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Secondary Trading in Fund Stakes to More Than Double in 2013 –Simplify

NEW YORK--With restriction on trading investments in hedge funds and private equity loosening, investors are increasingly turning to the secondary market to trade these private-fund interests, and the notional value of these trades is expected to more than double to $146 billion next year from an expected $65 billion this year, according to Simplify LLC, a provider of trading and risk products to investors.

While there is no centralized marketplace for buying and selling investments in private funds, investors often shed underperforming funds or rejigger their portfolio mix with the aid of brokers who handle the trades.

Secondary activities heightened in the aftermath of the financial crisis, as fund values plunged and investors were desperate to liquidate investments to free up cash. Investment managers, meanwhile, are increasingly more relaxed about letting investors with liquidity issues sell their fund stakes, doing away with lock-ups and fees on redemptions that discouraged capital withdrawal.

Some managers even have internal systems to match buyers and sellers to facilitate trading, though most of the flow is handled by brokers.

In its survey of 500 investors conducted between May and July, Simplify found that two-fifths of the secondary trades are in the $2 million-$5 million range, but a quarter of respondents said they have traded interests with a larger notional value.

The company expects the heightened level of secondary trading to continue for the next three to four years, on continued divestments by cash-strapped European financial institutions. U.S. banks, restricted in the type of investments they make with their own capital, are also potential sellers.

Simplify's founder Brian Shapiro said other U.S. investors, like pension funds and endowments, are also likely to sell their fund stakes, as they are in much better shape to bear the related losses.

"As the portfolio is going up (in value), it is easier to conceal the losses of nonperforming assets," he said. "The optics are better."

Simplify said forced sellers--motivated by liquidity needs or issues like changes in investment professionals--accounted for 30% of responents, while 55% of the respondents cited buying at a discount as the principal motivation behind a trade.

"With secondary trading, over the last two-and-a-half years, investors have been buying the average legacy asset at 30 to 60 cents on the dollar," said Jared Herman, a co-founder of secondary hedge fund trading platform Hedgebay Trading Corp., referring to securities whose prices are still hurting from the financial crisis.

Steep discounts on asset values can be enticing to investors who are optimistic that funds' underlying investments have the potential of appreciating as economies improve. This gives investors an additional source of profit on top of funds' returns.

Some active secondary investors have posted substantial gains from scooping up fund stakes over the past few years. Simplify, citing data provider InvestHedge, said a Permal Group fund focused on trading secondary hedge-fund stakes recorded a net return of 34% since inception in June 2009. The New York-based fund's performance is among the highest of funds formed in the same period.

But buying into secondary fund stakes carries risks as well. Fund interests traded at steep discounts are often illiquid securities placed in so-called "side-pockets" or a separate vehicle as prices were so depressed during the crisis. Mr. Herman said it may take four to five years for such investments to return a profit.

Considering all hedge funds, Hedgebay said stakes traded at an average discount of about 4% in July--a far cry from the slight premium investors paid in early 2000s as they clamored to get into funds that were closed to new subscriptions, but substantially higher than the 25% discount a year ago.

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