THE RISE OF REDEMPTION RESTRICTIONS—LIQUIDITY CHALLENGES IN THE CURRENT MARKET ENVIRONMENT

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Executive Summary

- A significant aspect of the current global financial crisis is a lack of liquidity across most markets.
- As a result, redemption restrictions have been imposed on a broad array of pooled investment vehicles ranging from short-term fixed income products to hedge funds.
- These redemption restrictions can restrict the ability of institutional investors to meet cash flow needs, re-balance portfolios, and/or take advantage of market opportunities.
- In many cases redemption restrictions are appropriate and in the best interest of long-term investors to protect them from the potentially negative impact of other investors exiting the fund.
- There may be opportunities to garner attractive terms from hedge funds and funds of hedge funds in exchange for extending lock-ups; however, investors should be cautious about making new investments in this area until near-term liquidity issues are worked through.
- Each client situation is unique and we recommend you discuss any redemption issues you may have with your consultant.

Background

One of the major symptoms of the current global financial crisis has been the evaporation of liquidity from the system. As the sub-prime crisis led to the failure or emergency rescue of a growing roster of major financial institutions, many of the traditional providers of liquidity to financial markets disappeared or significantly reduced the amount of capital they were willing to put at risk. Financial institutions de-levering and the dramatic re-pricing of risk by investors across the board has caused a vicious cycle of selling pressure and continuing market price declines. These factors have led to the "seizing up" of historically highly liquid segments of the global capital markets. High quality short-term securities such as A1/P1 commercial paper and AAA-rated short-duration asset-backed securities are suddenly not trading, except at significant discounts, while new issuance has dropped precipitously. Investment grade corporate bonds and non-agency mortgage-backed securities that historically have traded with tight spreads to government securities have seen yields balloon and bid-ask spreads of as high as 6-8%, if they trade at all.

THE IMPACT OF THE CURRENT LIQUIDITY CRISIS ON THE BOND MARKET HAS BEEN DRAMATIC AND PERVASIVE.

Fixed Income Funds

The impact of the current liquidity crisis on the bond market has been dramatic and pervasive, ranging from money market funds and short-term cash collateral pools to core bond funds. Many segments of the fixed income market where liquidity has historically been taken for granted such as money market funds, other short-term

investment funds, and collateral pools backing securities lending and derivatives overlay programs have seen unprecedented mark-to-market losses. These impaired asset prices have led to significant challenges in meeting withdrawal requests. Many of these pools are holding high credit-quality securities such as short-term asset-backed securities that are continuing to pay principal and interest, yet are currently trading at a significant discount to par. If these securities are held to maturity, they are likely to pay off at par; however, if the asset manager is forced to sell in the current environment, investors will incur a significant loss. In these cases, the imposition of redemption restrictions by the managers of these pools can represent a prudent action to protect investors from the impact of near-term anomalous pricing pressures and hasty investor withdrawals. The same is true of many longer-term bond portfolios, comprised of a mix of still liquid government securities and less-liquid corporate and asset-backed securities. Meaningful redemptions will force the manager either to sell the most liquid securities, thus putting the portfolio out of balance, or to sell *pro rata* across all types of securities and incur a significant loss in this environment.

SOME HEDGE FUND MANAGERS HAVE RESORTED TO INVOKING GATES, OR SUSPENDING REDEMPTIONS OUTRIGHT.

Responses to this liquidity situation have varied by investment manager, ranging from outright suspension of withdrawals, to staging of withdrawals, to redemption fees, to in-kind distributions, or a combination of the above. As a result of the diversity of approaches, it is important to evaluate every situation on a case-by-case basis, but in general, we view these restrictions as appropriate actions to protect existing long-term focused investors from fear-driven short-term selling.

Hedge Funds and Funds of Hedge Funds

HFs and FoHFs are facing liquidity issues that originate from several unrelated factors, including investor redemptions, tightening financing, and the rebalancing discipline of many of their investors. Investor redemptions are increasing due to recent negative performance or out of fear and uncertainty. Many institutional investors, especially in the foundation and endowment space, are looking for capital to fund anticipated operating cash outflows or private equity capital calls. Many HFs are also experiencing selling pressure as providers of liquidity lines and/or leverage are pulling these lines back. Lenders have been increasing haircuts (the required margin) increasing the price of borrowing, and, in some cases, not lending at all on specific securities, most notably convertible and high yield bonds. Also, given HF's performance relative to equity markets, investors following a rebalancing protocol are looking to allocate capital away from HFs to asset classes and strategies that have underperformed. In addition, FoHFs are, in some cases, exacerbating the situation by submitting larger-than-needed redemption requests of their constituent HFs, as discussed below.

Hedge Fund Response: Many HFs are selling as much as they can, in order to meet these liquidity needs. If redemptions exceed a certain level, managers can no longer sell securities without hurting remaining investors or causing their portfolios to become seriously unbalanced. In these cases, some HF managers have resorted to invoking gates (where only a fraction of assets are allowed to leave each redemption period), or suspending redemptions outright. Generally, HFs are moving toward longer lockup periods as they look to reconcile the liquidity terms between assets and liabilities and to protect the interests of long term investors. In the current environment, matching these assets and liabilities may require invoking gates and suspending redemptions for short periods of time. We expect this to become more prevalent until the market conditions begin to normalize, which may not occur for several quarters.

FoHF Response: FoHFs, which are encountering the same pressures as HFs, have responded in a manner that has put additional pressure on HFs. FoHFs have had to redeem from HFs in order to meet these liquidity and leverage lines. (Liquidity lines provide a buffer between the time when a

FoHF has to pay its investors and when underlying managers will pay the FoHF; leverage lines provide FoHFs with leverage at the FoHF level, for those that use such a strategy). Since FoHFs have to give notice to their underlying managers before they know investor redemptions, FoHFs have been availing themselves of the "free call option" with respect to redemptions. FoHFs are redeeming an amount from each underlying HF that is in excess of what they think they will need. Should they find that they have redeemed too much (or the underlying investors request less than anticipated redemption amounts), the FoHF can then rescind the excess amount. This is safer than underestimating the level of capital needed and easier than asking for a redemption from HFs after the HFs' redemption period has expired. This has caused HFs to slow or stop redemptions altogether (imposing gates or suspensions) or, in some cases where HFs have a strong brand name, the HF is not allowing investors to rescind their redemptions requests. In response to this, many hedge funds have been raising record levels of cash in their portfolios to help manage redemptions.

THERE MAY BE OPPORTUNITIES TO GAIN ATTRACTIVE TERMS IN EXCHANGE FOR EXTENDING HEDGE FUND LOCKUPS.

Fund Restructurings: Another response by HFs and FoHFs to the current liquidity crisis is to restructure funds that are experiencing higher redemptions than anticipated. They are offering incentives to investors to remain in place, including reduced management and incentive fees below the highwater mark *and beyond* (up to a limit) once the fund is profitable again. The deal is typically based on accepting an immediate lockup of 1 -2 years. The other option for investors is to retain their redeemer status and receive their capital as and when it is available. We are generally in favor of investors accepting these deals when they are investor-friendly and where investors are able to hold their investments to term but each deal must be evaluated on its own merits.

Investor Actions: When investors redeem from HFs or FoHFs due to fear or uncertainty, they are putting stress on a system that relies on long term investors who believe in the value of HFs as a source of low-correlated returns in a broadly diversified portfolio. Historically, HFs have outperformed traditional investments coming out of these liquidity shocks due to the flexibility of their investment mandates coupled with the longer term nature of their capital base.

We believe that the marginal HF investor, one who does not appreciate the value of HFs or is uncomfortable investing in this space, may not be able to withstand the current market conditions and will redeem. This may be beneficial for the HF industry going forward as there is likely to be a closer alignment between investors and managers, to their mutual benefit.

We recommend that clients with exposure to strong, institutional-caliber HFs or FoHFs stay the course and not submit redemptions unless they have an absolute need for liquidity. Even then, liquidity may not be assured. For clients that are considering allocating new capital to HFs or FoHFs, we recommend that they take a deliberate approach and evaluate delaying capital commitments until there is better visibility into the current year-end redemption cycle, and even the first-quarter redemption cycle.

Conclusion

This is an extremely challenging market environment, one that encompasses many risks as well as potential opportunities. Each client's situation is unique. The recommendations in this note are general and need to be applied in a customized fashion given the specifics of your investment program. Our consultants look forward to working through these important issues with you.