

## Hedge fund secondary market recovers some poise

After a torrid couple of years, hedge fund Net Asset Values started to show signs of moving from deep discounts to premium territory. But as David Walker explains, the revival has not been as swift or easy as many managers were hoping

You could hear the sighs of relief from exchanges earlier this year when some hedge funds began changing hands at a premium to net asset values for the first time since the credit crunch.

During the crisis, wide discounts on trades prevailed as investors who had looked unwillingly into open-ended portfolios used private exchanges to sell out quickly and at losses, and public exchanges experienced harsh forced selling of shares in closed-ended portfolios.

There were some opportunistic buyers on both markets, including investors setting up vehicles specifically to soak up cheap deals. But the meager demand could not match the flood of supply.

Private exchange Hedgebay did not have one fund transaction above NAV for 18 months, and steep share price falls on the London Stock Exchange led to a rash of buybacks and tender offers by the beleaguered sector.

### Private-public gaps

Edgar Senior, managing director and head of capital services at Credit Suisse in London, says participants on private markets had looked to discounts on the public market to gauge what was a reasonable gap.

Between May 2006 and September 2008, this seemed a reasonable practice, as the two transacted within about four percentage points of one another. Then the relationship collapsed.

On public exchanges, the average discount hit 29%, its widest point in December 2008. On Hedgebay it took a year longer for the extreme to be reached, at 20%. By March

2010 the gap was back within four points, but Elias Tueta, Hedgebay's founder, said curbs on redemptions weighed heavily on discounts for open-ended funds traded via private markets.

While noting that family offices and other sellers are no longer offloading stakes on Hedgebay at almost any price, as they once did, Tueta added private markets should experience the wider discounts for some months yet.

"I would expect this trend until the clean-up process of illiquid positions is completed. Then we shall see hedge funds will trade again on the [private] secondary market at narrower [discounts] to NAV than listed funds," he said.

### Discounts

Niall Campbell, head of alternative investments at brokers Tullett Prebon, says, even though a handful of funds have now swapped hands at modest premia to NAV, the primary attraction of secondary markets – to buyers at least – remains the discounts.

On public markets the gap in favour of the buyer currently averages 9.5%, according to Royal Bank of Scotland. On Hedgebay, it is 15%.

Andrew Weir, senior analyst at \$2.7bn investor Stierham, said his firm has steered clear of funds that traded at sharp discounts because of some form of impairment to them. Stierham used the private markets once, in 2007, to top up an existing holding in a fund at a marginal premium to NAV, he added.

Tueta and Weir agree due diligence when buying funds on private markets is crucial.

Campbell contended that in off-exchange trading it is more the value of the fund itself that guides where NAV units change hands, whereas the levels on public markets are more a reflection of supply and demand for shares.

Of both models, however, he said: "Buying something at a 2% discount to NAV means you have made 2% before you have even started, and that is good for investors targeting 8% to 9% returns in this low interest rate environment."

### Board action

Tullett Prebon is pricing up to 50 funds for investors at any one time, Campbell says.

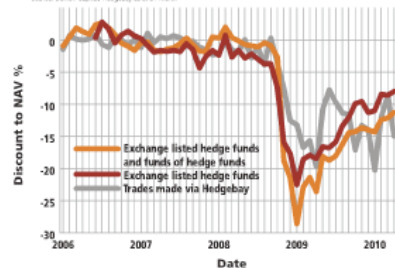
Robin Bowie, chairman of listed fund of hedge fund promoter Dexion Capital, said what is important for investors in closed-ended portfolios is how boards act to narrow discounts when they appear, and provide shareholders with exits if required.

The listed hedge fund universe returned approximately XX% of its assets to investors via corporate actions since September 2008, according to analysis by Winterford Securities.

Dexion's Bowie said greater demand for listed funds has closed discounts on those funds first, as arbitrageurs buy in on the hope some portfolios might fail continuation votes, then be

### Hedge fund NAVs

Source: Dexion Capital, Hedgebay, as of 31 March



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wound up and have cash returned more quickly.

Shareholders can leave listed funds inside three days, he said, even if taking a hit via a discount is the price to be paid.

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He said only the regulated public exchanges show bids and offers immediately on demand. Improved corporate governance has made the sector more transparent, he added. "In the listed sector there have been

examples of boards sacking managers," he added, "whereas it is so seldom in life people protect shareholders over managers."

Daily trading volume has also returned to exchanges, Bowie said, and it now sits between 0.15% and 0.25% of a fund's

market capitalisation, compared to about 1% for other listed entities.

Andrew Todd, chief investment officer at BlueCrest Capital Management, said one further benefit of buying funds via secondary markets is the ability to access portfolios otherwise closed to new investors.

Two of seven hedge funds managed by BlueCrest, which the listed AIBBlue portfolio invests in are shut to fresh investors, he said, making AIBBlue the only easily accessible route now left to access these managers.

AIBBlue was the first fund after the crunch to be able to raise fresh capital via a share issue, and it is doing so again now. Despite adding to the pool of its equity in this way, AIBBlue's shares now trade 3% above NAV, partly due to the 'access' argument.

### Private markets

It applies just as readily to popular funds changing hands on private markets, of course, and one broker said portfolios such as Lansdowne Partners' capped UK Equity fund or Nevsky Capital had regularly appeared on his list of in-demand managers.

But, speaking generally, Credit Suisse's Senior said managers usually must approve transfers of interests in their fund before investors can buy in using off-exchange routes.

Some open-ended fund managers may prefer to repurchase units in their fund from redeemers, and so remain in control of which investors step into the portfolio.

However, for many long-short managers at the moment, giving initiated investors a rapid exit from a fund via a secondary market sale may be preferable to having them left stuck in it. •

David Walker is a senior asset management writer at Investment Week

### Who are the players in secondary markets?

Three main motivations have underpinned participants in secondary markets.

Credit Suisse's Edgar Senior said one group of investors has sought to build holdings in funds at a discount to their NAVs, to hold as the managers' fortunes turned around.

The hedge funds may have been restructuring, or had exits temporarily closed, hence their appearance on secondary markets. "If you buy a hedge fund at a 10% discount, that is an uplift on performance you get from it," Senior said.

Additionally, since the financial crisis some funds have raised enough fresh capital to close to new investors again. Lansdowne Partners' UK Equity fund was one such portfolio, leaving the secondary market as the primary route in. Nevsky Capital was another, although its co-managers have announced they will step down next year and expected redemptions have followed.

A second group of buyers, one participant said, established funds deliberately short-term in nature to buy units and sell them at a profit as conditions, and discounts to NAV, improved. In some months, this strategy would have made handy profits. The average discount to NAV on Hedgebay narrowed by 4.4% in October and 9.3% in



Credit Suisse's Edgar Senior

January, assuming funds could be bought and resold in just months. However, in November traders would have lost 6.2% last September on a widening of the average discount to NAV, and another 7.3% in December.

The third group of investors were experts in asset classes such as credit, and bought into funds to agitate for in-specie redemptions. Such payouts occurred in a handful of cases, where hedge fund managers paid out redeemers in portfolio investments, rather than cash.

The participant said: "In early 2009, a number of products suspended or gated funds, and some managers of those funds redeemed by delivering instruments to investors. Some investors wanted to buy the distressed fund's shares, then force [this] payment in kind."

Many investors such as pension funds had little way of managing a handful of securities directly, but for investors who did, they could receive the distribution of their proportion of the fund's underlying investments, and either manage it themselves, or sell it down over time.