buffett and some hedge funds gave Williams the loan and generated about 30 percent in 15 months. That's when we said, 'We have to expand.'"

The expansion began with a credit business, but KKR also wanted to move into publicly traded stocks, both long and short, and the firm began looking at hedge funds. "It became clear pretty quickly that Prisma was the team we wanted to work with, and they happened to have a business model that was exactly what we'd been hearing that institutions wanted," Nuttall says.

It also helped that so many of the parties in the deal had worked at Goldman Sachs. Early on, Kravis pointed out to the Prisma partners that he'd had a summer job as an analyst at Goldman when he was starting out. Robert Gottlieb, head of human resources at KKR, also came from Goldman, and Reddy was pleased to see that he had brought in recruitment, retention and performance-review processes that were like those that Prisma used — all derived from Goldman. And both companies had a penchant for taking their time when it came to hiring, requiring that recruits meet just about everyone.

"One of the things that was extremely important was whether the team at Prisma would fit into our culture," Kravis says. "We spent a lot of time discussing this, as we do with anyone we hire. We got to know Girish and his team by spending time with them. When you do that, you're getting a sense of the people. What are their values? Are they in business for the quick buck? Are they in it not for the whole team but for just one person who wants all the returns to come to him? None of that was the case with Prisma. They operated as one cohesive team. They passed the culture test with flying colors. But we spent a lot of time talking about these issues. We talked to our management committee at length about this. We wanted everyone in the company to get to know them, and they had to get to know us. When we're looking at a deal, we don't want to have the people involved saying, 'I like George Roberts or Henry Kravis, but I don't know anyone else there.'"

Healey recalls that in 2012, nearly two years into their talks and after KKR had announced an agreement to buy Prisma, Nuttall banged on a conference table and said, "Ladies and gentlemen, we are going to close this by October 1." They pulled it off. Aegon sold its stake but remained an investor. Neither KKR nor Prisma would comment on the price. Inevitably, the deal made some Prisma investors nervous. "We did two things," Reddy says. "One, we made sure we kept our firm independent. Two, we made sure our people stayed on. All of our key team members have a lot of their own funds invested in our portfolios and locked up, so that gave reassurance to our clients. And all of our top senior people agreed to be here for five to eight years on a noncompete basis."

The treasury division of the Alaska Department of Revenue, the investment manager for $50 billion in state funds including the Alaska Retirement System, put Prisma on a watch list, standard practice when a fund manager is acquired. Chief investment officer Gary Bader told the Wall Street Journal at the time that he was worried the deal would be a distraction.

Now, however, Bader says he is reassured by the strong returns. The Alaska manager's customized portfolio earned 12.3 percent in 2013 and 1.1 percent in the first quarter of 2014. "We talked with Girish and [head of client management] Helenmarie Rod¬gers at length about the change of ownership," he says. "With the passage of time and their explanation, we became more comfortable with it. We think it gives Prisma additional resources to do their work."

The firm's growth in assets since 2013 has come largely from public pension plans. Assets from U.S. public plans now make up about 22 percent of Prisma's investors, while 12 percent of investors are U.S. corporate plans and 18 percent are non-U.S. pension plans, both public and private. Other investors include endowments, banks, family offices and insurance companies.

TODAY, PRISMA HAS ACCESS to KKR's big balance sheet, which reduces its borrowing needs. (KKR also invests alongside Prisma's clients.) The firm also benefits from wielding KKR's capital and clout to negotiate lower fees for investors. Reddy believes that what he calls a seismic shift will force funds of funds to generate higher volumes and lower margins. "First, the industry moved away from a single-fund, one-size-fits-all approach," he says. "Now institutional investors have become more familiar with this space, and they want to deal with one organization that offers them a complete solution at a very attractive fee level, lower than they could get by doing it themselves."

About 60 percent of Prisma's portfolios are customized, as opposed to commingled in a single fund of funds. That's the direction large funds of funds are taking, says Robert Leonard, head of capital services at Credit Suisse in New York, who oversees the bank's prime brokerage business. Even before the financial crisis, funds of funds found that wealthy individuals and family offices weren't necessarily long-term investors. Some hedge fund managers preferred to work with funds of funds that catered to institutions, which were less prone to move capital, particularly after 2008. No fund really escaped redemptions, however. Assets in the 50 largest funds of funds had plummeted to $503 billion by the end of 2009 from $877 billion in mid-2008, and they have yet to fully recover, with $539.6 billion at the start of 2014. Customized portfolios have been one way to recast the business, with the largest funds of funds portraying themselves as advisers that tailor investments and risk management. "Institutional investors don't want a product off the shelf," Leonard notes.

Nor do they want to pay traditional fees, which can run as high as a 1 percent management fee and a 10 percent performance fee on top of the 2 percent and 20 percent hedge funds generally charge. Reddy calls those fees on fees "a Band-Aid that has been ripped off." Typically, Prisma clients pay management and performance fees of 1.6 percent and 16.8 percent, respectively; there's no additional fee that goes to Prisma. Still, a fund of funds needs a lot of capital. "It's a very high-touch business," Leonard says. "You need to spend money to attract and keep the most-talented people." Principals and portfolio managers have to spend a lot of time with clients, talking to them about what's happening and providing risk analysis, client global analysis and due diligence. The customized model can work, Leonard adds, as long as the volume of business remains high.

Traditionally, funds of hedge funds risk losing business as investors grow savvier about how hedge funds work. At some point, institutional portfolio managers start getting questions from their boards about those 1 percent and 10 percent fees on top of hefty hedge fund fees. Reddy is banking on the idea that institutional managers will want to stay with a fund of hedge funds that invests less with the biggest names than with start-up funds showing great promise. The key is "great promise." According to investment data firm eVestment, hedge funds that had been in business for two years or less had much higher cumulative returns than older funds between January 2003 and December 2013. The newer funds returned 210.56 percent over that time, compared with 128.93 percent for funds that had been running for two to five years and 123.69 percent for those that were more than five years old. A March 2014 survey by London-based alternative-asset data tracking firm Preqin found that investor interest in emerging managers has declined over the past few years, although the study notes that when investors allocate to an emerging manager, they are generally seeking expertise in niche strategies. That sort of evidence works to Prisma's advantage. Reddy acknowledges that many institutions are hesitant to allocate to emerging managers, but Prisma's extensive due diligence in finding the best among newer hedge funds provides reassurance, as well as a service that most managers can't carry out in-house.

Reddy has a rule about hedge fund strategies: They can run the gamut, but no multistrategy funds are allowed. Most managers in Prisma's portfolios are focused on a niche. "We prefer to invest with managers who do one thing really well, an inch wide and a mile deep," says Eric Wolfe, a senior portfolio manager at Prisma. "They might just pick financial stocks, or it might be that manager who really knows Canada or Asia. We look for managers who focus on a small universe where we think they're the best talent in that space."

Going in as an early-stage investor makes it easier for Prisma to negotiate low fees. Wolfe says it's also easier to analyze risk factors in a specific niche. That's important because, as Prisma's Derman admits, a fund of funds presents some special challenges. Though Derman now comes into the office just one day a week, the kind of proprietary risk analytics he designed for Prisma has become a crucial ingredient for many funds of funds, according to Credit Suisse's Leonard. "Investors and their boards are responsive to big-name risk analysts or a fund that has unique risk analytics," he says.

Derman's risk analysis looks at standard factors such as leverage, style drift and asset concentration. In addition, he has been studying some big uncertainties, such as how to compensate for illiquidity that comes with tail-risk protection, a kind of insurance against the market's blowing up that's usually obtained by holding put options that pay off if prices drop. He is trying to keep Prisma hedged against the risk of interest rates rising, which is why the firm now is investing much more in event-driven and long-short equity funds than in fixed-income strategies. Derman says Prisma has to be doubly careful because fund-of-funds managers don't have control over their market positions the way hedge fund managers do. "A lot of our risk management hangs on due diligence of the hedge fund managers — looking at what their supposed edge is and why they think they can make money in that area," he says. "We look at whether their systems and stop losses are good enough and compatible enough."

As KKR sees it, Prisma is the heart of a broader hedge fund build-out. The firm may seed new funds and it may acquire or start some of its own. As KKR's Nuttall says, "In addition to managing our own investment funds, we think there's a lot of room for innovation in terms of how we work with external managers through seeding, stakes and other strategic partnerships." ••