Liquidity:
Overview of Hedge Fund Liquidity Structures

Ross Ford, Joe Childs and Graeme Terry explore investor concerns for greater liquidity in hedge funds. What strategies offer the highest levels of liquidity? What is the risk/return profile across the liquidity spectrum? Why do investors seek more liquid hedge fund strategies, and what are the maximum lock-up periods accepted by investors?

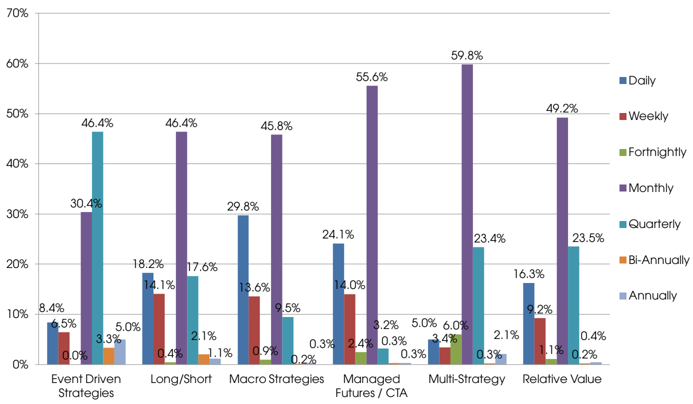
Liquidity – At What Cost?

Liquidity has been an important issue for investors and fund managers alike following the credit crisis in 2008. Fund structures have evolved to take advantage of this new liquidity-driven environment and there has been significant growth in the use of UCITS and managed accounts which can offer the liquidity many institutional investors are seeking. As our recent feature article on CTAs in November's Hedge Fund Spotlight demonstrated, strategies which can offer investors liquidity have thrived: over two times as many investors allocate to CTAs now than in 2008. In the current economic climate of increased market volatility, liquidity continues to be an important factor for investors when considering where to place their capital. Investors have learnt lessons from the global financial crisis in 2008, following gating of assets, a lack of understanding of the illiquid nature of some of their investments and overleveraged funds. In this edition of Hedge Fund Spotlight, we examine the liquidity of different hedge fund strategies, and how funds of different liquidity profiles have performed over the past few years. Preqin also conducted in-depth interviews with over 50 institutional investors to gauge their current sentiment towards liquidity in the hedge fund industry. Four years on from the credit crisis, has investor appetite for liquidity been sated?

Hedge Funds Liquidity Variation By Strategy

Preqin data shows that 46% of the hedge funds listed on the Preqin Hedge Fund Analyst database offer their investors monthly liquidity. The mean redemption notice period for all hedge fund strategies is 1.4 months with a mean redemption frequency of 35 days. The average lock-up period for all single-manager hedge fund strategies is 5.85 months. Fig. 1 shows how the different liquidity terms offered vary across the various top level hedge fund strategies.

Fig. 1: Liquidity Offered by Top Level Hedge Fund Strategies



Source: Preqin Hedge Fund Analyst

Fig. 2 shows the liquidity spectrum of the main groupings of hedge fund strategies; for the sake of comparison, CTAs have been separated from macro strategies. CTA and other macro strategies provide investors with the greatest amount of liquidity, allowing investors access to their capital, on average, more than once per month with the shortest notice period of all hedge fund strategies (two weeks notice for CTAs and three weeks for all other macro strategies). In cases where a lock-up is in place, these also tend to be short, at an average of 2.3 months and 2.9 months for CTAs and other macro strategies respectively. The underlying assets held by CTAs and macro funds tend to be more liquid than some of their counterparts in the wider hedge fund industry. CTAs may have daily or weekly holdings and the systematic models used continually rebalance holdings. Some macro strategies, such as those that trade foreign exchange markets, may have daily or intra-daily trading. As a case in point, 47% of all foreign

Fig. 2: Single-Manager Hedge Funds - Mean Liquidity Terms Offered By Top and Lower Level Strategies

Liquidity Profile	Core Strategy	Mean Redemption Frequency (Months)	Mean Redemption Notice (Days)	Mean Lock-Up (Months)
Most Liquid	Managed Futures / CTA	0.7	14	2.3
	Macro Strategies	0.8	21	2.9
	Relative Value	1.3	36	4.3
	Long/Short	1.5	31	5.8
	All Hedge Fund Strategies	1.4	35	5.9
	Multi-Strategy	1.6	44	6.5
	Event Driven Strategies	2.7	62	10.4
Most Illiquid	Other	2.1	71	10.3

Source: Preqin Hedge Fund Analyst

exchange funds offer their investors daily liquidity. The underlying liquidity of their assets is matched by liquidity at the fund level: any liquidity mismatches would not be tolerated by the investor market.

At the other end of the spectrum, event driven hedge funds offer their investors the lowest levels of liquidity of any hedge fund strategy, with the majority of funds only offering quarterly redemptions. On average, investors can only access their capital every 2.67 months with a two month notice period. Event driven hedge funds can also have significant lock-up periods; for event driven funds which initially lock-up capital the time period amounts to over 10 months. Event driven hedge funds look for inefficiencies caused by corporate events; in order to create value from these positions investments are often held for significant periods of time. Event driven managers often need to impose liquidity restrictions on investors in order to fulfil their investment period and ensure they do not need to exit an investment prematurely before value is created. Distressed hedge funds are one of the most illiquid hedge fund strategies; on average they offer their investors access to their capital every 3.65 months with 106 days notice.

Beyond event driven strategies there are a few other niche hedge fund strategies that tend to exhibit very illiquid characteristics. These include asset and mortgage-backed lending funds and insurance-linked strategies. For instance, the average mortgage-backed lending fund has a mean redemption frequency of 2.3 months with at least 81 days notice. For these funds which are providing credit in illiquid markets, the liquidity restrictions on the underlying assets can be significant; therefore, investors in these funds may be required to have less access to their capital than those strategies which may only have daily holding periods.

Within the extremes of the liquidity spectrum lie relative value and long/short funds. Long/short strategy funds exhibit the greatest variation in redemption periods from fund to fund. Relative value funds offer their investors more frequent access to capital than long/short funds (an average redemption frequency of 1.3 months compared to 1.5 months for long/short funds), but this is coupled with a longer notice period (36 days versus 31 days).

