Hedge Fund Redemptions Dec 2008

Hedge funds will face massive redemption requests for 31 December 2008 as investors seek to reduce risk across the board. This is an unprecedented position for the industry. Hedge funds often face liquidity mismatches in that there are positions with longer duration than the redemption intervals offered by these funds to their investors. They can therefore only meet a portion of redemptions should everry investor redeem fully from the fund. In case redemptions exceed a certain proportion of total assets under management, hedge funds have mechanisms which limit redemptions (called Gates), or have the right to suspend redemptions. Another failsafe is the right to meet redemptions in kind, that is delivering securities held in the portfolio, to redeeming investors.

Fund of hedge funds are in a similar if not worse liquidity mismatched position as hedge funds.

As investors redeem from funds of funds, they in turn are forced to redeem out of the hedge funds they invest in.

Hedge funds provide liquidity on a monthly, quarterly or annual basis. Some have lock ups ranging from 1 year to 5, but few have more than 3. 10 years ago, most hedge funds provided monthly liquidity. Today, most funds have at best quarterly liquidity and the number with lock ups has also increased.

The industry is today caught in a Prisoner’s Dilemma. Performance of the hedge fund notwithstanding, the expectation of redemptions incentivizes investors to redeem. Stable holders aim to redeem ahead of weak holders so that individually rational decisions lead to collectively irrational outcomes. Extrapolation leads to the conclusion of mass redemptions leading to closure.

For the hedge fund manager who has performed poorly, there is no escape, and closure is inevitable. Their security strategy, is to do nothing, face the flood of redemptions requests and either gate the fund or suspend redemptions.

For the hedge fund manager who continues to perform well, there are various options. Their best strategy is to communicate with their investors and to manage the investor base.

For too long, hedge fund managers have neglected the management of their investor base. For a company structured with variable capital, this is a necessary and crucial part of risk management since capital can be withdrawn. Leverage is a function of capital and can increase precipitously if capital is withdrawn.

For the hedge fund manager, a prudent strategy would be to communicate with their investors so that the majority of their capital can be secured. This should be done before assets begin any substantial decline, before any substantial redemptions are submitted. The investors, in effect shareholders, should be presented with a strategic plan for either supporting the fund as a going concern, or an orderly liquidation. In any case, a suspension of redemptions would be a likely feature of the plan, as well as time line for which to either lift the suspension or liquidate the fund. A number of hedge funds have done this, albeit when their assets have declined severely, and redemption orders have flooded in. A pre-emptive coordination with investors preserves the reputation and franchise of the hedge fund manager.