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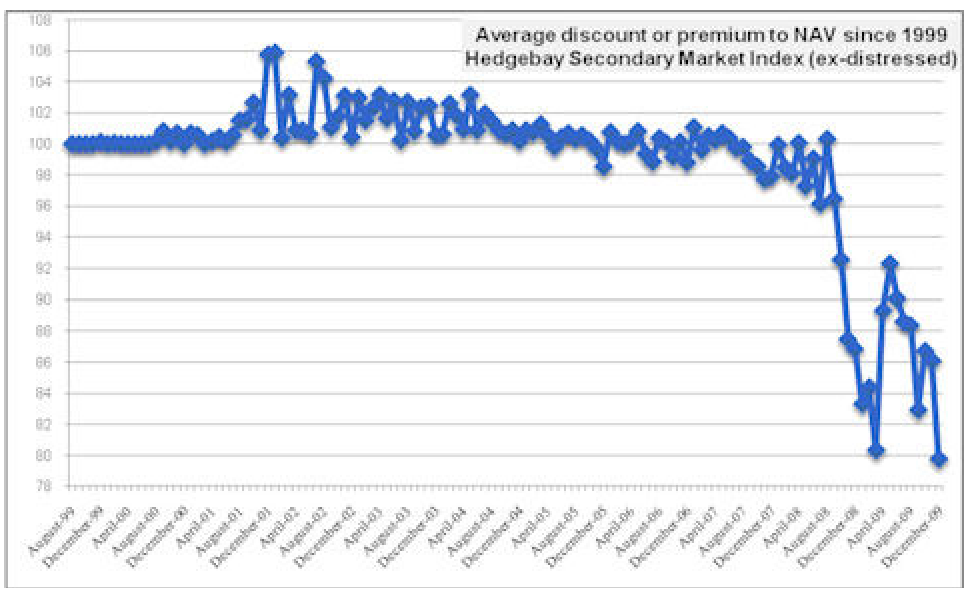
The Secondary Market for Hedge Funds – Revisited

MFA REPORTER COMMITTEE MEMBERS:
HOLLY SINGER AND ANTHONY PECORARO

In January 2007, *MFA Reporter* published an article describing the evolution of the secondary market for hedge funds. Three years later, following a tumultuous market environment, hedge funds' use of gates, extreme liquidity issues and new sets of investor demands, we are revisiting this topic. From a historical perspective, the secondary market, initially a strategy for investors to gain access to highly sought after managers or to rebalance their portfolios in the 1990s, has in the past several years evolved to provide a liquidity mechanism for investors. The past year has brought several new providers of these services, more investors actively buying and selling, higher volume and dramatically discounted average pricing of transactions relative to fund net asset values (NAV).

For this article, we interviewed several providers of secondary market trading services for hedge funds including Hedgebay Trading Corporation's Jared Herman; SecondMarket's Jeff Bollerman; CogentMarkets' Glen Beigel; Tullett Prebon's Neil Campbell; and ICAP's Laura Prager. We also obtained index price data from 1999 through December 2009.

With regard to overall pricing of secondary market transactions as a barometer of the cost of liquidity, the last decade has evolved from fairly tight dispersion of prices around the NAV and average premiums to NAV in many months before the latter half of 2008 to a dramatic change in the recent environment. The late 2008 through 2009 period brought the performance of many hedge funds below their high water mark, use of gates and led to secondary market trading at substantial discounts to funds' NAV. The graph below reflects these changes in investor sentiment as an indicator of the cost of liquidity.



** Source: Hedgebay Trading Corporation. The Hedgebay Secondary Market Index is a proprietary, asset-weighted index that describes the average premium or discount paid for hedge funds that trade on Hedgebay's secondary market platform in any given month.*

How has the Secondary Market Changed? How did Gates Affect this Business?

The past two to three years have brought a greater number and mix of investors entering the secondary market, buying and selling hedge fund interests, together with more providers of trading services and platforms. Increased supply of funds combined with lower price points, *i.e.* discounted trades and continued high dispersion in transaction prices, contrasts sharply with earlier years when investors paid a premium for access to closed hedge funds. The advent of lock-ups and gates, particularly in the past year, has spurred rapid growth of secondary market activity as a liquidity solution, enabling investors to cash out. ICAP's Prager commented that liquidity demands from investors have been largely driven by asset reallocation requirements, and recent/upcoming capital calls related to commitments in the private equity and real estate sectors, which have triggered heavy redemptions in many hedge funds.

The universe of secondary market participants now includes high-net-worth individuals and family offices, funds of funds, endowments, foundations, banks, insurance companies and pension funds around the world. According to Jared Herman of Hedgebay, which pioneered this market about a decade ago and is now servicing hundreds of investors spanning over 40 countries, recent developments including the proliferation of platforms have led to improved validation of the secondary market concept and its added value overall. He noted that the firm's volume of transactions increased considerably during the 2008-2009 period, reaching approximately $2 billion of transactions.

What are the Primary Mechanics and Pricing Elements?

The hedge fund secondary market service providers differ slightly in their mechanics and pricing. Other then Hedgebay, which started in 1999, the others entered this space during 2009. The commonalities are a focus on facilitating investors' purchase and sale of interests in hedge funds and match-making (not market making), combined with an effort to maintain anonymity of buyers and sellers. All transactions require the fund manager/general partner's approval in order to complete a transfer of the fund interests between the specified buyer and seller. None of the firms would be considered an Automated Trading System (ATS).

Some providers offer an online venue that provides investor-driven listings, a model applicable to Hedgebay, SecondMarket and CogentMarkets. The process outlined by Hedgebay's Herman begins with price discovery, followed by negotiation between investors (seller/buyer), leading to agreement on terms and conditions including documentation, and settlement which is customized per transaction. He added that Hedgebay's commission is 50-100 basis points per transaction, fully transparent, generally split between buyer and seller.

SecondMarket and CogentMarkets both offer auction formats and platforms that show bid/offers online to registered investors, providing a hybrid approach that combines technology with expertise of personnel to deal with complex illiquid assets, creditworthiness of counterparties, relationships, etc.

SecondMarket's Bollerman indicated that his firm charges a flat percentage fee, negotiated up front with the seller; amount varies depending on the size and complexity of the transaction. He also noted that by operating as a "Qualified Matching Service" (QMS) under the IRS tax code, SecondMarket provides for the fund to maintain a preferential tax treatment of limited partnership transfers (within a 10% threshold). However, a QMS enables the users to cancel their transaction within a short period of time after agreeing to the transaction.

As CogentMarkets' Beigel noted, his firm has been developing investor relationships for third-party marketing since 1992, although the secondary market trading began in early 2009. CogentMarkets' commission is typically 50-100 basis points, paid by either side or split between the buyer and seller.

Tullett Prebon, an inter-dealer broker serving counterparties around the world, launched the secondary hedge fund trading platform in the past year. The firm employs a model that is focused on voice-based institutional brokerage together with a bidding process and settlement of transactions through KAS Bank. Tullet Prebon actively seeks improved bids to close the spread and profits by charging a commission to the buyer and seller. As noted by Campbell, the least liquid strategies such as Asset Based Lending (ABL) may have very wide spreads of up to 30 basis points.

ICAP is an interdealer broker that entered the secondary market for hedge funds in 2009. According to ICAP's Prager, they offer an alternative approach, working with sellers on a 'confidential' basis and on off-market transactions, protecting at all times the anonymity of the GPs, LPs and institutions. She added that ICAP goes beyond the bid/ask process by facilitating discussions between their buyers and sellers in each of the hedge fund, private equity and real estate spaces. As Prager noted, ICAP's assistance in structuring secondary market closings enables the general partner to replace limited partners through transfers in the secondary market that are not viewed as redemptions by the manager since there is no redemption request involved. However, redemptions and transfers are treated the same from certain regulatory perspectives. ICAP's brokerage fee, applicable only upon closing, is paid by the buyers as a means of accessing product pricing and worked into the discount of the limited partnership interest relative to the NAV.

Conclusion

In recent years, new entrants to the roster of secondary market trading firms have expanded the sources of services for investors seeking to buy and sell stakes in hedge funds. In conjunction with their business development efforts, the service providers have created a wider range of product/structuring opportunities in the meantime as well. Hopefully, a related trend is growing acceptance by managers of such transfers by investors.

The contributors to this article include Holly Singer, President, HS Marketing, LLC, holly@hsmarketing.com, and Anthony Pecoraro, Senior Vice President, MF Global Inc., apecoraro@mfglobal.com.