



Liquidity: At What Cost?

Overview of Hedge Fund Performance

Liquidity and the Performance of Hedge Funds

From the first section of this report it can be seen that there are clear differences between strategies when it comes to liquidity (Fig. 2). In addition, when looking within strategies there can be significant variation from fund to fund (Fig. 1). The frequency and degree to which investors are permitted to access their capital is an important consideration for them when assessing new hedge fund opportunities, but the likely liquidity also needs to be balanced with the potential returns available. Infrequent redemption periods provide managers with a degree of stability and facilitate the pursuit of longer term investment strategies. Regular redemption periods enable the quick release of capital during times of crisis, but does this come at the cost of comparatively lower returns?

Less Liquidity, Greater Returns?

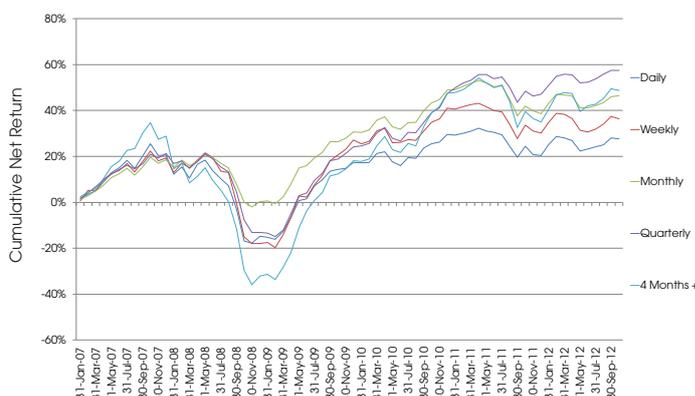
As an example, Fig. 3 demonstrates the returns of funds within the long/short sector differentiated by their redemption frequency. Over the full 70-month period it shows that funds providing investors with access to capital on a quarterly basis have performed significantly better than funds with more frequent redemption periods.

Daily redemption and weekly redemption long/short funds have posted cumulative returns of 28% and 36% respectively since 2007. Although this compares favourably with public markets – the S&P 500 index declined 0.43% over the same period – it is short of the 46% generated by funds with monthly liquidity, the 58% posted by quarterly redemption funds and the 49% returned by funds with less-than-quarterly redemptions. So does it follow that less frequent access to capital results in better returns for investors?

As shown in Fig. 3, funds with redemption terms less frequent than each quarter (4 months +) noticeably outperformed other long/short funds during 2007, posting 29% for the year. By the end of 2008, however, the performance of these vehicles had declined significantly and more steeply than funds with more frequent liquidity. The cumulative return for the two years to December 2008 stood at -32% for funds providing redemption opportunities on a less than quarterly basis. This drawdown occurred at a crucial period for investors, when liquidity was vital as investors faced credit drying up in other areas of their portfolio and called for capital to be returned. The combination of being locked into a fund with capital redemption periods only every few months and very poor market returns can explain the dissatisfaction and concern that many investors expressed at this time with less liquid hedge funds, as well as the growing appeal of more liquid funds, which offered investors greater opportunities for asset protection.

Quarterly redemption funds also faced a sizeable drawdown during 2008, dropping to a 24-month return of -13% at the end of the year. This was not as severe as the decline faced by less liquid funds, and

Fig. 3: Performance of Long/Short Hedge Funds with Different Redemption Periods, January 2007 - October 2012



Source: Preqin Hedge Fund Analyst

was of a similar magnitude to the fall experienced by daily and weekly redemption long/short funds. The subsequent performance of funds offering quarterly redemptions has outstripped that of funds with more readily available capital.

The indication, therefore, is that less liquid hedge funds have provided superior long-term performance in recent years, despite also suffering considerable drawdowns. However, for many investors it can be difficult to maintain such a long-term investment horizon, particularly when faced with the falling values and uncertainty witnessed in 2008. Investors faced a liquidity squeeze in 2008, and funds with longer redemption periods often exacerbated the problem and contributed more to poor portfolio performance.

Liquidity of Strategies & Stability of Returns

As discussed previously, different levels of liquidity made available to investors tend to reflect the nature of the underlying strategies of hedge funds. Therefore, in addition to investment horizon, it is important for investors to consider whether a fund offering infrequent liquidity is likely to balance this with better returns or lower volatility. Is it possible to achieve superior performance or stability via a similar fund that provides more frequent access to capital?

Fig. 4 and Fig. 5 depict the volatility level and returns of hedge funds with different strategies and different redemption periods. Fig. 4 relates to the two years to the end of 2008; Fig. 5 demonstrates the same data for the longer period of January 2007 to October 2012.

Performance Differences: Strategies, Liquidity and Time

For a number of hedge fund strategies, the provision of less liquidity over the long term has led to higher volatility but has also yielded better returns. This is true in the case of long/short, relative value and multi-



strategy funds, where quarterly redemption vehicles outperformed monthly redemption funds, albeit at the price of higher volatility, in the period 2007-2012. However, the same quarterly redemption funds struggled during the period 2007-2008, when credit and liquidity were widely squeezed amid the collapse and state-backed bailout of a number of financial institutions.

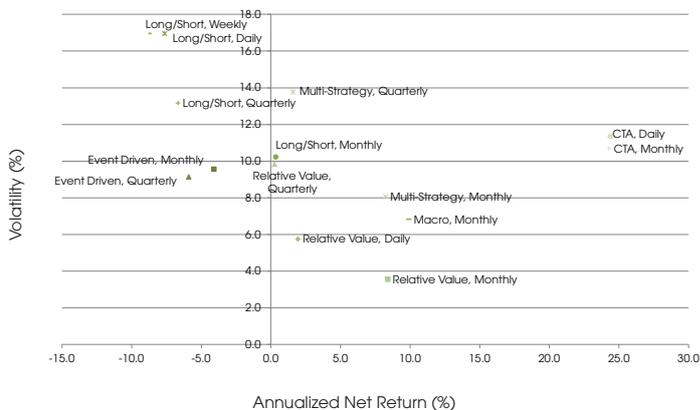
Relative value funds offering daily and monthly liquidity terms posted attractive returns and low volatility in both the 2007-2008 and 2007-2012 periods, emphasizing that the strategy delivers absolute returns regardless of market direction. Moreover, monthly redemption relative value funds experienced both higher returns and lower volatility than their daily redemption counterparts. This suggests that investors in relative value funds, which tend to employ comparatively high leverage, can access better performance if they are able to sacrifice daily liquidity for less frequent access to capital. The least liquid relative value funds – those with quarterly redemption periods – demonstrated higher levels of volatility. Over the longer term this has been matched with higher annualized returns but over the two years to the end of 2008 performance was only just in positive territory.

The risk-return profiles of multi-strategy and long/short funds tell a similar story to that of relative value vehicles. Quarterly redemption funds balanced higher volatility with better returns than monthly redemption funds in the long term, but in the shorter term between 2007 and 2008, low or negative returns were achieved with greater volatility.

CTAs and managed futures funds are typically more liquid than other alternative investment strategies. Figs. 4 and 5 show little difference between the risk-return profiles of daily and monthly redemption vehicles. However, daily redemption CTAs have performed slightly better with lower volatility since 2007 than those offering monthly redemptions.

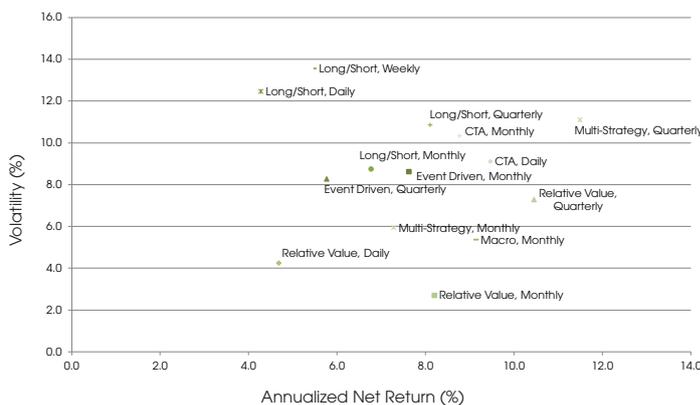
Monthly redemption event driven funds have also posted better returns than less liquid counterparts, with quarterly redemption funds generating lower returns in both periods. This is somewhat counter-intuitive because, in contrast to CTAs, event driven strategies tend to be comparatively illiquid, with longer investment horizons designed to capture the value as portfolio companies are restructured. However, it is worth noting that from the limited data available, there are indications that event driven funds offering less-than-quarterly redemption periods (bi-annually or annually, for example) have performed better since 2007 than those with more frequent redemption terms.

Fig. 4: Comparison of Hedge Fund Risk-Return Profiles by Strategy and Redemption Frequency, January 2007 - December 2008



Source: Preqin Hedge Fund Analyst

Fig. 5: Comparison of Hedge Fund Risk-Return Profiles by Strategy and Redemption Frequency, January 2007 - October 2012



Source: Preqin Hedge Fund Analyst

In the same way that managers must match the liquidity terms afforded investors to the likely liquidity of their own investments, investors themselves need to match fund liquidity terms with their investment horizons. Investors that are prepared to and are able to tie-up their capital for a sustained period are more likely to benefit by accepting less frequent redemption terms. However, faced with market uncertainty and negative returns, it is often difficult for investors to accept or justify less liquidity. With the credit crisis still so fresh in the memory, have the liquidity expectations of hedge fund investors changed?

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