

## Funds of Funds Play Liquidity Tug-of-War

By Jacob Bunge, Financial Correspondent | Thursday, July 31, 2008

SAN FRANCISCO (HedgeWorld.com)—Lately liquidity weighs heavy on the minds of investors, in an era where illiquid holdings in subprime mortgages led to the downfall of several hedge funds and more general liquidity concerns helped bring down the investment bank Bear Stearns Cos. Inc. in March.

In this environment, fund of hedge funds operators must perform a special balancing act, proceeding with one eye on the tighter liquidity restrictions imposed by hedge funds wary of hot money, while monitoring the funds of funds' own investor base to make sure they're not caught out if investors flee *en masse* after a tough month.

Jeffrey Axelrod, chief executive of Cogency Software, sees both sides. His company develops applications for funds of funds that perform portfolio management and shadow accounting, allowing funds of funds to track liquidity issues both on the investor side and across the hedge fund managers with whom they're invested. Mr. Axelrod said that the liquidity analysis aspect has become one of the most asked-about features among potential fund of funds clients.

Though the fund of funds industry itself has seen better days in terms of performance, Mr. Axelrod said that funds of funds aren't seeing wholesale redemptions, and still have the favor of investors. "The funds of funds continue to get money these days, even despite the published average returns of hedge funds and funds of funds not being great the past three quarters," he said. "Funds of funds are still doing well because they're seen as active managers, and they are—they're paid to watch hedge funds on a monthly basis."

And the volatile environment of the past six months hasn't been lost on fund of hedge funds managers. Mr. Axelrod said that fund of funds portfolios are showing more churning and turnover in terms of the hedge funds in which they're invested, but the funds of funds are not taking money off the table. "Ultimately, they have to find new hedge funds; that's their mandate," he said. "Net-net they're not pulling out, they're just being more cautious. There's so much talk of due diligence in the fund of funds world right now."

Indeed, at a recent conference on fund of funds back-office operations, nearly all the talk was about due diligence matters, Mr. Axelrod noted. "They know that's why they're being paid."

Despite trying times for performance, Mr. Axelrod said, single-manager hedge funds' general liquidity terms have not changed much, with most funds employing lock-ups of anywhere from 12 to 36 months. But he said that he is starting to see more outliers—three-year liquidity, or 180 days' notice.

From the fund of funds side, managers and investment committees more than ever are demanding a clear picture of their hedge fund investments' liquidity risk, as a growing number of funds enact gated redemptions to stem the outflow of assets after a tough couple of quarters. Not only do funds of funds want to know what percentage they own of each hedge fund manager and whether a redemption will trigger a gate, Mr. Axelrod said that they're also taking a close look at each manager's investor base to get a sense of how quickly investors might redeem if a big drawdown hits.

"Three to four years ago, we weren't being asked to track that," he said.

Mr. Axelrod in turn recommends that funds of funds interested in a complete liquidity picture also scrutinize their own investor base, to see how much money might be pulled out should the fund of funds post a bad month.

While many funds of funds have gated redemptions as part of their own terms, Mr. Axelrod said he hasn't seen any cases where such gates have been triggered. But he has seen hedge fund managers come in with what he called "investor-level gates," which specify that an investor can only redeem, say, 25% of an investment in each redemption cycle. This is in addition to typical fund-level gates, which temporarily halt redemptions after a certain percentage of the fund's total assets have been redeemed in a redemption period.

"It's not typical, but it is among the vocabulary of liquidity terms," Mr. Axelrod said of such investor-level gates. "There are some fairly well-known funds with terms like that."

Mr. Axelrod also said that he's hearing from more funds of funds who want to manage private equity fund holdings. "It used to be just how to manage a 3% side pocket, that grew to 10%, and now they're in full-fledged private equity funds," he said. This is part of the ongoing merger of the private equity and hedge fund worlds, according to Mr. Axelrod, and it's happening across various types of funds of funds.

Funds of funds treat these less-liquid single-manager funds a couple different ways, Mr. Axelrod said. On one hand, those funds of funds that are explicitly going into private equity and similar vehicles may create less-liquid share classes of their own, and make these available to investors. On the other hand, if a fund of funds doesn't consider itself a long-term investor aside from a handful of private equity-style holdings, the managers may in their portfolio construction keep a small portion of the portfolio open for such investments to maintain some exposure to good deals with long-term investment horizons.

This is part of the reason why Cogency introduced support for side pockets about a year and a half ago, Mr. Axelrod said. Currently the firm is working on developing a capability for new B-structures that parallel closer to private equity structures.