SECOND WIND

Post-financial crisis, the secondary market has looked promising – but as liquidity demands increase, how long can the activity bump last?

BY ROB LANGSTON

Since the financial crisis, the secondary market has played a central role in helping managers to free up liquidity to meet investor redemptions, while also providing a hunting ground for funds with longer lock-ups. Indeed, current data suggests trading volumes have remained steady as established names and new players alike seek outsized returns.

Initiatives this year include J.P. Morgan's joint-venture with Texas-based firm Crestline Investors and fresh interest from Blackstone. Credit specialist Avoca Capital, Betzwood Capital Management, BCM & Partners, RiverNorth Capital Partners, UG Investment Advisers, and Waterfall Asset Management, are among the active players listed by BarclayHedge.

"I would probably say that volume is still the same – maybe a tenth of private equity secondary volumes, something between $2-3bn per year," says Neil Campbell, head of alternative investments at Tullett Prebon, adding that many of the transactions are in the prime or distressed ranges, with the latter dominated by asset-backed lending and loan funds.

However, while current data is generally considered healthy, some observers have questioned how long the purple patch can last, as investor demands nudge the industry towards wider use of flexible liquidity terms. Hedgebay itself recently conducted a survey of secondary market investors seeking suggestions for how to improve efficiency and information in market trading. Greater transparency and education may have come as little surprise, but requests for pricing improvements may prove more telling.

"The people that do sell, generally have a reason to do so that is not necessarily connected with what's inside the side-pocket," says Jared Herman, founder of Bahamas-headquartered Hedgebay, citing the cost of maintaining the structure and the asset being the last in the portfolio as among the key reasons. "Relatively few are selling because they have a view and believe the market has overpriced."

He continues: "The people that own these things and don't need the money are not selling, but they are pricing – and there are a lot of people doing that. There are a lot of people asking 'how is this asset doing?' or 'how is that asset doing?'. It's almost exclusively for intellectual curiosity or for discussion with an investor or a board."

Derek Watson, managing director of Wake2o, a specialist intermediary in the secondary market and parent to the wake-x platform, is another to note stable trading volumes. "Positive performance of side-pocketed investments has allowed investors to sell their illiquid holdings with a minimal impact to their performance," he says.

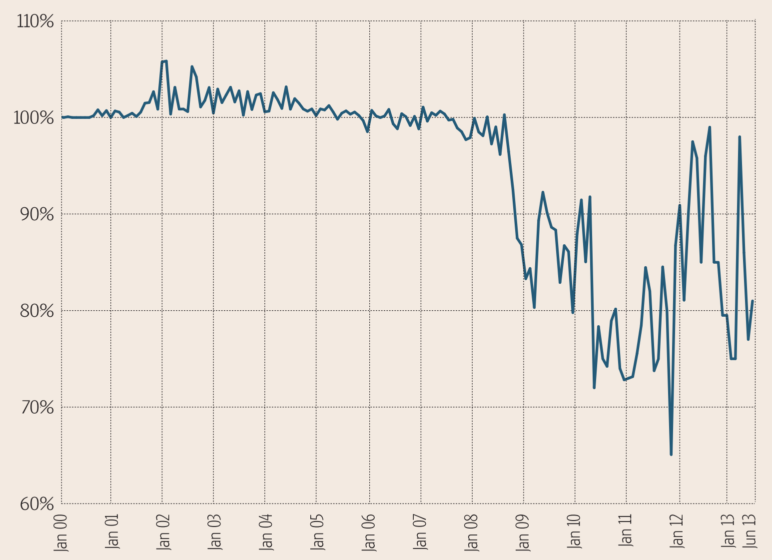
Hedgebay data reveals that the average price of trades had risen back to 81% of net asset value (NAV) last month, up from 77% in May – although the discount to NAV recently touched as high as 98% in March. There is also a wide spread of prices for different assets with the lowest recorded trade last month struck at 29% of NAV.

Watson also notes that the largest activity for investor logins at Wake2o is at quarter end, "which would indicate that managers are pricing their portfolios. We also allow interested parties to enter a 'watch list' so that any price movements in the names they are interested in is instantly conveyed to them."

According to Jarrod Quigley, portfolio manager at Morgan Stanley Alternative Investment Partners, one of the secondary market's biggest participants, trading firms in general are the ones familiar with the hedge funds themselves but also those that have had the ability to raise some capital that is much longer-dated than traditional hedge fund capital. "Hedge funds now seem to have much more appreciation to matching the type of investments they are making to the redemption rights of the investor base," he says.

Few doubt that the secondary market faces a significant challenge to maintain the healthy levels of interest and activity it currently enjoys. The growing sophistication of its participants will no doubt aid such efforts – attempts to understand the ways the space is being used, and to improve it, will also help. One final factor noted during interviews, however, could yet prove a true market enabler: the Basel III capital requirements. Without the secondary market, notes Florian de Signy, managing partner at illiquid investments specialist Gamma Finance, it would be difficult to answer the regulatory requirements to deleverage of all illiquid assets. ■

HEDGEBAY SECONDARY MARKET INDEX Average % of NAV



Source: Hedgebay Trading