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Illiquid assets: Improving transparency for investors

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Now more than ever, investors and regulators are demanding greater transparency when it comes to hedge funds that invest in illiquid financial instruments. This should come as no surprise given that the defining business failures of 2008 were related to illiquid assets: AIG's downfall was caused by investments in structured credit derivatives that were difficult to value, while Bear Stearns' and Lehman Brothers' descents were due in part to the illiquid non-agency mortgage assets they held. Many hedge fund investors suffered significant losses in the recent financial downturn, and consequently want a closer view of portfolio assets and valuation processes.

What are illiquid investments?

Illiquid assets are investments that can be difficult to sell and value due to limited market participants, infrequent transactions, complex structures or highly uncertain future performance. In some cases, it can take years to realize a return on the investment. Illiquid investments are frequently held in portfolios managed by hedge funds, private equity groups or investment banks. Examples may include investments in private equity or venture capital companies, distressed credit, bankruptcy claims, over-the-counter (OTC) derivatives, whole loan pools, convertible bonds, auction rate securities and collateralized debt obligations (CDOs). Because of the lack of observable transaction prices, illiquid investments are often valued using models that may include significant management judgment.

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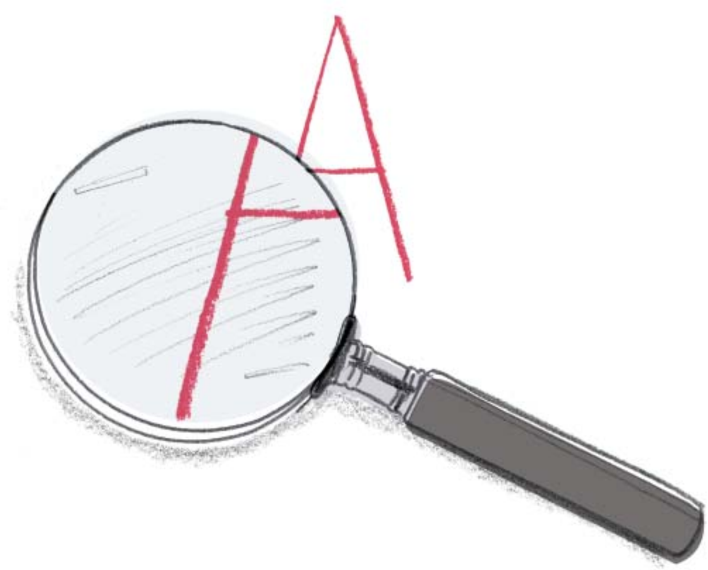

Upfront due diligence

In order to mitigate the risk posed by illiquid investments, institutional investors need to perform increased due diligence relating to a fund's investment strategy. They need to be able to answer questions such as: What experience has management had with liquidity shocks? What informational advantages or specialization do they have in the marketplace? What else is required in order to implement the fund's strategy, such as sufficient ability to sell/hedge positions in a dealer market or continued financing terms?

It's also important to ensure that the fund structure is appropriate to meet the cash flow needs of investors and the investment strategy, as well as the financing requirements of asset managers. Is the fund's structure appropriate given the liquidity profile of its investments? Consider issues of leverage, redemptions and side-pocket accounts that have been used to separate illiquid assets from other, more liquid investments. Is the financing or leverage of the fund appropriate given the composition of its assets? For example, a highly leveraged capital structure with short-term financing is not advisable when combined with illiquid investments.

Lock-up periods, which may restrict an investor's ability to exit a fund investment, are another area of growing attention due to the recent liquidity crisis. While many funds that specialized in illiquid assets were able to negotiate long lock-up periods for redemptions, other firms were forced to sell in order to satisfy investors' requests for cash. Funds with long lock-up periods were well-positioned to buy assets at favorable valuations when their competitors had insufficient capital available to make investments. For funds with large concentrations of less liquid investments, a long lock-up period is an appropriate structure.

Hedge funds with long lock-ups need to be able to instill investor trust in their managers' investment approaches and their funds' interim values. If investors are restricted in redeeming their fund investments, they should have sufficient information to assess the value and report to internal constituents. In addition, investors such as university endowments, pension funds and family offices should carefully consider the effect of long lock-up periods on their institution's operating models.

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Valuation policies and procedures with an independent, third-party review

Hedge funds need to establish and follow clear policies and procedures for the valuation of all assets, but this is particularly true with regard to illiquid investments. During due diligence, investors should review the fund's written valuation methodologies to ensure management is adhering to industry best practices. Investors should also consider the methodologies used to compute manager or fund historical returns. Academic research has shown that the inputs and methods used in mark-to-model pricing tend to smooth out historical performance due to infrequent observed trades, limited use of liquid instruments for model inputs, and sticky models, i.e., trader bias toward using the same valuation approach over time.

Hedge fund management can ease investor uncertainty by engaging an independent third party to review the fund's valuation policy, process and the resulting asset prices used for investor reporting. The third party may be hired to review the valuation process and inputs for reasonableness, or alternatively to provide an independent value of the defined assets. An experienced audit firm will also test management's significant assumptions, the valuation model and the underlying data.

Additional disclosures to investors

In response to market dislocation, many hedge funds have made disclosures above and beyond what may be required by GAAP in their financial statements to investors. Currently, these disclosures are not part of the regular financial statements but are provided in an investor letter or as part of a supplemental investor reporting package. However, with the expected increase in hedge fund regulation and the trend toward greater transparency in financial reporting, we may also see additional disclosures required related to fair value measurement, as well as structural or contractual risks.

Such disclosures can help clarify the risks to investors, such as an estimate of transaction and search costs required to liquidate assets, a discussion of market participants and exit strategy, or an estimate of the time necessary to sell or unwind a position — especially a large position. Hedge fund disclosures may also include the liquidation or quick-sale value, i.e., the price if the manager is compelled to sell.

Looking ahead

Prior to the market downturn of 2008, strong returns for alternative assets enabled certain fund managers to provide limited information to investors, but the tide has turned since the market collapse. Large, successful hedge funds cannot afford to ignore investors' demands for increased transparency regarding key performance risks. Simply put, those funds that have an appropriate structure, clearly defined valuation processes and an independent third-party review of these processes will be more attractive to investors. •

In this issue of Hedge FundAdviser:

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