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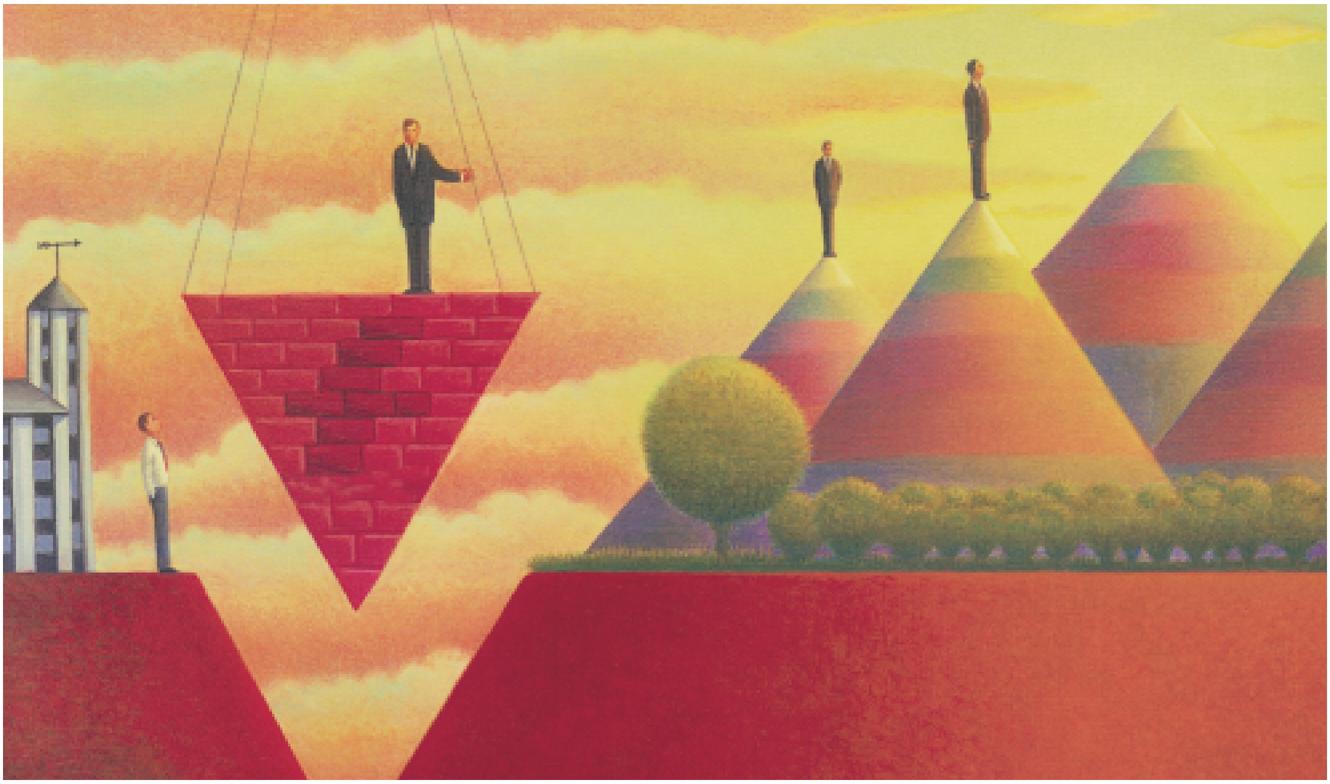

Matchmakers fit investor needs to manager demands

Secondary market trading is booming despite resistance from many funds

writes Sarah Wood

Trading of hedge funds in the secondary market is flourishing and is showing every sign of increasing as managers handcuff investors with increasingly long lock-ups. On one day in September, blocks of shares in 150 funds were on the auction block at www.Hedgebay.com. The greatest demand was for especially well-regarded long/short and global macro names.

On the other side of the equation, investors were seeking to sell $43 million of shares from a single convertible arbitrage fund, more than those of any other money manager on the site. Interestingly, there was as much money ($10 million) chasing shares in a leading multi-strategy fund as there were shares in the fund that were up for sale.

No one knows exactly how many hedge fund shares trade on the secondary market. Hedgebay, which is believed by investors to have booked several hundred million dollars in trades since its launch four years ago, is only one of the growing number of places that eager non-U.S. investors can buy and sell funds – a trend that many managers dislike because they no longer control their share register.

Among the other marketplaces are many of the Swiss private banks, which offer their customers the chance to buy and sell funds through nominee accounts. The beauty of the system is that the manager has no idea that their shares have been traded because the underlying investor has not changed – the private bank's nominee account will still be the registered investor.

Other secondary trading platforms are Astaire Partners, the London-based stockbroker, which trades Soros and Caxton funds, Geneva-based Quaker Securities, and commercial banks, such as BNP Paribas, Societe General and RBC, which have also got into the act through their huge business of trading exposure to the same pools of hedge funds that they buy to secure principal-protected notes and other leveraged investments. In particularly efficient transactions, the banks can sell the underlying hedge funds' returns to investors through total return swaps, call options and other derivatives.

"I would guess that we're just on the tip of the iceberg," says Jared Herman, a principal of Hedgebay, one of the most transparent dedicated hedge fund trading platforms. Herman, formerly of Westport, Connecticut fund of funds Weston Capital, launched Hedgebay in 1999 with partners Elias Tueta, a former bond and warrant trader who was previously with HSBC, and Jocelyn Sadegh, who has run a family office and once worked with the private bank CBG.

Herman points out that at least 500 hedge funds are now closed to new investments, forcing investors who want access to the best funds to turn to the secondary market. What's more, the secondary market allows investors to avoid the risk of a decline in the NAV between filing a request to get their capital back and actually getting it back. They are also spared the opportunity cost of having to wait to invest their capital with another fund.

People familiar with the secondary market argue hedge funds have begun to look more and more like private equity funds, demanding multiple-year lock-ups and then placing strict "gates" on the total withdrawals that can be removed each quarter, it is only natural that hedge fund investors have begun seeking the same kind of liquidity relief from a secondary market that private equity investors have long had.

Trackers of the secondary market repeatedly referred to Caxton – particularly when it was clocking 30%-plus returns – as the hotly-traded hedge fund. It is perhaps no surprise, then, that the firm started its own controlled secondary market, which has been run by Astaire Partners of London since 1998.

Using a pre-set, rather than a market-determined premium, Astaire matches buyers and sellers in both Caxton Global Investment and the Soros Fund Management's Quantum Endowment Fund, charging the counterparties nominal brokerage fees for their trades. Caxton, despite netting just 1.47% through September 22 of this year, is trading at a bid of 5% and an ask of 5.75% – the highest level it has traded at since the late 1990s, when it was offered at a premium of as much as 12% and an ask of about 9%.

But Caxton and Soros are somewhat of an anomaly in their wish to facilitate secondary trading. While Tudor Investment and Trout Trading once encouraged secondary trading through private bank nominees to simplify their own investor relations, many hedge fund managers – particularly younger, U.S.-based managers – don't like their shares traded. Many managers are uncomfortable with the idea of their funds selling at a premium that is collected by someone else – and especially do not like being traded at a discount. Moreover, they don't like the fact that they are unable to control who invests with them.

Typical hedge fund documents reserve this right to approve of transfers of hedge fund shares, and, since the recent passage of the U.S. Patriot Act, money managers have been forced to know their clients – or to be very careful in delegating that responsibility to other parties, such as bank nominees.

Private bank nominees vouch for their clients, but employees at banks say they now often notify managers before trading their shares. They acknowledge that despite low transaction fees, totalling less than 1%, the combination of the Patriot Act, the greater awareness of secondary trading activity by unreceptive managers, and lackluster returns have contributed to a general recent dampening of trading at their banks.

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Notably, the twin challenges of Hedgebay obtaining the hedge fund managers' approval for a trade and the investors' pursuit of due diligence on a closed manager, has meant that most matches made on Hedgebay have been made with investors who are already in the fund that they are buying, and are simply looking to build up their positions. The fact that the investor and manager already know one another eases the transfer, and, in turn, much of the firm's business is now from repeat customers.

Whether managers like it or not, everyone expects secondary trading to continue growing, particularly when there is an uptick in hedge fund returns. And the biggest sticking point – approval by managers – is showing some signs of softening. Managers are increasingly grasping the benefits of secondary trading, such as improved capital stability, and seem to be willing to accept that it is the price they have to pay for the longer lock-ups they are increasingly imposing on investors.

"It's good for the managers because they can continue to get locked-up capital," said Shane Gadbaw, a managing director of XE Capital, a New York firm that offers hedge funds, fund of funds and advisory services.