The liquidity conundrum

As hedge funds increasingly explore investment in less liquid asset classes such as private credit, private equity and infrastructure, Daniella Skotnicki of Harneys examines some of the challenges this presents.

In response to market pressures which range from quant and index funds to political and economic factors, in order to seek alpha and deliver returns to investors hedge fund managers are increasingly looking to less liquid strategies such as private credit, private equity and infrastructure.

Some 35 percent of hedge funds offer private credit products or plan to by 2020, and 28 percent aim to invest in private equity, according to EY's 2018 Global Alternative Fund Survey.

Managers will often seek to add an illiquid component to an otherwise liquid strategy to bolster decreasing returns; only 16 hedge funds were able to deliver positive returns before fees in 2018 from a universe of 450 monitored by HBSC's alternative investment group.

The demand to adapt the liquidity provisions and structuring of Cayman funds to manage the diversity of liquidity across investments has increased and there is an increase in demand for "hybrid funds" with liquidity and fee terms which include aspects of both liquid and illiquid strategies. Mechanisms such as side pockets, which for a period of time went out of favour, are becoming more common.

Illiquid assets within existing funds

Generally, investors in hedge funds structures have the right to redeem periodically. The typical hedge fund articles of association will provide certain mechanisms for the management of liquidity such as:

- A hard or soft lockup period, being a period of time in which the investors are unable to redeem from the fund or are subject to an additional fee for doing so;
- Investor or fund level redemption gates which permit only a specific percentage of net asset value (NAV) to be redeemed on any redemption date;
- A redemption notice period which requires a certain notice period for redemptions; and
- Rights to suspend the calculation of NAV, the redemption of shares and/or the redemption payments.

If a manager is investing a potentially large proportion of the NAV in illiquid assets, the redemption notice and lockup period may be insufficient to manage the illiquidity, and managers often prefer not to rely on suspension rights, as this may give a negative signal to the market as to fund performance.

Managers of existing funds are also bound by the investment strategy and restrictions in the offering documents which may not allow for investment in less liquid strategies

Establishing a separate vehicle

As a result of such issues, managers will often look to establish a separate vehicle to hold illiquid investments but this, in itself, may

create complexities and will increase costs. For instance, the manager needs to consider how investments will be allocated between the funds and if investing in the same assets, whether the vehicles will enter and exit at the same time.

Managers will need to consider the tax implications when determining whether a separate vehicle will be more appropriate.

Structuring funds to allow for illiquid investments

The alternative is to establish a fund which will have the flexibility to invest in both liquid and illiquid investments. If the fund is to allow redemptions, the fund terms will need to incorporate mechanisms to manage the illiquid portion.

Multiclass funds

The articles of association of Cayman funds are generally drafted to allow for new classes to be offered by the directors on different terms, which may include more limited or no redemption rights.

There are several issues with this approach: the manager will also need to ensure the appropriate allocation of expenses between the classes as the liquid class expenses and the illiquid classes could vary dramatically. There is also potential cross-class liability if an investor fails to satisfy a call on a private equity fund and the class is unable to meet its liabilities, investors could then look to the liquid classes.

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Managers may prefer that one class of shares is issued to investors with the flexibility to invest a portion of the NAV in illiquid assets; this allows the manager to allocate between illiquid and liquid assets without redeeming existing investors or converting the shares to different classes.

Segregated portfolio companies

A second option is to form a segregated portfolio company (SPC) which will create both illiquid and liquid portfolios with statutory segregation of assets and liabilities between the portfolios.

However, there are certain drawbacks to this approach: SPCs are generally not popular with institutional investors, and the segregation of assets and liabilities has not been tested by courts outside the Cayman Islands and operationally can be burdensome, with the directors having the obligation to maintain the statutory segregation of assets and liabilities, and any contracts need to state clearly that they are being entered into by the relevant portfolio.

There will be similar issues in respect of the appropriate allocation of expenses and the inability to easily switch between illiquid and liquid allocations.

Side pockets

Another option is to provide for the creation of side pockets. The benefits of a side pocket are that: (i) only one class of shares will need to be issued; (ii) the assets held in the side pocket may not be valued; (iii) the shares issued in respect of the side pocket will not be redeemable at the option of the shareholder; and (iv) once these assets are realised, the redemption payments less the relevant fees will either be paid by the fund or investors will be issued with additional shares of the original class.

Only investors at the time the asset is declared illiquid will participate in the side pocket. Other options are to place the assets in a liquidating account or trust until they are realised, but the treatment of these assets is often difficult from an accounting perspective. These vehicles can be used to hold a portion of the portfolio or a single asset.

As managers of liquid strategies have been placed under increasing competitive pressure to deliver returns, the move to less liquid strategies has continued and managers should consider whether the fund terms and structure permit the flexibility to invest in these type of assets. ■

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