HDF
20 Years in Funds of Hedge Funds

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HDF Briefing

Liquidity in funds of hedge funds

Is good liquidity the way to reduce risk?
Investors can reduce risk in several ways. One common approach is to look for investments that are liquid, meaning that they can be sold off quickly and at a good price if the investor thinks that returns will fall short of expectations.

Contrary to what one might think, artificially improved liquidity can actually increase risks.

Hedge fund investors are chasing returns
First and foremost, hedge fund investors are looking for high absolute returns, that is, returns that are not correlated with the ups and downs of the financial markets. To meet their needs, fund managers are constantly devising innovative investment solutions across a broad spectrum of instruments and asset classes.

Delivering returns takes time
While top managers identify opportunities before their competitors do, it may take time to realise their vision. The capital entrusted to them therefore needs to be stable over time, so that they can deliver the very best returns. As a result, more and more hedge funds, including many of those that are deservedly in the top flight, have begun offering liquidity on a less frequent basis, say quarterly or semi-annually, and are extending notice periods to 90 or 180 days. Some funds are even introducing one-year or two-year lock-ups.

Mitigating risk through funds of hedge funds
Investor demand for absolute returns, coupled with controlled risk, is what has driven the growth of the FoHF industry. At HDF, we mitigate risk by carefully selecting the best investment strategies and fund managers and by diversifying our investments through painstaking construction of the underlying fund portfolio. In our view, however, managers who try to go one better by offering fund of funds investors better liquidity than that of the underlying funds create an asset/liability mismatch that significantly increases risk.

Some FoHF managers expose investors to risk by offering them overly favourable liquidity
In the event of large-scale redemptions, FoHF managers that have offered investors overly favourable liquidity relative to that of the underlying funds leave their clients exposed to lower returns or even losses. The manager has three options:

(1) he can sell his most liquid funds, but in so doing he will alter the quality and structure of his portfolio and increase the risks to investors
(2) he can borrow to meet the redemptions, but this would increase leverage and hence risk
(3) or he can temporarily suspend redemptions, but this would damage his reputation, potentially triggering a wave of additional redemptions once the suspension is lifted.

At HDF, we believe that liquidity mismatches should be reduced and managed with great care to avoid exposing investors to unforeseen risks. Moreover, managers need to be extremely open about these sorts of mismatches. A forewarned investor is a forearmed investor.

Having entrusted their money to hedge FoHF managers, investors have an interest in understanding how these managers are able to keep their promises on returns, risk mitigation and diversification relative to conventional asset classes. But they also need to be familiar with an area that is seldom addressed, namely, how managers plan to deliver on their liquidity-related commitments.

Please contact your usual HDF account officer if you require further information.

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