CHAPTER 8
Redemption

Having an understanding of what drives the hedge fund manager is critical for investors and their assets. Managers must want that understanding; they need to be able to articulate what it is that causes them to buy or sell a security. It is the drive, ambition, and ability to maintain their edge that separates good managers from mediocre managers. While the main challenge of hedge fund investing is achieving consistent returns, the biggest test is actually dealing with manager hubris. Investors should seek managers who are driven by the intellectual challenge of investing and facing the challenges of the markets. Taking it a step further, the best managers are in fact mercenaries working for the common goal of the manager and the investors. The question that is raised is: how does an investor build a relationship with a mercenary and then deal with the manager when it is time to redeem?

REDEMPTION REQUESTS

The most frequent reason for redemption is performance results. Although performance-based redemption profiles vary according to investor class, many investors are merely return seekers. They chase the return; in the industry this is called ‘‘hot money.’’

The hot money is usually held by high net worth or family office investors. These groups usually do not go through the same painstaking stages or periods of due diligence to identify the manager; they simply look for managers with good returns and invest.

Institutional investors, including pension plans, invest for the longer periods and are more concerned about absolute return as well as meeting the liability portfolio requirement for their actuaries. Rather than chase returns, they are concerned with how hedge funds and fund of funds can act as a tool to reduce the volatility of the rest of their portfolios.

Institutional investors are generally concerned with alpha, but they are also concerned with volatility and Sharpe ratios. First we look at standard deviation, which measures the dispersion or spread of data around the mean value to measure portfolio volatility. It indicates the level of risk associated with the risk of the portfolio. As risk rises, portfolio value should increase as well. It boils down to this: The larger the variance, the greater the risk; the greater the risk, the greater the potential for gain or loss. In comparing the returns of managers within the same sector, investors should look at average annualized returns and then review the standard deviation.

How to Pick a Manager

Suppose you are looking at two long/short equity managers, both with a 15 percent return; however, one has a standard deviation of 9 percent and the other a standard deviation 12 percent. It is clear that one is more volatile then the other. Drilling down and looking at month-to-month comparisons, the overall return is the same, but the month-to-month volatility of the 12 percent deviation is much higher, which should cause investors to be concerned. Generally, the 9 percent volatility manager is statistically preferred, but further review will be required to determine how the returns are actually generated. It is not easy, it is not a science, but it is something that needs to be done.

The second factor that most investors look at is the Sharpe ratio. This is a risk-adjusted measurement used to calculate the return that is achieved, then it is compared with the level of risk that was taken to receive the return. Developed by William Sharpe, the formula uses standard deviation and excess return over the risk-free rate (generally Treasury bills) to calculate the ratio and to determine how the return compares for the risk taken. Expressed as a formula, the numerator is the average monthly return minus the risk-free rate divided by the denominator of the monthly standard deviation. Investors seek a high Sharpe ratio.

For example, a Sharpe of 1 indicates one unit of return per unit of risk, a Sharpe of 2 indicates two units of return per unit of risk, and a negative Sharpe indicates a loss or high level of risk taken to achieve returns. It tells us whether the manager is smart or took a high level of risk to achieve the returns. Strategies with lower volatility (standard deviations) have higher Sharpe ratios (e.g., fixed income or other types of arbitrage strategies), whereas long/short hedged equity will have a lower Sharpe. A Sharpe over 2.0 is very good and 3.0 is outstanding. At the end of the day, most institutional investors seek high Sharpe ratios and low standard deviation.

Institutional investors will closely monitor returns but are also concerned about quantitative evaluations of volatility and risk. They rely heavily on standard deviation and Sharpe calculation to make portfolio decisions.

Besides portfolio volatility and high levels of risk, additional reasons for redemption are varied, but the second most frequent cause for redemption is style drift in this unique asset class. Style drift can take many forms, but the most common is that the mandate of the hedge fund or fund of funds manager changed as the market grew. What started initially as a focused, low-volatility fund has morphed into a fund with multiple funds across a broad range of sectors. With the explosion of fund of funds assets, the manager may be more concerned with asset growth than with the performance results that were the primary focus in the early years. With the moderation of returns of assets as assets boomed, the manager may be less risk averse or less focused on returns. A fund that may have started several years ago as a small, focused fund may have now grown to a large behemoth with mediocre performance results. The problem may be too much money under management. The solution is to redeem.

Many firms that have also experienced robust growth have not adapted the infrastructure to handle the increased size of the assets. Consequently, they are unable to determine how to attract high-quality personnel and then manage the teams to operate infrastructure so as to both manage the money and deal with investors. Successful firms have integrated teams working together looking for investment opportunities. Some hire armies of young analysts who are actually filling seats completing forms. Many firms have handled the growth spurt well, while others have not. Thriving firms have been able to adapt to changing global markets, are tactically adept, and have performance results that reflect this. Others have failed. Early redeemers usually detect this deficiency.

FUND OF FUNDS DUE DILIGENCE ISSUES

Many fund of funds that participated in the credit market blowup of 2006–2008, took advantage of market opportunities, and were short credit and produced strong results. Other fund of funds did not understand credit, and also did not know how to participate or source ideas and trends; as a result, they got killed. With rapidly changing global capital markets, change is required, and the best investment managers regardless of structure seek new opportunities in new strategies with the aim of attracting new flows of funds to increase assets under management. Others languish. Personnel turnover or the strategies that are no longer viable all contribute to reasons for change. It is important to note that for fund of funds, due diligence, research, and allocation is an art, not a science, and certainly is not suitable in all situations. There is a lot of differentiation from one fund of funds to another, and sophisticated investors should be aware of the differences. Simply put, one size does not fit all; just as with snowflakes, no two fund of funds are alike.

After all, the decision-making process varies from traditional long-only to hedge funds to private equity managers. More often than not, the final decision about whether to use a specific hedge fund or fund of funds is a "gut" decision, and the investor must rely on his or her instincts and try to reduce the decision to a quantitative evaluation.

Remember this: strict and formal hedge fund due diligence investment procedures are important and should be adhered too. Due diligence must be consistent, and it must evolve and change as the markets evolve and change.

LESSONS LEARNED

There have been many lessons that investors have learned in the wake of the demise of Long-Term Capital Management (LTCM) and the 2008 market meltdown. The question is: are managers doing this differently today than they did in the late 1990s or in 2006 or 2007? The answer is not clear.

The good news is that institutional investors make investment decisions that take a long time to come to fruition, because they are making long-term capital commitments. Remember Sharpe ratio and standard deviation? The investor should not look at one calendar year unless something has changed dramatically with the hedge fund. Patience is a virtue that investors need to practice.

Fund of funds cannot easily change investment positions, do not make monthly decisions, and commit their assets for usually at least a year. This is how we believe most investors should act as well. Being late or early to the party is not an excuse. It is, however, sometimes quite rewarding.

There were several credit managers that were early to the subprime meltdown and started shorting in 2006. There were a few that were early to the commercial loan fallout who invested in 2007. The thesis was right; the timing was poor. Investors lost. Managers lost. Had they waited nine months, they would have made a killing. Unfortunately, in investing it's all about timing.

Taking it a step or two further, fund of funds are removed from the investment process of the underlying manager but determine global macro trends, evaluate opportunities for investment, and then put money to work at just the right time after the conclusion of the consistent investment and due diligence process.

HOT MONEY, COLD RETURNS

Hot money fund of funds—not the entire industry, just a small number—are often ready to redeem after one or two bad months in a row. As the derivative crisis of 2007–2008 demonstrated, investors will move money as soon as they sense that something is not going well. The holding period for underlying manager positions will vary from strategy to strategy, but certain strategies have limited or reduced liquidity inherent in them. Fixed-income arbitrage strategies, distressed, and derivative strategies have reduced liquidity, and in periods of market stress, it can get very dicey. Arbitrage strategies that depend on high levels of leverage also have reduced liquidity because of the overall increase in the size of the leveraged portfolio. If we look at the flow of capital into strategies that are deemed "hot" or the "next best place to invest" that no one else has discovered, what happens when the floodgates are opened for redemption because of investor dissatisfaction? Even assuming a moderate change in performance, the redemption by the largest or several large investors may cause a tidal wave of redemptions by other investors. Although hedge fund and fund of funds investing is part quantitative, part qualitative, there still is a herd mentality.

The arbitrage for the underlying manager is bad. The manager has positions (or assets) that may need a longer term to realize the economic benefit of the trade in the case of activist, event-driven, distressed, or various arbitrage strategies. The liability of the fund balance sheet is redeeming investors who want out at the same time. Will the manager sell positions to meet the redemptions? Or will the manager impose a gate to restrict redemptions?

The asset/liability mismatch of hedge fund balance sheets of security positions and frequent redemptions causes many hedge funds to extend redemption periods to protect partner capital and reduce the risk in the portfolio. The lengthening of the liquidity window has been occurring over the past few years as many managers have moved from monthly to quarterly to biannual, to annual; now, some put in place two-, three-, and four-year lockups. Before investing in a hedge fund, the fund of funds must decide whether the returns and benefits of the strategy are warranted by a longer lockup. With longer lockups, the investors must decide whether they are investing in a hedge fund or a private equity fund. They must ask, is hedge fund money the proper allocation for a private equity type of structure.

NEW CHALLENGES

Longer lockups for underlying managers present a new set of challenges for the fund of funds portfolio manager. One of the strengths of the fund of funds is its ability to dynamically reallocate capital and make changes in response to changes in the market, or to changes in the performance and structure of the underlying managers. With longer lockups and less liquidity, the fund of funds portfolio manager faces a new set of limitations. Despite the marketing material presented by the hedge fund managers, both investors and fund of funds learned in 2007–2008 that strategies that were not supposed to be correlated, in fact were. Longer lockups and imposition of gates made portfolio management more complicated and put pressure on performance results.

Size is very important in hedge fund land. Generally, according to a recent study compiled by Infovest21, new emerging hedge fund managers have better results than seasoned managers; in many cases, they put up really good numbers.

However, there is risk associated with investing in a manager who recently left a larger firm and has no track record. Other reasons include the fact that the manager truly has "fire in his belly" and eats, sleeps, and breathes his strategy. The manager knows every position in the portfolio intimately and can react to smaller positions and thereby maintain a higher level of liquidity. The manager may assume a higher and greater risk profile than a larger manager in order to demonstrate his trading and research acumen.

Another risk lies with organizational structure. Suddenly, the portfolio manager is managing a business—a portfolio—and trying to raise outside capital as well as manage investor relations. This creates a lot of tension; the markets have witnessed the self-destruction of many managers.

Darwin is alive and well in the hedge fund industry—perform well, and asset flows grow. Poor performance leads to an average life of hedge funds of approximately three years. It is, unfortunately, just that simple.

Redemptions are restricted by lockup periods with required notices before the actual redemption date. Hedge funds in general have an initial lockup that ranges from one to five years, with the norm being one year. During the past several years, many lockups have gravitated longer and have extended out to two to three years. The best performing funds, the ones that command greater pricing power, have the ability to demand longer lockup periods and set these restrictions in the private placement memorandum.

LIQUIDITY ISSUES

Fund of funds are wracked by additional liquidity issues. Often, the underlying funds may be forced to liquidate positions that are less liquid (or not liquid at all) or sell securities at a loss, due to redemptions requests. This reduces the performance of the underlying fund. The use of leverage may also exacerbate the magnitude of the loss, requiring the manager to sell larger chunks of the underlying positions, usually in periods of market stress.

As investors have learned repeatedly during various market gyrations, market selling begets selling and puts pressure on hedge fund redemptions. Fund of funds redemptions put pressure on hedge funds, contributing to the overall selling pressure. Investors must know what the notice period is for redemptions as well as the terms of any stated liquidity gates.

When the markets are in disarray, the selling pressure can create opportunity for funds that have liquidity and have restrictions on redemptions. These opportunities often lead to significant profits when those besieged with redemption requests seek liquidity.

Redemption Issues

Redemption issues represent another element of risk management for the fund of funds manager. The fund of funds may provide monthly, quarterly, semiannual, or even annual liquidity, but the underlying hedge funds that the manager may wish to redeem may have only annual liquidity. Within the varied liquidity requirements for the underlying hedge funds in the portfolio, this gives rise to the need of the fund for funds to have a credit facility to provide liquidity for redeeming investors. At the same time, the manager must be prepared to hold some of the unwanted positions longer than desired.

With a spike in market volatility—managers holding larger positions and an increase in the use of illiquid products—hedge fund managers are increasingly imposing gates as of 2008 to place restrictions on the proceeds that will be available for redemption on a particular date. A gate will place limits on the amount of capital that may be withdrawn at a particular period.

A 25 percent gate will allow investors to redeem 25 percent of the funds per period, usually quarterly, but that will vary depending on the portfolio's liquidity. This permits an investor with a one-year lockup to receive proceeds equal to 25 percent over a four-quarter period after the expiration of the lockup. The gate allows the manager to increase exposure to less liquid or longer holding periods for security positions. In addition, it discourages investors from making rapid movements of funds from manager to manager.

Gates encourage longer lockup investing, placing greater pressure on the due diligence process and ensuring that the manager selection decision was indeed correct. The longer lockup stability provides greater comfort to the hedge fund manager and limits flight of capital in times of market stress. In addition, it allows for longer planning, similar to the planning of private equity or real estate investing. In the end, gates limit investors from cashing out quickly.

Irwin Latner, a lawyer at the New York–based law firm Herrick Feinstein, has a specialization in hedge fund partnerships. He has said that "the gate is triggered when the aggregate redemption requests from investors as of a given date exceed the stated percentage threshold of the fund's net asset value."

"When the gate level is exceeded, the fund documents often permit the fund to defer excess redemptions above the gate level to the next permissible redemption date, and only satisfy redemptions on a pro rata basis up to the gate threshold," Latner added. "If aggregate redemptions on succeeding redemption dates exceed the gate, the fund may invoke the gate with respect to those succeeding redemptions as well until such time as the aggregate redemption requests fall below the gate level. Many but not all funds have gate provisions."

The due diligence process adopted by the fund of funds manager should focus on strategies that employ gates. Some of these strategies include asset-backed securities, private placements, and other hard-to-value securities. Generally, more liquid strategies such as long/short equity and traditional fixed-income arbitrage do not have gates.

"Gate provisions should be properly summarized in the PPM together with adequate risk disclosure with respect to their effect on an investor's ability to redeem its capital," Latner stated. "Investors must be made aware of which strategies employ gates and ask the fund of funds what happens in a 'what if' scenario."

The million dollar question is, "How can a fund of funds expect to get paid in the event of redemptions if the gate is imposed?" The answer is simple: It can't. Often, the imposition of a gate by underlying fund managers will negatively affect funds of funds that have invested in the gated fund because

- The fund of funds is often the investor that is seeking to pull out but is restricted by the gate.
- The fund of funds may be forced to impose a gate or other measure in its own fund if it is faced with redemption requests from its own investors and it cannot redeem a sufficient amount of its own capital from the underlying gated funds in which it is invested.

Along with high net worth investors, many hedge funds think of fund of funds as "hot money." When a fund of funds needs money to meet redemption requests, hedge funds with liquidity are the first to go from the portfolio. Fund of funds are usually the first to redeem, especially when they sense something not right in the hedge fund manager in terms of performance, style drift, and employee turnover. If fund of funds are not quick to pull the trigger, they themselves may be hit with redemptions. The key to successfully weathering a storm is communication. Both hedge funds and fund of funds must be proactive in communicating with the LPs in the fund and try to use moral suasion to keep their assets in the fund. The worst-case scenario for the hedge fund is to convey a sense of mismanagement or misrepresentation rather than just poor investment decisions.

High Water Marks

What sets traditional long-only managers apart from alternative investment managers is fee structures and the fact that the interests of managers of hedge funds, fund of funds, and private equity funds are aligned with their investors. Hedge fund and fund of funds managers manage for alpha and therefore are in the business of actually managing money.

Hedge fund and fund of funds managers continue to collect management and incentive fees as long as the fund is earning a positive return. If the investor makes money, the manager makes money. However, if the fund is losing money, the hedge fund manager receives only the management fee, which is calculated on the asset under management.

"The high water mark kicks in to prevent the manager from taking performance fees in subsequent periods until the fund recoups the prior period losses and becomes profitable again on a long-term cumulative basis," said Latner. "That's why it's called a high water mark."

Suspending Redemptions

Redemption halt or *suspending redemptions* are terms that cause hedge fund investors to shudder. Usually, it means that something bad is happening and the manager is literally sinking. When a fund suspends or halts all redemptions indefinitely, it means the fund is in liquidation, or better yet, the manager wants to liquidate and cannot price the portfolio because there is no liquidity. Halting redemptions is very bad. A gate prevents only redemptions that lie above the gate level; a halt or suspension of redemptions is enforced on all assets.

Most suspensions of redemptions are usually tied to a broader market disruption event or a difficulty in computing net asset value, whereas a gate may be invoked for more isolated reasons having to do with the operation of an individual fund. When a fund suspends redemptions, it is usually the death blow for its continued existence. After such a suspension, no new investors would come in, and the fund usually begins to wind down and liquidate its assets in an orderly manner. However, new high water marks allow for catch-up by investors to potentially recoup the loss.

Take a look at the Bear Stearns fixed-income hedge funds. Shortly after suspending redemptions, the funds declared bankruptcy due to the liquidity squeeze and inability to correctly price the securities. In short, many believe the suspension of redemptions was the first nail in the coffin.

While fund of funds managers have a challenge in dealing with the illiquidity issues of gates, it presents a greater problem for direct investors in hedge funds. In either case, it gives a severe case of ‘‘agita’’ to all when a fund announces or declares anything other than positive returns.