

Painting a Clearer Picture

Funds of funds are in search of clarity in their cash flow

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This summer's credit crunch was a wake-up call for many funds of hedge funds caught on the wrong end of the liquidity curve. Investors had been adapting to low volatility in the market and had sought wider alternative strategies and employed leverage to improve portfolio composition and returns. Much of this pain was caused by funds of hedge funds (FoHFs) suffering from an expanding duration gap: what they owned was longer-dated than what they owed. It was a classic problem.

The three major operational issues that were exposed for FoHF managers were lock-ups, hold backs, and caveats in the structures of underlying funds. All are in need of being addressed going forwards, if liquidity is to be more precisely managed in future bouts of market turbulence.

Lock ups are getting longer

Lock-ups have become more of an issue as market opportunities have evolved and funds have migrated towards more esoteric strategies. This has been the prime driver behind the duration gap issues FoHFs have had to grapple with going into the autumn. The market has changed under their feet. Underlying managers are now involved in longer-dated deals, including private equity style investments. This has led to longer lock-ups for their investors.

Hold Backs

A common practice amongst many hedge funds is to hold back 5-10% on withdrawal of the investor's assets until completion of the annual audit. This can mean a wait of up to 18 months if the redemption request is submitted early in the financial year. For FoHFs, this can also create difficulties if they are in turn seeking to meet their own investor redemptions. The large, institutional investors that are now accessing the hedge funds marketplace via FoHFs tend to treat the FoHFs as just another asset class: they are less inclined to be patient with managers on the strength of long-term relationships.

Negative performance will quickly raise questions and result in redemption requests driving redemptions to underlying hedge funds. While the Hold Back is technically no longer at risk in terms of the fund's performance, the monies are also no longer performing and do not accrue interest.

Fund structures

The caveats that have been sewn into fund structures as a provision by managers to control liquidity and lock down assets, have come under increased scrutiny recently. This is being discussed at both the industry and regulatory level, so we may see changes in practice going forwards. However, some of these restrictions have been in place for a long time in the case of seasoned managers, and they are rarely invoked.

One of these caveats is the 'side pocket', a mechanism used by many funds increasingly to segregate certain investments in the portfolio and apply a different valuation mechanism from the rest of the holdings. Side pockets are helpful in expanding the investment horizon and allocating these to the right investors. So FoHF and other investors can find themselves owning several different holdings from the single investment they made. Again, this is a fairly dormant feature that has been available to most hedge funds but one which has been used increasingly as new opportunities have been developed by managers. The side pocket creates a new liquidity profile to the initial investment, so tracking this separately is essential to fully managing the portfolio.

Another of these caveats is the 'gate'. Gates essentially limit how open the door of the fund is to redemptions occurring at the same time. Of course the original purpose of this was to support an orderly sale of securities by the manager so that the remaining investors are not disadvantaged by selling these. The particular difficulty with gates is that the FoHF cannot be certain when the door will be closed because it can be relative to other investors.

A number of FoHFs have been receiving new investment through structured products, with the additional leverage this implies, but these structures have also exacerbated FoHFs sensitivity to lock-ups and hold backs and other caveats in the hedge fund itself such as side pockets and gates. As structuring institutions sought to reduce leverage in the summer, this caused some FoHFs into cascading redemptions which are difficult to implement.

All of the above has led to a need on the part of FoHFs to build a more accurate internal picture of their liquidity position in an effort to avoid any nasty surprises. A complete statement of time-to-cash requires painstaking analysis of every investment held, and when that investment can be redeemed. This has to take into consideration the lock-ups and their optionality and associated cost (generally referred to as 'hard' and 'soft' lock-up terms). FoHFs also need to consider the redemption fees quoted by those underlying managers which maintain a redemption penalty regime and gates which may be imposed at fund and investor level.

With hold backs, FoHFs need clarity in order to be able to manage tail risk and the cash flows associated with the tailing off of the redemption payment from the manager. Tools that can accurately track every outstanding payment can be helpful here. It boils down to being able to build a daily picture of who owes the fund what, how quickly that cash will arrive and the supporting of pro-active management.

A changing culture?

The culture within the FoHFs business is changing, requiring CIOs to stay on top of the trading aspects of holdings and positions in a way they weren't required to do five years ago. This includes being able to break down portfolios according to liquidity and strategy concentration terms, and treating underlying funds more like securities in a traditional investment portfolio. FoHFs need to keep track of their options, and communicate these more efficiently to investors when required. Up until recently, that great crutch of financial technology, the Excel spreadsheet, has been equal to most of the tasks imposed on it within the FoHFs environment, but it is starting to show the strain. It is not able to robustly capture the depth of information CIOs require consistently. Analysts can take days at the moment to compile an accurate calculation using Excel, yet if internal data is managed correctly, this could be done at the touch of a button.

When addressing structured products valuations, FoHFs need to be aware of their gross and net exposure. What will be the effect of any losses on these structures? It may seem trite, but being able to manage such risk management data at the touch of a button challenges the capabilities of Excel. FoHFs that are being developed through structured products will need to be particularly aware of any losses they have suffered, as this will have to be reported in detail to the structuring institution. This could require the FoHF to sell some of its holdings, and therefore be ideally ready in advance with the details of which managers it can quickly redeem against. The key here is having the technology that can provide the CIO with a picture of where his portfolio is, and options on how he can liquidate sufficient capital to meet the investor demand, with in addition, control over the impact on the composition of the overall portfolio. It requires aggregating accurate data along with all the terms and conditions surrounding that investment in order to be able to manage internal liquidity on a day by day basis if needed.

Conclusion

The summer's market turbulence has been a useful lesson in liquidity management for the FoHF industry. As institutional capital continues to flow into hedge funds, and the demand for structured products linked to FoHFs carries on apace, we are expecting many leading FoHFs will be addressing the way they manage their internal portfolio management data to take account of the ease – or lack thereof – of redemptions within their underlying portfolios. This will be essential if they are to be prepared to meet any further bouts of turbulence with a solid liquidity management framework, a framework which will, at the same time, help them to build investor confidence. **THFJ**