Hedge funds for sale: going cheap

News analysis

The growing market for second-hand funds is hitting bargain basement prices, writes James Mackintosh

For sale: One hedge fund, hardly used, needs some work but nice runner, one careful driver – bargain price.

Don't expect to see this in the classified ads, but the quiet trade in second-hand hedge funds is growing fast as investors desperate to raise cash offer to sell at far below the face value of the funds.

Holdings in some of the biggest-name hedge funds are for sale at hefty discounts to their assets, after restrictions on withdrawals left many clients unable to raise the cash they want by redeeming.

Multi-million dollar stakes in Citadel's flagship Kensington fund, Harbinger Capital's flagship and the Children's Investment Fund are being hawked by investors on a new online trading facility set up by Cogent Alternative Strategies, a US hedge fund sales group.

Meanwhile, Hedgebay Trading, until December the only platform for buying and selling second-hand holdings in hedge funds, said trades doubled to $1bn last year and are continuing to rise. Even some banks are getting in on the game, helping to link buyers and sellers of frozen funds, in deals that should help everyone involved.

"It is really to do with providing liquidity, because hedge funds can't be immediately transformed into cash," said Elias Tueta, co-founder of Hedgebay. "If you have the ability to transform an illiquid investment into cash then you're providing a service."

Hedgebay has been running for a decade but volumes have been low until recently, hampered by managers being unwilling to allow trades to take place and the boom in the industry, which meant sellers only wanted to dump funds no one wanted to buy.

However, in the past year hedge fund investors have been badly caught out by unexpected losses and restrictions on withdrawals from hundreds of funds, as well as by the creation of "side pockets", where toxic assets are locked up until they can be sold.

At the same time, managers have moved from having waiting lists of investors wanting to put in money, to having queues at the exits, overcoming their reluctance to allow second-hand trades.

"The manager is benefiting because they are getting an investor who wants to be there instead of an unhappy investor," said Glen Beigel, chief executive of Cogent.

Hedge funds cheapen

Discount to face value in secondary market

Source: Hedgebay Trading Corporation

On Hedgebay, discounts have soared, with the average now at about 14 per cent, from zero a year ago.

Some of the funds for sale are closing down, including funds from Drake Management; are bankrupt, in the case of Basis Yield Alpha; or have assets caught up in the Lehman collapse, including Amber Capital's main fund. In 2007, a third of Hedgebay's volume came from sellers of disasters such as Amaranth Advisors or the Sphinx funds, but bankers say there are few buyers for such hard-to-value assets.

Investors buying in tend to be existing clients of the fund, partly because of the time it would otherwise take to carry out due diligence before a deal could be struck.

One sticking point for managers is the "high water mark", the previous peak of the fund which must be reached before performance fees are earned.

When investors subscribe for new shares they pay performance fees on all gains, but if shares are sold second-hand the buyers usually hope to keep the old high water mark.

Mr Beigel said high water marks were a matter for negotiation, and could be kept if the manager agreed, or reset in return for a bigger discount.

Still, platforms like Hedgebay and Cogent are closer to classified ad systems than they are to fully-fledged markets.

The platforms list "offered" and "wanted" ads from investors for funds, then act as intermediaries for anonymous negotiations on the price of a deal.

And even now, buyers and sellers are often far apart on price.

"There are a lot of opportunistic buyers out there," said Mr Beigel. "There's a good deal of activity between buyers making bids and sellers making offers but it is going to take time before bids narrow."

> 'There are a lot of opportunistic buyers out there ... there's a good deal of activity'

Hedgebay yesterday launched a pricing system allowing access to bid prices for funds for a fee, in order to make trading easier.

But much trading in the opaque second-hand market takes place privately, as investors sell to friends and institutions they know – sometimes with the help of managers, sometimes without.

Ken Kinsey-Quick, head of funds of hedge funds at London's Thames River Capital, has increased his holdings in some suspended credit hedge funds recently by buying at a discount from clients who want to exit.

"You can get things at even 20 or 30 per cent discounts," he said. He approached managers to find other investors desperate to get out, rather than using one of the marketplaces, and kept their high water marks.

Permal, a fund of hedge funds, is preparing to launch a fund dedicated to buying second-hand stakes to take advantage of the soaring discounts.

Some managers are organising auctions to help people get out of funds where the managers believe the underlying assets cannot be sold at a reasonable price.

GoldenTree Asset Management and Plainfield Asset Management, two US credit managers, have held Dutch auctions – where the price starts high and drops until a buyer is found – for funds with the help of Credit Suisse.

Exiting Plainfield investors sold at a discount of about 20 per cent, according to people familiar with the deal, and in both cases the buyers were mainly already investors in the funds.

"Anybody who's got a gate or suspended is thinking about their next steps and this is one of the next steps," said one prime broker, who said they expected many more similar auctions.