THE HEDGEFUND JOURNAL
[SEPTEMBER|OCTOBER 2012]

Post-Crisis Liquidity: How investors can protect against liquidity events

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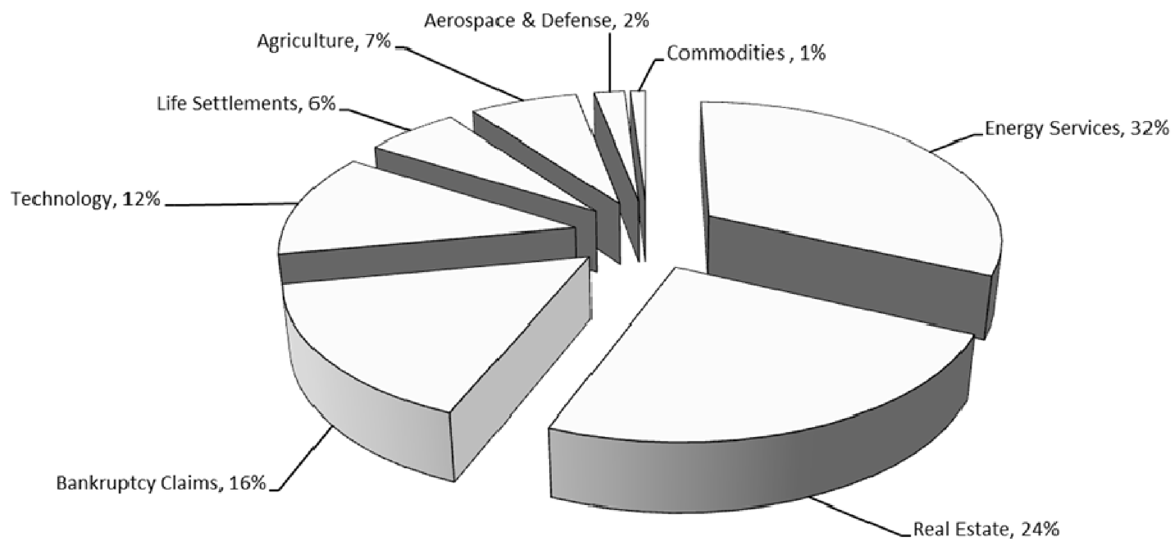
September 2012, the four year anniversary of the collapse of Lehman Brothers, has witnessed moves from European and US policy makers that demonstrate the continuing legacy of the 2008 credit crisis. Germany's constitutional court backed the launch of the European Stability Mechanism as the lender of last resort to the Eurozone, whilst the Federal Reserve has pledged to continue injecting money into the US economy until it recovers whilst systematically buying mortgage-backed securities. An environment of deleveraging persists across institutions, corporates and individuals, whilst the downward revision of economic growth forecasts is also all too common.

Metrics that show liquidity is increasing also reveal that liquidity is flowing to the highest quality, lowest risk investments – as demonstrated by the meaningful inflows into German and US Government Bonds. The hedge fund sector has struggled to raise assets, with investors still wary of allocating to riskier assets, and with capital inflows concentrated on the largest quasi-institutional players, evidenced by industry consolidation and the demise of many smaller players. Increased regulatory and compliance burdens have also impacted the fund management landscape.

The growth of investment structures such as UCITS III funds (which have grown over the past few years to now represent 10% of the hedge fund market) demonstrates that investors are comforted by regulatory protections in the area of risk management, transparency and liquidity management.

Any investment strategy that seeks returns from outside of the most liquid asset types such as government bonds, foreign exchange and large/mega cap equities, will by definition involve taking increasing liquidity risk. Whilst the general trend is towards more liquid investments, groups that are less susceptible to redemption pressure – such as family offices, sovereign funds, HNW and private equity funds - have sought to benefit from the enhanced returns that are available from longer liquidity investment opportunities. A snapshot of assets that are held

within liquidity-impaired hedge fund portfolios gives an indication of the wide range of invest-ments that have experienced an extension to their liquidity profile that often leaves the asset no longer suitable for that investment vehicle, and the frequent use of side-pockets:



Having focused upon lower-liquidity hedge fund investments in the pre-crisis world, and then experienced the largely unanticipated transformative impact of the liquidity deterioration upon investments, Gamma has observed the merits of focusing upon the following:

Understanding Leverage

Ensure that the implication of any leverage is fully understood. During the years leading up to the crisis, as capital flowed to all areas of the investment universe, the high levels of demand resulted in decreased yields. Fund managers sought to enhance their returns through applying leverage - a strategy which is successful as long as the underlying yield exceeds the financing cost, and the fund is able to meet its repayment terms. In 2008, the widespread decrease in liquidity meant that the liquidity profile of the assets no longer enabled the credit to be re-paid, resulting in many portfolios being placed into default. The considerable number of in-vestment banking leverage desks which today are still unwinding their lending books due to cri-sis-driven defaults, illustrates the extent to which Warren Buffett's well known observation that utilising leverage is akin to "picking up pennies in front of a steam roller" was largely ignored leading up to the crisis. Regulatory capital rules such as Basel III are also encouraging banks to deleverage, generating a supply of lower liquidity assets of high quality.

The obvious danger of leverage is that the liability to repay the financing remains fixed, whilst the value and liquidity profile of the underlying asset can fluctuate - and if the asset devalues by a sufficient level, it can trigger a default. At this point, the leverage provider is generally entitled to commence foreclosure proceedings – and if there is insufficient immediate value in

the assets to cover the debt, the equity holder is wiped out. As such, leverage does not just magnify profits and losses, but presents the very real risk of eliminating the equity holder – many fund-of-hedge-funds have been unable to return any capital to their investors for this reason. Assets should be rigorously tested to ensure that in stress scenarios they generate sufficient liquidity to meet financing repayment terms.

Investments can change shape quickly and significantly

Investments typically evolve over time. An exit strategy that was appropriate during the first six months of an investment may no longer be relevant two or three years into the investment cycle. A stark example of this is those hedge funds operating "shadow banking" strategies, such as those issuing secured loans to small and mid-size corporate borrowers. Such funds are categorised as credit funds, yet when loans fall into arrears the fund either restructures or forecloses on the collateral, at which point the fund's balance sheet no longer holds a credit instrument, and instead holds the collateral – for example, real estate, or equity in the borrowing company. Many credit funds have morphed through the credit cycle in to quasi-private equity funds.

A potential challenge for those managing portfolios in this situation is that their specialism may be in credit, not in private equity – and an exit strategy for a credit instrument may not yield the optimal outcome when seeking to monetise a private equity position. Gamma works with experienced hedge fund clients in exactly this situation, and has helped clients with transactions from $1 million to $200 million. Since the launch of the Real Asset Advisory business in early 2011, Gamma has won advisory mandates of over $400 million from clients seeking to optimise their exits from a diverse range of lower-liquidity assets, including real estate and equity in energy companies.

Limitations of diversification

Diversification is an efficient way of reducing the impact of market volatility. In a normalised environment, asset classes exhibit their own distinct characteristics, however during periods of severe systemic pressure, correlation can increases across all "riskier" markets, which subsequently experience a decrease in liquidity.

As such, diversification is a portfolio construction technique that can mitigate the dynamics between different areas of the capital markets - but does not hedge against major macroeconomic downturns, when usually uncorrelated assets can exhibit a high correlation in terms of deteriorating liquidity profile. The financial crisis has shone a clear light on the limitations of diversification.

Suitability of redemption terms

By the end of the first quarter 2009, approximately 15% of all hedge fund assets were held in side-pockets, or funds that had restructured into wind-down share-classes. This was a result of a severe reduction in liquidity across asset classes, coinciding with an increase in redemption requests. Fund managers are today aware of the severity of the stress events that need to be modelled and investors are increasingly scrutinising this particular dynamic.

There was, pre-crisis, a general under-estimation of the extent to which liquidity could reduce – and the levels of investor redemptions that might be experienced. Portfolios were well structured to deal with "normal" market conditions of, say, 20% redemptions per quarter, and investments were selected to enable such levels to be paid out through cash reserves and the sale of assets, without impairment of the remaining portfolio. However, the funds saw redemption levels of up to 80%, just at the same time as the liquidity within the underlying assets deteriorated, compelling fund managers to side-pocket investments, or formally restructure. In the post crisis world this balance between asset liquidity and investor redemption terms is subject to more analytical focus.

Service Provider and counterparty risk

Finally, the crisis has highlighted the vulnerability of even the largest institutions. Clients and counterparties of Lehman Brothers are still waiting for settlement of their claims, and the secondary market in such claims has developed - an area in which Gamma is also active. Constant assessment of service-providers' liquidity and balance sheet strength is essential, with high profile bankruptcies and bailouts meaning that the days of relying purely on reputation have passed.

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