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FINANCE & ECONOMICS

Hedge funds

All locked-up

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Once investors fought to get into hedge funds. Now some may be fighting to get out

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NO ONE wants to be stuck in a house when the floor is shaking underfoot, however palatial the mansion. Some investors have found this out the hard way as subprime-related troubles have rattled parts of the hedge-fund industry, leading to steep losses at funds such as Sowood Capital, Basis Capital and United Capital Asset Management. Until recently, investors were jostling with each other to gain access to the best alternative investments. Of those who got in, some now face the opposite problem: how to get out.

That is because, in their eagerness to invest, they agreed to long "lock-ups", signing contracts with fund managers to keep their money in the fund for a minimum period before redeeming it. In a hard lock-up, investors have no right to redeem before their time is up; in a soft lock-up, they can get out early but have to pay a redemption fee of, say, 3-5%.

The cachet of investing in the best hedge funds meant a few celebrated managers were able to bargain for the longest lock-up periods. One of the most prestigious recently secured a ten-year lock-up—enough to withstand a Biblical plague, let alone a private-equity cycle. ESL Investments, the firm run by hotshot manager Eddie Lampert, has set up a fund with a five-year lock-up. Most funds manage only one to two years.

For managers, the benefits of lock-ups are clear. A fund with few restrictions on getting out attracts investors who like liquidity, but the ability to redeem money quickly can turn the fund into a ready source of cash when markets turn sour: investors tend to sell what they can, rather than what they should. Also the best trades often crop up at the point when investors are most nervous and markets are most volatile. As Dan Higgins of Fauchier Partners puts it, all managers want "dry powder in times of market stress."

Lock-ups have also enabled hedge funds to shift from quick-fire investment strategies such as convertible and merger arbitrage, where competition is fierce, into more exotic and less liquid areas. They include distressed debt, activist investing, lending, and buy-outs. It would be foolish for a manager to make a three-year loan when his own investors could cut and run within a year; the mismatch of assets and liabilities could be ruinous.

For investors, too, there are reasons why lock-ups make sense. Emanuel Derman of Prisma Capital Partners, a fund of hedge funds, has shown that for many strategies good hedge funds continue to outperform their peers and bad funds tend to remain in the same rut; there is little reversion to the mean. So investors in a good fund ought to be happy to stay put. Mr Derman calculates that an investor is likely to earn about 1% more per year when choosing a three-year lock-up over a more liquid one-year lock-up. But his evidence suggests that the lock-up premium reaches a limit of around 3% a year by the seventh year (so there's not much additional benefit from risking your money for longer).

And for those who are rattling the cages to get out, an escape network of sorts has sprung up. Companies such as Hedgebay Trading have developed a secondary market for hedge-fund shares. Typically, an investor can sell a stake for 1-5% less than its current value to another investor in order to leave a hedge fund. If the fund is particularly popular, the investor might even earn a premium on his stake. As for disasters like the recent Bear Stearns' casualties—bidders were offering five cents on the dollar for one fund in early July. It later emerged the shares were worthless.

So is an investor with a short lock-up safe? Not really. Not all investors get the same lock-up terms, and the ones with the longest—however short that may be—could be the last to collect their money. Also, fund managers have the ability to invoke “gates” , which restrict how much can be withdrawn in any period, as the managers of Basis Capital did recently.

Further fine print may give fund managers even more discretion. An activist fund with a big shareholding in a company may find there are regulations barring the sale of its stake during a takeover battle, for example. That constraint may enable the manager to stop or limit redemptions, says David Efron of Schulte Roth & Zabel, a law firm with many hedge-fund clients. In hedge funds, as in life, there is rarely a get-out-of-jail-free card when you need one.

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