

Tullett Prebon Alternative Investments – The Secondary Hedge Fund Market

History

Like most OTC markets, the secondary trading of Hedge Fund LP interests was an invention borne out of necessity.

In simple terms, the early market was based on two factors: liquidity and access. In times of ample liquidity, with funds trading at or close to a premium, investors would primarily base their pricing on the demand for a closed hedge fund manager (access), and to a much lesser extent the time value of money (liquidity). For example, if an investor had redemption with a 3-month waiting period, he may adjust his price accordingly based on 3-month cash rates. So, say 3-month Libor was at 4%, the seller might initially adjust his offer price by -1% to 99% of NAV. Furthermore, the seller might also relinquish a high watermark which would also have a monetary value. However, the additional, and mostly overriding factor, was access, where in the boom years of the industry many well-performing managers were closed to new money.

Therefore, we could say the secondary price of an interest used to be a factor of three things:

1. Time Value of Money.
2. Value of High Watermarks.
3. Value of Access to Fund Manager.

Often enough, factor 3 was sufficiently highly valued as to make sure most trades were transacted at a premium.

Crisis Period 2007 -

For obvious reasons, the dynamics of the market have experienced a radical shift in the last two years. The period of Q4 2008 in particular was when hedge funds, with most other markets, came under acute stress with sharply declining asset values and a huge demand for liquidity from investors. Many fund-of-funds managers were scrambling to meet redemptions and avoid suspending liquidity for investors, and as such disposed of high quality, performing managers at whatever the market could offer them at the time. There were instances where even managers that generated good and consistent returns in 2008 were sold at double digit discounts in order to generate cash flow. This was a typical 'fire-sale' period where markets became totally liquidity driven rather than asset quality driven.

Therefore, whereas the market in the pre-crisis period was largely about access, the current environment is still almost exclusively liquidity driven, as very few managers are closed to new money. As such, there is very little motivation for buyers to bid at a premium for the vast majority of managers, and it has become a 'discount market'.

Market Themes

The market has largely split into two segments over the course of 2009. The first are the markets in the large multi-strategy, widely-held hedge funds that have seen a gradual increase in pricing over the year as liquidity has improved and positive performance has gone some way to clawing back losses in 2008. The second segment of the market is the huge

overhang in illiquid and distressed names that have remained largely stagnant and where, if anything, bids have moved back over the year and sellers have on the whole been reluctant to liquidate the assets at those values regardless of their sentiment towards them.

This has led to a dilemma for fund of funds managers with illiquid holdings and side pockets, especially as most are still charging management fees on the par value of these assets. Do they liquidate these holdings at discounted values on the secondary market to pay out their investors and therefore lose assets and management fees in the process? Or do they hold on to the assets, however mismarked they may be, and keep charging fees on the published value of their fund portfolio? Indeed, this is a phenomenon that also resonates strongly on the single manager level, as hedge funds also stand to lose precious fee income if they aggressively mark down assets. How this stand-off will eventually play out is still uncertain.

This leads us to a crucial issue in determining the clearing value of these assets – transparency. While there are a huge number of market participants ready to provide liquidity for distressed and illiquid assets such as side pockets, this is only possible if the underlying GP is willing to disclose the underlying assets to a potential new investor. In many cases this is a sensitive issue as managers are often resistant to provide transparency to their own investors, let alone potential new customers and possible competitors. Therefore, the bid side for certain funds often becomes dominated by a small number of secondary buyers that have been granted access to value the underlying portfolios and have established relationships with the GPs in question. Limiting this information flow and restricting the number of buyers inevitably leads to a weak bid side in terms of volume and price, as well as a prominent imbalance in bid and offer volumes. Were transparency terms to ease, there is no shortage of buyers willing and capable to price these holdings, and this would go a long way to begin the clear out of illiquid assets from investor balance sheets.

Factoring the Current Discount

There are many factors individual to each fund that currently make up their trading price on the secondary market. While deciphering the specific factors or developing a pricing model for this discount is a topic too ambitious for this exercise, if we were to suggest a very broad outline of key factors these might be:

1. Liquidity: The liquidity as per the fund redemption terms, as well as the relative (il)liquidity of the underlying assets. Typically, the liquidity premium that has been applied to secondary funds in 2009 has been roughly 7-10% per annum depending on the underlying liquidity of the assets as well as other manager specific factors.
 2. Valuations: This pertains to how accurately, or 'mis-marked' the market believes the published NAV of the fund is. For example, investors may feel that the manager has not marked down certain illiquid positions aggressively enough to their true bid value, thus giving way to an artificially inflated published NAV.
 3. Manager Size & Brand: By definition, the larger and more widely held a manager is, the more participants there are familiar with the fund that are able to enter the market and tighten the bid-offer spread. In less well known and closely held managers, markets are often illiquid and spreads can be very wide.
 4. General Market Conditions.
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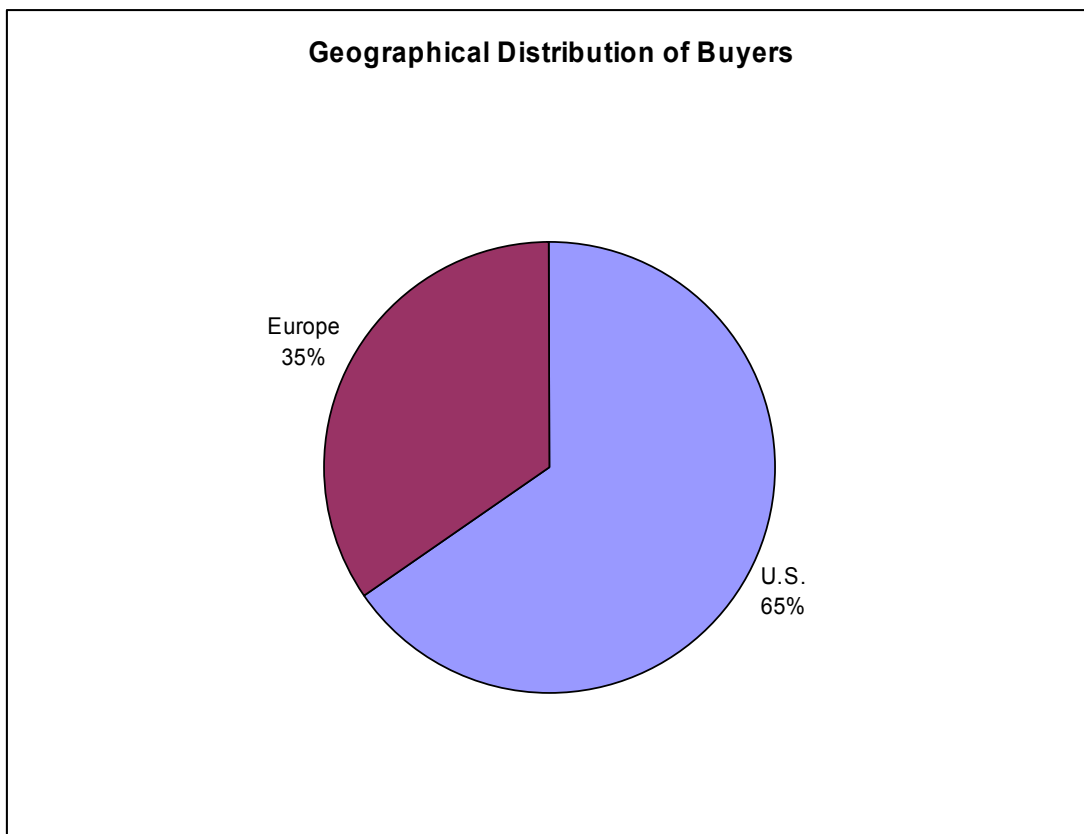
Evolution of GP Attitudes

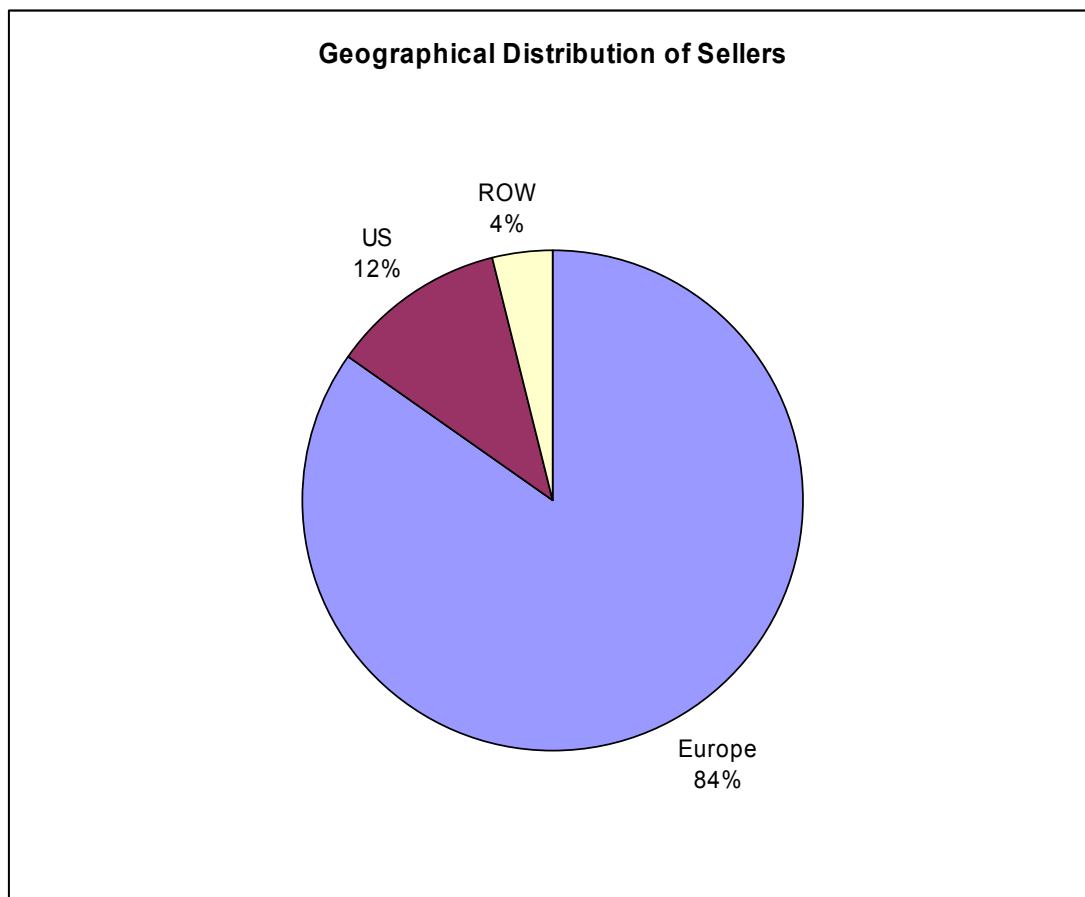
Many GPs were resistant to the idea of secondary trading in the pre-crisis period, as liquidity was often readily available from the manager on their stated terms, and as such they felt little pressure from investors to approve transactions and transfer high watermarks. However, in

the post-crisis environment these attitudes have dramatically changed with many of the most resistant managers conceding to pressure from investors, all the more so when their vehicles are gated or have impaired liquidity terms. Indeed, many GPs have actively embraced the market and recognized the value to investors, especially when trying to raise locked up capital or pursue more illiquid strategies. Investors take a degree of comfort in the fact that if they need liquidity in the due course this could be facilitated in the secondary market, and the manager does not have to unwind positions to meet redemption payments. Furthermore, it gives GPs the opportunity to create relationships with new and non-traditional secondary buyers that otherwise may have been difficult to access.

Geographical Market Flow

One trend that has been clear in the secondary market is the presence of European based sellers and US buyers. The below charts demonstrate the (non-volume weighted) geographical distribution of buyers and sellers.





Typical Trade Process

The secondary market is an OTC market with each deal individually priced and structured, with transactions executed between custodian banks using share transfer forms. The process is overseen and ultimately executed by the fund manager and administrator once all monies have been received and accounted for. Transactions are typically based on monthly fund valuation dates.

Process

1. Price is anonymously agreed between counterparties through Tullett Prebon and manager consent is obtained for the transfer.
 2. Agreement is then made between the custodian banks to enter into the transaction and settlement processes are confirmed.
 3. Buyer and Seller will both complete a share transfer form and send copies to the fund administrator.
 4. Upon confirmation of receipt of proceeds from the buyer, the administrator will authorise the transfer of shares. Alternatively, Tullett Prebon can provide an escrow service in partnership with KAS Bank.
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About Tullett Prebon

Tullett Prebon is one of the world's largest inter-dealer brokers and in many products the world's number one. With over 1,500 brokers located in offices in over 20 countries, Tullett Prebon offers unrivalled access to liquidity in the secondary market.

We have our principal offices in London, New Jersey, Hong Kong, Singapore and Tokyo, with other offices, joint ventures and affiliates throughout Europe, North America and Asia Pacific.

The Tullett Prebon Alternative Investments division was launched in February 2009 and has since executed several hundred million dollars worth of Private Equity and Hedge Fund secondary transactions. These have included matched order trades, structured portfolio transactions, as well as solutions that have been established with individual GPs to facilitate liquidity for their investors. The Alternative Investments desk focuses on operating a broker model and finding the most competitive prices for our customers, creating liquidity from a global network of counterparties.

For live information on the current supply and demand for funds, please register at www.tpalternatives.com