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Hedge fund losses help secondary trading

The lacklustre performance of the hedge fund industry over the first half of the year has sparked increased demand for secondary trading in hedge fund stakes among investors. Each of the 23 strategy sub-indexes within the overall Hennessee Hedge Fund Index posted at least one month of negative performance over the first six months of 2005. Over the same period, trading volumes on Hedgebay, a Bahamas-based online secondary market for hedge fund stakes, reached their highest level since its inception in 1999, with around 10 transactions executed each month.

"The stakes that are being sold are on average around $3 million–5 million, and the third quarter was a very busy time," says Jared Herman, one of the firm's founders. Around 700 non-US hedge funds are included on Hedgebay's database, most of which are closed to new investment or are illiquid.

The increase in interest in this niche market was, in part, caused by investors wanting to unload stakes in convertible arbitrage and credit funds earlier this year. These strategies took a battering during the second quarter, with the Hennessee Convertible Arbitrage Index down 7.1% over the first five months of 2005 – the strategy's worst performance in more than a decade. Although some investors were quick to spot the value of a liquidity platform such as Hedgebay, Herman says that it also highlighted many investors' irrational reasoning that it's always better to sell at net asset value (NAV).

Reluctance

For example, when one fund began to hit the skids in April and May, buyers were bidding for a stake with a discount to NAV of around 2%. "At the time, some investors were reluctant to sell at that discount, believing that the situation would turn around if they held their nerve," says Herman. "They were indeed able to exit the fund at NAV 30 days or 60 days later. The trouble was, the NAV had dropped by substantially more than 2% in the interim."

On Hedgebay, deals are struck at a best estimate of current NAV, plus or minus a discount. When the fund's third-party administrator subsequently calculates NAV, any discrepancy with the initial estimate is reconciled.

Once a deal between buyer and seller is agreed in principle, Hedgebay approaches the hedge fund manager to seek their approval for the stake sale. "Investors are able to capture the opportunity cost of redemption," says Herman, referring to the period of time investors attempting a traditional exit manoeuvre remain un-invested as they await payment of redemption proceeds. Such investors typically have to wait two months, adds Herman. The firm charges a fee of up to 1% of the face value of any deal it successfully intermediates. Its clients are institutional investors, including funds of funds, ultra-high-net-worth family offices and banks.

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