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Mosaic: the latest way to keep trading tap flowing

As if to prove financial innovation is alive and well, a trade has emerged over the past 12 months that will help investors extract some cash from otherwise illiquid hedge fund holdings, with the potential for their counterparties to make large profits.

Investors have been trying to deal with the problem of illiquid hedge fund stakes since the collapse of Lehman Brothers four years ago.

Many hedge fund managers discovered in late 2008 that they could not meet their investors' redemption requests because they could no longer sell all of the assets in their portfolios.

The best they could do was park the illiquid investments, including assets such as mortgage-backed securities, into what the industry refers to as side pockets.

High net worth individuals and funds of hedge funds discovered, to their anger, that this portion of their capital was locked up, possibly for years.

The initial solution to this problem was to use the secondary market, where investors buy and sell stakes in hedge funds. Funds are still being launched to purchase the stakes on the secondary market.

New York-based LSV Advisors has already successfully raised $800m in three funds since its foundation in 2008, and is currently planning to launch a fourth. LSV declined to comment.

But Benjamin Keefe, of advisory firm Gamma Finance, estimates there are only about two dozen meaningful buyside players. Keefe said: "It is still a small club of deep-pocketed investors often backed by big institutions."

Drip, drip, drip

Some of those who own stakes in these side pockets are forced sellers, such as funds of hedge funds under pressure from their own investors. But there are plenty of other investors in side pockets under no pressure to sell.

The easy trades have now been done, according to Neil Campbell, head of alternative investments at broker Tullett Prebon. "The bulk of transactions, I would argue, have happened. It's probably got another year to 18 months to go," he said.

Whereas the average discount to net asset value on trades was 90 cents on the dollar a few years ago, Campbell said discounts are now 30 to 50 cents on the dollar: "Average discounts are falling, which indicates that we're coming to the end of the cycle."

Jared Herman, one of the founders of Hedgebay, a pioneer in the hedge fund secondary market since 1999, agreed that the volume of deals is falling: "The pace of forced selling has slowed compared with 2008, 2009 and 2010."

Over the past two years, Hedgebay's Illiquid Asset Index has been running at between 30 and 60 cents on the dollar. Herman said: "We're at the upper end of that range right now."

Mosaic trade
But while the scope for plain trades on the secondary market is petering out, there are still investors that would like to liberate their cash from illiquid hedge fund holdings.

Campbell estimates that $50bn to $60bn remains in hedge fund side pockets globally. These investors need a new solution.

To help these investors, Gamma Finance has pioneered what it calls "mosaic transaction" solutions. The portfolios are sliced up into different sorts of assets, with each slice appealing to different investors.

For example, a fund of hedge funds with stakes in the side pockets of 20 hedge funds can place its stakes in credit-related funds with Buyer A, and its stakes in emerging markets-related hedge funds with Buyer B, Keefe said.

Those who can buy the stakes and hold them may do well. Herman said: "I can't think of one place right now where I'd be [more] confident of getting 25% rate of return per annum."

Richard Watkins, chief executive of Liability Solutions, a third-party hedge fund marketer, said: "If I were a pension fund or endowment fund I would absolutely be in this space. It's one of the top areas of the hedge fund market. It offers huge potential.

"Existing investors are saying: 'If you buy the whole portfolio, I'll take 40 cents on the dollar', whereas individual positions might well be worth 60 cents on the dollar.

They are giving away these small positions because there's no chance of them ever being sold separately."

The middle men could do well out of it, too, Watkins said: "I get the impression that there are more intermediaries than there are genuine end buyers.

Some buyers have told me that, when they see an offer, they sometimes have six intermediaries all showing them the same thing."

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