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Evolution of the Secondary Market for Hedge Funds

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What began as a means to assist institutional investors in buying and selling stakes in highly sought-after hedge funds has evolved into a global OTC market where hedge funds and other alternative assets, like private equity, are traded on the secondary market in order to dramatically improve investor liquidity, which has notably deteriorated with the proliferation of longer lock-ups and the extreme demand for high-quality hedge fund returns.

Historical Perspective

Back in the mid-90s, there were only a few hedge fund managers who had funds that limited liquidity to periods longer than three months (for example, Tiger Management and Long Term Capital Management). Most of the premier managers, the substantial majority of whom are still very much in business today, had very good liquidity terms ranging from monthly to quarterly. As a result, the transactions I was involved with most often centered around investors who were interested in rebalancing their portfolios to either reduce the size of funds that had done so well that they were too large, or to increase the size of a fund that had closed to new investment. Consequently, these transactions almost always took place at a premium to net asset value (NAV).

As the hedge fund market grew, both in number of participants (managers and investors alike) and in the sophistication of the strategies being offered, it became clear that certain strategies were going to be capacity constrained at some point and, more importantly, that the demand for these strategies was overwhelming. What transpired comes as no surprise: managers with solid performance began to command better and better terms from their investors. This was true not only with respect to the fee payable to those managers (i.e., higher management and incentive fees), but also (and more importantly) from a liquidity point of view. With a wave of demand coming at funds, it was clear that investors would be willing to lock up their capital for longer periods in order to be granted access to the return that the manager was delivering.

This appears to be where the market is heading: better liquidity for investors without detriment to the funds or the fund managers.

In the mid-90s, the typical investor who participated in secondary market transactions was a fund of funds. Today the range of market participants has expanded to include not only funds of funds, but also ultra-wealthy family offices, banks, pension funds, endowments and foundations. All of these investors are trying either to add to their investments in hedge funds that do not accept new investment, or to withdraw from funds having long lock-up periods, preventing quick redemptions, or that have no liquidity at all. This appears to be where the market is heading: better liquidity for investors without detriment to the funds or the fund managers. The secondary market acts as the facilitator-agent for investors seeking to purchase and sell interests in hedge funds. Because it is not dependent on a common domicile, the existing secondary market provides the most efficient of pricing mechanisms.

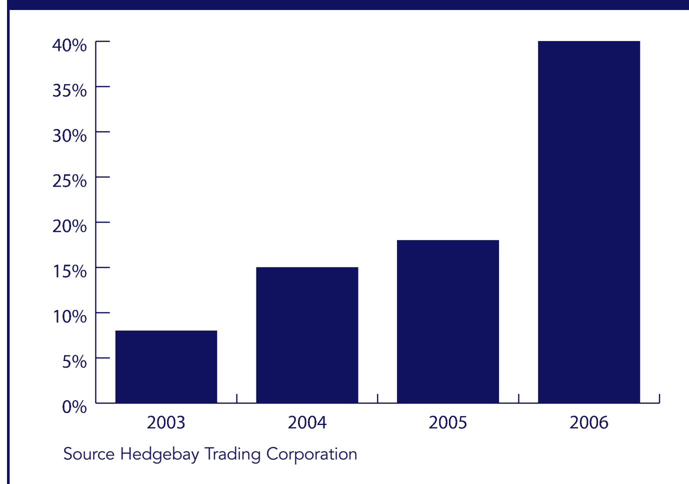
Evolution from Access to Liquidity Strategy

The best way to get a sense of how the market has evolved and/or rotated from an access strategy to a liquidity strategy is by looking at the Hedgebay liquidity indices. On the access side there is the secondary market premium index (SMPI), which

reflects the average premium investors were willing to pay to acquire shares of a fund closed to new investment.

Over the last four years, the premium that investors have been willing to pay for an in-demand hedge fund has been falling. Premiums that averaged almost 2.7% in 2003 have fallen to 0.9% in 2006. This fall in premium has been a direct result of two factors. The first is the reduction in performance of the hedge fund industry as a whole. The second is the trend towards longer and longer lock-ups by quality hedge fund managers. Taken together, investors are saying they are unwilling to pay more for a less liquid investment the returns from which have degraded.

On the other side of the equation is the secondary market discount index (SMDI), which reflects the average discount investors were willing to accept to get liquidity from a hedge fund investment. What the data from this index shows is twofold. First, the frequency with which investors have been willing to avail themselves of the ability to get liquidity has dramatically increased over the last several years. Second, the levels of discount that investors paid to get liquidity were reasonable.
The net effect of hedge fund redemption provisions is that they prevent investors from reinvesting redemption proceeds timely or efficiently, with a consequent loss of value. The following example illustrates this effect.



Example of a Hedge Fund Redemption

If you are an investor in a typical hedge fund with quarterly liquidity and 45-day notice, your practice is to provide notice of redemption which is then confirmed by the fund. You wait 45 days until the end of the quarter, but have to wait perhaps a further 10 days, until approximately the 10th business day of the next month, to receive an estimated 90% of your redemption proceeds, far too late to reinvest those proceeds in another hedge fund. And, what happens to the remaining 10%? That generally is distributed in the following year after the audit is completed.

On average, an investor who redeems from a hedge fund, regardless of the liquidity, is un-invested for two months. With a 12% annual return target, the cost is 2%. This is a significant opportunity cost, particularly for a fund of funds that competes fiercely for investor capital.

Many investors utilize credit lines, but credit lines merely mitigate a portion of the lost opportunity cost, and at no small price. With LIBOR above 5% and the spread for most lines of credit at 100bp, the opportunity cost is reduced to perhaps 1% — that is, NAV = +/-99. Better, but not NAV and you still have to chase the remaining 10%. Therefore, an investor considering redeeming its interest in a hedge fund should be prepared to arbitrage the opportunity cost in the secondary market by selling the holding at a discount that is less than, or at worst equal to, its opportunity cost.

Left out of this discussion are the risks inherent in redeeming hedge fund interests in the customary fashion. For example, market risk. Two other risks are the lost opportunity of tactical or opportunistic allocations and tail risk (the risk that the fund from which you have redeemed has an extraordinary loss event). Those risks alone may have a value of at least 1%. So, is 99 your "real" NAV? Or is it 98?

Regardless of what type of participants are involved in a given trade, manager permission for a transfer of ownership is requested once the terms of a transaction have been agreed by the two parties. As a result, the transaction is 100% transparent to the hedge fund manager.

Regulatory Perspective and Outlook

Equally as important as the terms of the transaction is the regulatory perspective. What is clear is that purchase and sales transactions in the U.S. are subject to regulation by the NASD and the SEC, and purchase and sales transactions in the United Kingdom are regulated in the United Kingdom by the FSA.
Counsel for Hedgebay and for managers involved in secondary market transactions have determined that there are no legal or regulatory impediments, restrictions or limitations to secondary market transactions executed by Hedgebay. On the contrary, a variety of regulators around the world have welcomed the

development of the secondary market. (For additional information, refer to the *European Central Bank June 2006 Financial Stability Review* – page 140 and footnote 241 in the SEC's response to the ABA.)

What is clear is that the secondary market for hedge funds is in growing demand from investors. Volume levels have increased, investor adoption has accelerated and there is no sign that the trend for longer lock-ups will abate, let alone reverse, any time soon. As more and more managers become aware of the opportunities offered to their investors and to them by the secondary market, it is likely these secondary market trends will accelerate.

Hedgebay provides the gateway to the secondary market for hedge funds. As the leader in secondary market-making, Hedgebay is preeminent in matching sophisticated buyers and sellers of hedge fund interests and other illiquid alternative investment assets. Founded in 1999, Hedgebay has been successful in sourcing, executing and settling billions of secondary market transactions. Hedgebay's clients include funds of hedge funds, ultra high-net-worth family offices, banks providing leverage and structured products, pension funds, and endowments and foundations. For additional information, contact the author at ***jared@hedgebay.com***.

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