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# Hedge fund investors opt for liquidity over returns

By **Martin de Sa'Pinto** | ZURICH

The rush for liquid hedge funds is costing investors juicier opportunities elsewhere as institutions opt for a safety first strategy after being burned in the financial crisis.

The preference for liquid funds is also squeezing returns as more assets and a growing number of managers try to capture alpha, or outperformance, from a finite number of suitable asset classes.

Hedge fund companies are making efforts to meet investors' liquidity needs, with many launching funds regulated under the European Union's Ucits III regime which imposes strict liquidity requirements and clear pricing of assets, and limits leverage.

Following the 2008 crisis, many investors want funds they can sell quickly if market turmoil hits, opting for Ucits or for segregated accounts, which offer visibility and control over their assets. Some managers say this strategy has its limits.

"You're not going to make money if you're forced to sell every time something goes down. People will have to realise this when they invest in their Ucits III structures," said Wouter ten Brinke, head of Amsterdam-based fund of funds Theta Capital.

"If you have staying power, if you're not forced to liquidate, that's where you can benefit most from less liquid strategies or instruments," said ten Brinke, whose company manages $850 million (559 million pounds).

While investors are reluctant to be contractually tied to funds, or "locked up", studies have shown hedge funds with lock up provisions produce excess returns of 4 to 7 percent per year over their relevant liquid benchmarks, ten Brinke said.

His company's Theta Deep Value fund invests in illiquid strategies, including funds buying the asset backed securities at the root of the subprime crisis. Deep Value returned 45 percent from launch in July 2006 and April 2010, well ahead of a 4.2 percent rise in the Lipper Fund of Hedge Funds Index.

Conversely, large inflows to the most liquid hedge funds may be crowding their ability to make money.

Managed futures, among the most liquid strategies, had big inflows after performing well through the crisis, but Lipper data show them among the worst performing hedge fund segments of 2010, with year-to-date losses of 4.05 percent.

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Even many investors without immediate liquidity needs are avoiding illiquid strategies, which are seen as more risky and are often undervalued by liquidity-obsessed markets.

"The upside of outperformance for pension funds doesn't compensate for downside of a potential blowup. In hedge fund investing the biggest risk for institutional investors is headline risk, reputational risk," said ten Brinke.



Industry experts say investors now want funds to hold enough cash and liquid securities to meet withdrawal requests without having to sell assets when markets are in freefall or blocking withdrawals, as many did in 2008, in order to contain losses.

"They (investors) don't want to be parted from their money. Right now (liquidity is) the key issue we see with investors," said Peter Schoenfeld, chief executive of hedge funds company PSAM LP at June's GAIM hedge funds conference in Monaco.

Moreover, few pension funds or insurance companies have enough in-house expertise to be comfortable with illiquid securities or funds, said Rebecca Meijlink, head of capital introduction company Alphabet Capital Advisors.

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"Also their structure is cumbersome, their committees can take a year to decide what they can invest in, so it is hard to grab opportunities when they arise," said Meijlink.

Fund of hedge funds, still the largest hedge fund investors, are also favouring funds they can sell easily after many had difficulty closing positions during the crisis so could not meet investor requests to redeem their assets.

"Even if funds of funds think illiquid strategies can outperform, they need to ensure the liquidity in their portfolio matches the terms offered to investors," said Meijlink.

Larger institutions with specialist staff are still investing in long-term hedge fund strategies, said Gerlof de Vrij, head of tactical asset allocation at 240 billion euro Dutch pension manager APG.

Tony Broccardo, Chief Investment Officer of the 15 billion pounds Barclays Pension Fund (BARC.L), said his fund held enough liquidity to be flexible, but would use it to buy into illiquid areas when good opportunities arose.

But Barclays and APG are in a minority. High net worth clients invest in less liquid funds if returns promise to be more appetising, but the ground has now changed for hedge funds as institutions like pension funds have grown in prominence.

"The objectives are very different," said legendary hedgie Byron Wien, now a director at Blackstone (BX.N). "Individuals are willing to take the risk to get the performance, institutions are willing to give up performance points on the upside to get the protection on the downside."

(Editing by Sitaraman Shankar)

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