

Hedge Funds: Is Their Illiquidity Worth It?

Some hedge funds have a worrying lack of liquidity. Investors need to consider whether this limitation is justifiable and make sure that they are compensated for the temporary immobilisation of their capital. These issues are all the more important now that hedge fund liquidity is on the decline. We are seeing the emergence of new managers who are using strategies that are fairly similar to those used in private equity funds, meaning that their investments need to be held over extended periods.

The same trend is apparent among veteran fund managers, who have to adapt to these new niche opportunities and protect themselves against the consequences of the arrival of a client base that is quick to sanction poor short-term performance. In this article, we will show how the illiquidity of hedge funds can be justified from an economic standpoint and that it is often essential to ensure the sustainability of their business.

In principle, a hedge fund cannot invest in assets if the average time required for their liquidation is greater than the fund's redemption period. Furthermore, certain strategies – particularly activist, credit and event driven – which rely on catalysts with more or less long-term horizons, require the appropriate level of liquidity in order to have enough time to generate results. If these managers allow too much liquidity it poses risks to the investor. Take the example of a fund manager that only has access to three or four investment opportunities per year, and whose talent is such that he selects those that are highly profitable in more than 70% of cases. This fund manager would need more than a year to prove his skill. Managing redemptions by means of appropriate liquidity would allow him, among other things, to limit the flight of capital resulting from a knee-jerk reaction to poor short-term performance, thereby allowing the outperformance promised to his investors to be generated.

The above examples indicate the necessity and advantages of having liquidity levels appropriate to the investment strategy implemented by a fund. In order to check whether these qualitative reasons effectively translate to a liquidity premium, we carried out a quantitative analysis comparing the average historical returns of liquid and illiquid hedge funds. We first constructed a database representative of all the hedge funds that have existed over the past ten years. In order to do this, we aggregated (by eliminating duplicates) the funds in six commercial databases. All multi-strategy funds and CTA funds were eliminated, since the databases for the former group often include funds of funds and the inclusion of the latter group would bias the assessment because, owing to their strategy, CTAs are only found in liquid funds. The final restriction was that each fund assessed existed for more than 24 months between January 1997 and September 2006. Using this information, we separated the funds into two groups, reflecting the two extremes of liquidity:

- All funds with annual liquidity (354 funds)
- All funds with monthly liquidity (1800 funds)

The table below represents the average annual performance of these two groups of hedge funds between January 1997 and September 2006. These results show that illiquid funds outperform liquid funds by around 2% per year. This premium was observed historically for all years during which the liquidity of the markets was good. There were four exceptional years: in 1998 and 2002 liquid funds outperformed due to the liquidity crisis caused by the Russian debt default and the bankruptcies of Enron and Worldcom. With regard to 2005 and 2006, the average outperformance of liquid funds is attributable to a bias in the analysis, which is explained and corrected below.

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	AVERAGE
Annual average of illiquid funds	26.5%	5.4%	33.4%	15.3%	11.8%	-0.4%	22.1%	12.3%	8.4%	8.2%	14.3%
Number of illiquid funds	122	141	161	196	229	274	302	314	314	288	
Annual average of liquid funds	20.7%	9.5%	26.1%	15.0%	7.1%	3.2%	14.6%	7.4%	9.7%	8.8%	12.2%
Number of liquid funds	244	323	446	597	776	1051	1346	1586	1714	1528	
Liquidity premium	5.8%	-4.2%	7.3%	0.3%	4.7%	-3.5%	7.4%	4.9%	-1.4%	-0.6%	2.1%

At least three different factors might explain this 2% outperformance:

1. liquidity
2. the difference in strategy distribution between the two groups. For example, the illiquid funds group contains a more significant proportion of credit funds.
3. experience (i.e. the average age of the funds in the two groups is not similar), which is ignored in this assessment, as the survivorship bias of the databases and the 24-month existence required attenuates the disparity between the fund managers.

The second premium can be compared to the liquidity premium: as explained above, certain strategies demand a low level of liquidity reflecting the illiquidity of the assets in which the funds are invested. In this case, therefore, the strategy premium is linked to the liquidity premium.

In order to understand the contradictory results of 2005 and 2006, we had to refine our study. Since the difference in the distribution of annual returns and the number of funds between our two groups could distort the average, we conducted the same exercise, comparing the average annual performance of each distribution quartile (i.e. we classified the funds according to their annual return and divided each group into four sub-groups of equal size). These results confirm the long-term outperformance of hedge funds with annual liquidity compared to those with monthly liquidity, including the years 2005 and 2006.

In conclusion, on the basis of our sampling, the above-described methods allowed us to show that the supplementary risk resulting from investing in illiquid hedge funds is compensated by an annual premium of around 2% compared to more liquid hedge funds. Moreover, the longer redemption period granted by the investor allows the manager to ensure the stable capital base required to extract the alpha available in niche markets.

Dr Fabrice Dusonchet, Quantative Analyst, E.I.M. S.A.