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Learning to Love the Secondary Market

By Anastasia Donde

The continuing economic uncertainty hanging over the markets has left risk-averse investors feeling less patient than ever with asset managers who aren't delivering the goods. Take Paulson & Co. The firm, founded by John Paulson, grew enormously popular with investors after making billions shorting the subprime market, but after posting double-digit losses in its flagship Advantage funds for two years in a row, some investors have gotten frustrated and are looking to cash out. But others think Paulson has a decent shot at making the money back, and they're willing to bet on him – though they may not want to approach the firm directly to make an investment.

Enter the secondary market, which connects investors looking to buy and sell hedge fund stakes. Once viewed primarily as a place for liquidity-starved investors to offload stakes in special purpose vehicles or side pockets, which were created during the credit crunch of 2008 to sort through some of the more illiquid stakes in hedge fund or private equity portfolios, the secondary market is maturing into a place where investors are now looking to trade regular hedge fund stakes.

The secondary market can offer benefits to both managers and investors. In the Paulson example, investors looking to exit could do so immediately, at that day's net asset value, rather than having to give 60 days' notice. And Paulson would benefit from having a ready source of replacement capital to make up for the redeeming investor.

This type of transaction represents a growing change in the secondary market. Most secondary marketplace providers, including Wake 2o, have been trading interests held in special purpose vehicles or side pockets so far, says Derek Watson, founder of Wake2o, a secondary market provider in Geneva. But now, Watson says, they are looking to trade stakes in regular continuing hedge fund classes. "Now it's your normal every day hedge fund, rather than liquidating vehicles," he says.

The problem is, hedge fund managers have historically been reluctant to participate in secondary market transactions. "When I first started doing this, the world was a very different place," says Jared Herman, founder of Hedgebay, one of the earliest secondary market access providers, which started in 1999. "Managers were closed to new investments and as a result they were highly sought after. They had cachet, very strong performance and great liquidity. It was all about access back then, and funds were trading at a premium. "

Herman says things began to change after the 2008 market crisis, when many managers lost money via poor performance and investor redemptions. Then, the balance of power began to shift toward investors. "The secondary route became an elegant way to help investors get liquidity," Herman says. Still, managers weren't exactly happy about the changes. "Historically, managers would, at best, begrudgingly accept these transactions, and many outright refused."

This is in part because managers generally don't like to think of their funds trading at a discount to their net asset value. "To be a successful hedge fund business, the guys making the key decisions have to have high degrees of confidence in what they are doing," says Herman. "Let's face it, we all have a certain degree of pride, but hedge fund managers are not surprisingly known for a higher level than most. When someone redeems, it stings. So you can imagine what the emotions must be like when they learn that the fund is being traded at a discount."

But times have changed, and the secondary market has been growing regardless of managers' willingness to accept it. According to a recent survey by Simplify LLC, a provider of trading and risk analytics and research for investors and consultants, since 2006 the secondary trading of private placement shares — particularly in hedge funds, funds of funds, private equity and their derivative side pockets and SPVs — has grown to about $65 billion in annual notional volume. That's expected to grow by another 125 percent during the next 12 months to $145.25 billion, according to the survey.

Hedgebay and Wake2o executives both believe that manager involvement in the secondary market will help the market mature faster and will become a good source of long-term capital for the managers. While Wake2o's clients are ultimately hedge fund investors, and the firm gets paid on transaction fees, Watson is also trying to work with the managers on secondary market transactions for this reason. "We want to be a replacement capital solution for them — where we can bring new investors to them," Watson says. Hedgebay's Herman believes the secondary market could one day perform the same function as reinsurance businesses have done for hedge funds, in terms of providing them with a pool of stable, long-term money.

Lately, investors wanting to sell their hedge fund stakes have been doing so for a variety of reasons, such as volatility, poor performance or to lock in gains. Wake 2o recently launched a second part of its platform, which aims to trade in open-ended hedge funds with at least quarterly liquidity, rather than just unloading stakes from side pockets or SPVs.

"The trading mentality has become more prominent than previously," Watson says. "The risk on/risk off paradigm is contributing to that, as well as the volatility that's driven by fear. A lot of the time, investors don't understand where regulation is going to take them." In other cases, if a firm has outperformed dramatically, some investors may want to lock in those gains, Watson says.

The second part of Wake2o's platform launched in September, and the firm now has about 800 registered investors that use its website as a dating site of sorts, where investors can anonymously post stakes they are looking to sell or ones they are interested in acquiring at a discount. There is about $3.419 billion worth of interests on the Web site right now. The average price is 52 percent of net asset value, and the most interest is in global macro funds. Wake2o's original platform, which is still up and running, focuses only on selling secondary interests from liquidating vehicles.

When market conditions improve, Watson thinks the secondary hedge fund market will still play a big role among hedge fund investors and will continue to mature. Trading this way will become just another avenue for investors to get into and out of hedge funds, he says.

But not everyone thinks the market will evolve in this way. Mark van der Zwan, a managing director at Morgan Stanley Alternative Investment Partners, the bank's funds of funds division, says most of the action is still in liquidating vehicles, in part because post-2008, managers can no longer force investors into the kinds of terms, such as long lock-ups, that they used to. "Managers who once had onerous main fund liquidity terms generally now offer better liquidity terms, lessening investor need for the secondary market to act as an alternative to liquidity," he says.

Van der Zwan's business deals frequently in secondary market transactions, with Morgan Stanley AIP acting as a discretionary purchaser of illiquid assets on behalf of a range of clients. "We're purchasing limited partner interests, where the hedge fund remains the general partner and manages out of the underlying assets over time," says van der Zwan. He adds that while he could possibly see the secondary market turning into something more evergreen after those legacy assets are sorted out, the story could also go another way. "I do think another plausible scenario is that the hedge fund secondary activity will diminish significantly, after the legacy interests are sorted out," he says. Those interests, however, are likely to take another several years to work through, which will likely translate into continued high transaction volume for some time to come.

Still, secondary market dealers think the market is growing more mature — and that it's something heretofore reluctant managers will have to learn to live with.

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