

## *Liquidity Events and Hedge Funds*

For this month's Tapestry SPOTLIGHT, we focus on liquidity "events" in the financial markets and how they apply to hedge fund investing and portfolio management.

There are a number of common factors that exist during what can be described as a "liquidity event" or "market meltdown"; that result in the financial markets selling off rapidly (potentially for an extended period of time) or trading erratically after the initial shock.

Typically, leading up to this "panic," the market and investing environment is viewed by participants to be "normal." Such a market can generally be characterized as an upward trending market with relatively tight bid/ask spreads. In this environment, investors typically have the ability to borrow cheaply, relative to expected returns from the capital markets, and thus could leverage ones investments to magnify the return potential.

It has been our experience that in a market positioned with large amounts of leverage and investor hubris across the system, sharp price and/or investor psychology dislocations can result in greater uncertainty and risk averseness leading to a potentially dramatic shift in market liquidity. The ensuing "mass" flight to safety can be further exacerbated by a reactionary shift in macro-economic policy/regulatory stance and can lead to more specific issues such as the uncovering of fraud/misuse of leverage, etc. that were allowed to flourish during benign market conditions. This leads to further deterioration of market confidence and we get caught in a vicious unwind circle.

In an attempt to return to the once "normal" market environment, measures can be taken by the Governments and their Central Banks to ease the situation including implementing various stimuli and easing policies. In some instances, there are times when inaction is the policy move, since modern financial markets provide for a self correcting mechanism to flush out the excess. If the liquidity event has a more specific issue such as fraud or malpractice then the reaction is typically directed to discussions of increased regulation.

From an investment perspective, hedge fund and commodity trading advisor strategies are generally viewed to provide a somewhat independent return stream to the broader, directional markets. In times of stress, some of the "normal" market relationships breakdown and some of these strategies can become more correlated as evidenced by the Equity Long/Short manager universe in 2008.

In 2008, strategies with directional equity (the ones that emphasized enhancing equity market beta rather than security selection) and credit exposures suffered the most from the dramatic sell off whereas systematic CTAs benefited from trends present in the markets. In general, managers in the arbitrage community who relied on substantial leverage and failed to account for potential illiquidity of their positions were the predominant victims of the year.

Modern financial markets are extremely interconnected and it has been our experience that in the hedge fund world, correlations generally break down as a function of liquidity events. Hence, we at Tapestry strive to be cognizant of manager liquidity both in terms of the assets they trade and the structural nuances in their portfolio construction methodology. In spite of this, we also were a bit surprised by the disappearing "bid" across many market sectors.

**Key items to consider when constructing multi-manager hedge fund portfolios:**

Given that liquidity events and unwinds are two important factors in the hedge fund arena, a couple of imperatives to take note of when constructing a portfolio are an investor's timeline and their liquidity requirement. This greatly impacts how these liquidity events are handled and also defines what sort of portfolio is to be constructed.

Hence, it is imperative to have a considered view of the market backdrop (outlook) when constructing a portfolio. This allows one to choose strategies that may benefit from trends that could occur in the financial markets – i.e. will the economic climate going forward be inflationary or deflationary and will this affect asset classes/strategies? However, we do caution against trying to time markets, strategies and/or policy initiatives. In our opinion, this is not a sustainable investment approach.

The benefits of “normal” diversification of strategies generally work in “rational” and well defined market environments. Extreme market dislocations are brutal in nature and can distort portfolios constructed in more “normal” times. Thus, it is important to bring forward a true range of possibilities/outcomes considered from both a quantitative and qualitative perspective when constructing a portfolio. Factors to consider in this regard include:

- The hedge fund portfolio manager's experience/background – has he or she invested over multiple economic cycles and faced illiquid environments before. If the answer is yes, then how have they navigated previous illiquid periods and what was the outcome? Have they ever suspended redemptions?
- The hedge fund's strategy – as is the case in normal, positively trending markets hedge funds are able to leverage and maximize returns. When liquidity shocks occur how will the strategy be affected i.e. is it a strategy that typically only does well in certain market environments?
- The hedge fund's strategy, part two – has there been a style drift or diversification in the hedge fund so much so that the fund is now investing in asset classes or utilizing strategies that it did not originally set out to do? Has this been a result of increased asset gathering and pressure to increase returns for investors?
- What is the hedge fund's valuation policy? Does the fund use third party verification? How are positions priced? How frequently are these positions priced? If they are less liquid positions, is the pricing being used to smooth returns and understate the actual volatility of the fund? How much of a hedge fund's alpha is a function of investing in securities that are less liquid?
- What is the hedge fund's fee structure? In the bull market years (2003-2008) hedge funds demand outstripped supply and investors had to give up a lot of the economics to managers. Since the liquidity shock of 2008 and subsequent de-risking within the investor community this balance has started to shift towards the investors' benefit.
- Who are the hedge fund's counterparties (prime brokers, FCMs, OTC counterparties)? In the event that a liquidity shock occurs, how will this affect the fund's counterparties versus the hedge fund itself in terms of stock borrow, leverage, ISDA's etc.
- What are the hedge fund's policies towards utilizing leverage? Heightened systematic leverage in market unwinds affects hedge funds that rely on leverage at a strategy level to generate returns, no matter how the underlying hedge fund's portfolio is composed.
- What is the hedge fund's side-pocket policy?
- What is the composition of the investors in the Fund?

Liquidity can be measured in a variety of ways. The impact of the ability of a hedge fund manager to liquidate a position gets interesting when markets stop functioning or become highly erratic.

Positions can quickly move from 'Gems' to 'Baggage' to 'Illiquid' to 'SPVd' – a good short term trade quickly becomes an unknown long term investment.

Hence getting an understanding of how the hedge fund manager approaches the concept of liquidity is imperative. Are they being realistic in setting up their risk systems and tempering it with personal experience/views?

Quantitative and portfolio optimization tools for portfolios and sizing of managers should be used in concert with common sense and experience of market cycles. Being street smart and having a strong relationship with the hedge fund manager/team is a key component to any portfolio build.

Qualitative considerations include, ascertaining the hedge fund managers approach towards the capture and monetization of gains when everyone is running for the door? Are their returns delayed with the view of a sizeable pickup to come later? In this regard, ongoing communications with management is key to get a "feel" of how the manager is trading, sizing, hedging and watching the markets.

### **Looking ahead:**

The massive liquidity event that occurred in 2008 and bootstrapped 2009 has reduced the number of hedge funds in the alternative investment universe and also the amount of leverage utilized. Going forward, leverage will continue to remain significantly lower than in the bull market years of this decade driven primarily by availability, cost and risk management considerations.

We at Tapestry believe this should lead to greater inefficiencies in the markets, enhanced flexibility and a tighter more experienced set of managers to choose from when creating a multi-manager portfolio.

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