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Summary: This is the second in a series of three White Papers that explores the costs of unintended portfolio illiquidity and the possible benefits to selling less liquid and illiquid Hedge Fund Limited Partner Interests in a secondary market transaction. This White Paper explores in more detail the costs of unwanted illiquidity and the possible benefits of selling these interests along with the psychological process of making the decision to sell. A final installment will discuss other considerations including structuring and counterparty options. Overall, the reader should walk away recognizing the costs/benefits of using the secondary market for their less liquid and illiquid Hedge Fund LP interests as well as, other considerations when evaluating and trying to access further liquidity.

The Bullfighter Doesn't Always Win

Past Performance is No Guarantee of Future Results

During a business trip to Spain, a businessman's supplier takes him to the bull fight and afterwards, they eat at the arena a menu item labeled, the "Bullfighter's Special". It is the best meal he has ever had. A year later, the businessman vacations with his family in Spain, takes them to the bull fight and then to the same restaurant, bragging all the way about the "Bullfighter's Special". The waiter returns with a meal that is much smaller than the one he remembers and does not taste quite the same. He complains, "When I was here with locals, this was a different serving but, as a tourist, you think you can fool me and give me so much less?" The waiter replied, "Sir, the Bullfighter doesn't always win." The same can be said about less liquid and illiquid Hedge Fund LP interests and their underlying investments, particularly those that end up in side pockets. Those investments do not always pay off, let alone at a premium to current marks.

Many institutional investors who end up with less liquid and illiquid Hedge Fund LP interests tend to assume those investments will eventually "work out" while not properly assessing both the direct and indirect costs of continuing to hold on to these types of investments. Take the example of a large endowment with an aggressive allocation to alternative investments, i.e. Hedge and Private Equity Funds and the like just prior to the 2008 Great Financial Crisis (the "Crisis" or "GFC"). The endowment confidently over-allocated to alternative investments because at the time it was staffed by former and future hedge fund managers and the team was considered one of the most sophisticated Institutional Investors of the era, with access to the capital markets, the "best" managers, and investment ideas. Despite all this, the Crisis hits and reveals unintended illiquidity in the endowment's portfolio which manifests itself in both direct and indirect costs to the endowment and ultimately, its beneficiaries. The direct costs of unintended illiquidity in the endowment's portfolio include the obvious financial problems of a reduced operating budget and the need to halt construction on new facilities, organizational distress including the need to let go of employees and eventually the entire investment office going through a wholesale restructuring as a result of its tarnished reputation. The indirect costs of unintended illiquidity in the endowment's portfolio are less obvious and cause the endowment to be stretched too thin as they grapple with problems within their existing portfolio while simultaneously missing out on newly available investment opportunities that came about during the Crisis. This real-life example is undoubtedly extreme, but unintended illiquidity can negatively affect everyone in an organization, from the Board of Directors to the investment staff, all the way down to the ultimate beneficiaries. As in this case, the bullfighter does not always win and unloading the less liquid stub positions earlier on, even at substantial discounts, may have cost them less than holding on and the attendant other costs to the organization and beneficiaries that followed.

Know When to Hold 'em and Know When to Fold 'em

Benefits of Selling into the Secondary Market

The opportunity costs of unintended illiquidity may come in financial and non-financial forms and can affect every part of an organization. These types of investments typically outlast the investment staff (and the consultant) that made the initial investment, leading to a natural degradation of institutional knowledge, relationships, and ownership over the investment which only further exacerbates a lack of transparency into the underlying assets and making it difficult to forecast duration or valuation of the ultimately recovery. But, what about the benefits of selling less liquid and illiquid Hedge Fund LP interests into the secondary market? A secondary market sale of such investments may offer an easy way to side step all of these issues (freeing up human capital) while simultaneously generating liquidity (freeing up financial capital) which can be redeployed more productively.

Proactively seeking liquidity for less liquid and illiquid Hedge Fund LP interests benefits the overall portfolio by taking back control of investment outcomes from the outside manager. It is worth pointing out that when a hedge fund manager creates a side pocket investment they may have a "tails I win, heads you lose" mentality that ultimately serves the hedge fund manager more than any individual LP stuck in the side pocket investment. While the probable "upside" of holding onto the side pocket investment is "worth it" to the hedge fund manager, to the individual LP's the size of the side pocket investment to their overall portfolio may not be "worth it". For instance, take the example of a $10 billion endowment that allocates 10% to hedge funds, i.e. $1 billion, and then later on when it chooses to redeem, 10% or more of this balance ends up gated, suspended or in side pocket investments. Thus, the $10 billion endowment may now only have 1% of its assets in these less liquid assets (10% allocation to hedge funds and once redeemed 10% of the 10% AUM allocation to hedge funds is gated, suspended or side pocketed).

Placed in the proper context of a $10 billion portfolio, selling off this remaining 1% of AUM even at 50 cents on the dollar of where it is presently valued by the manager, i.e. the stated NAV, would just be a 50-basis point hit to the overall $10 billion portfolio. A small, but not inconsequential price to pay to free up both human capital and financial capital that can both be redeployed more productively to say nothing of the ongoing costs and distraction of holding on to those investments. This is especially the case as this remaining 1% position is not one position but rather, side pockets in a number of smaller position adding up to just 1%. The relatively small size of a side pocket investment is an excellent reason to seek secondary liquidity. Small residual illiquid fund interests are disproportionately expensive to monitor and maintain and can act as a drain on organizations' time and resources. Moreover, secondary sales have become reasonably efficient, so a secondary sale would likely cost fewer hours overall than continued monitoring and management.

The Eye Sees Only What the Mind is Prepared to Comprehend[1]

Cognitive and Emotional Biases, Kubler-Ross and the Fear of Missing Out ("FOMO")

Notwithstanding the potential benefits of using the secondary market to rebalance an institutional portfolio, many investors are hesitant or unsure of how to embark on such a process. Despite the aforementioned direct and indirect costs of holding onto less liquid and illiquid Hedge Fund LP interests and unnecessary risk these allocations create for the portfolio itself and institution at large, many allocators have not developed the right mindset to think about selling these investments into the secondary market because of the cognitive and emotional biases involved in making such a decision.

[1] Robertson Davies, *Tempest-Tost*

Potential secondary market sellers must go through several psychological stages to arrive at a "sell" decision. Institutional investors must contend with their "Fear of Missing Out" (FOMO) while working through both an intellectual and emotional process to reach "acceptance" prior to making the decision to sell assets in the secondary market (especially at a discount to where they are currently valued). We generally refer to the process that secondary market sellers go through as an adapted version of the Kubler-Ross "Grief Cycle", namely a seller's temperament to accept a discounted bid generally goes from "denial" to "anger", then "bargaining" and "depression", and ultimately "acceptance", especially once they realize the true cost/benefits of a sale.

Figure 1: Adapted Kubler-Ross Grief Cycle

The Kubler-Ross Greif Cycle argues that it is generally hard for people to accept and react quickly to unexpected change. Reluctance to sell at a discount is perhaps the most common barrier for sellers to overcome, and it is usually associated with the "Denial" stage of the Kubler-Ross process. The investor may justify this position based upon the published NAV of the assets in question or guidance provided by the underlying manager. If the underlying manager says it is worth NAV, why would anyone accept less?

It can be useful to reconsider the problem from a different perspective. Why not consider a secondary market sale of less liquid and illiquid Hedge Fund LP interest as an exercise in factoring a receivable (i.e. your gated, suspended or side pocketed L.P. interest)? In this way, you are not selling an investment at a loss, but rather accelerating the timeline of a divestment decision that has already been made. In this situation now, the buyer essentially "factors" the redemption claim like a business may "factor" their receivables with a bank. However, unlike regular merchant factoring, the credit risk not only reflects the credit quality of the "borrower" (the fund), but it also participates in the economic risks of continuing to hold the "inventory" (the portfolio of assets and the rise or fall of its NAV). This introduces a higher degree of uncertainty for the factoring party as the NAV may drop and recovery time may be greatly extended, hence justifying the discount to sell the investment.

Don't Forget the Time Value of Money

A Bias Towards Action

Yet another perspective is to consider the impact a potential secondary market sale would have on an investment's overall, life-to-date return profile. The illustration in Figure 2 shows how the overall performance impact of a secondary market sale (even at a steep discount) may be minimal in the context of the investment's overall return profile.

Figure 2: Discounts May Not Materially Reduce Overall Performance[2]

	MOIC	IRR
Hold for 2 More Years	1.50x	8.4%
Sell Today for 35% of NAV	1.48x	8.0%

[2] Assumes an investor whose initial $100 million investment has grown to $150 million over the course of five years. Now the investor redeems and receives 97% of the investment in cash and 3% in a liquidating SPV with an expected term of at least two more years and limited upside.

As noted in Figure 2, the overall return profile of this investment does not really change between holding the liquidating SPV for another two years versus selling it today at a 35% discount to NAV and this example focuses solely on the difference in overall performance outcomes and does not take into consideration the direct or indirect costs of holding the unwanted stub assets, nor does it factor in the opportunity cost of redeploying in a more attractive opportunity during that two-year period. As painful for some investors to admit they “sold at a discount”, the optics of the discount do not impact the overall performance of the investment. With a Kubler-Ross process in mind, investors should be aware of their progress toward acceptance, and work quickly to overcome the cognitive and emotional biases barriers that may be preventing them from making the decision to sell and moving forward with their investment program. As Tom Peters, author of *In Search of Excellence,* says “Good managers have a bias for action”.

This reminds us of the story Woody Allen once told, “When I was kidnapped, my parents snapped into action. They rented out my room.” This is a tongue-in-cheek example of Mr. Allen’s parents choosing the Joy of Missing Out (“JOMO”) over the Fear of Missing Out (“FOMO”). Institutional investors considering a secondary market liquidity solution are also confronted with a choice between “FOMO” and “JOMO”. The FOMO mindset is fear-based thinking that is focused on “what-if” and best-case outcomes. The FOMO investor stakes their own reputation on the manager’s mark and accepts the manager’s viewpoint, despite having already decided to terminate the fund investment. While the FOMO investor is worried about missing out on an investment’s upside, the JOMO investor acts decisively to terminate an investment and proactively redeploy the capital into new opportunities. The JOMO investor recognizes that they are not able to know more about the asset than the manager, so they proactively resolve the situation rather than waiting on unfulfilled promises. Just as Woody Allen’s parents did, sometimes moving quickly to deal with less liquid and illiquid Hedge Fund LP interests can provide a better recovery.

Every New Beginning Comes from Some Other Beginning's End

Getting to Acceptance

Institutional investors may hold on to less liquid and illiquid Hedge Fund LP interests believing the manager always wins but history has shown the Bullfighter doesn’t always win. As such, selling ones less liquid hedge funds interest earlier, rather than later, may provide a better result overall and not just with price and value but also, measured by other metrics like organizational stress and opportunity costs.

Despite many billion dollars of transactions in the secondary market for hedge fund interests over the past ten years, many institutional investors may be reluctant to engage with the secondary market due to a lack of familiarity and experience with the process. In most cases their fear is unwarranted because the secondary market for Limited Partnership Interests has matured over the last decade, and there are established norms that buyers follow as well as, some can actually assist with complexities that might arise. Thinking about how best to approach embarking on a secondary market sale transaction, including structuring considerations and counterparty options, is the subject of the next and final White Paper of this series.

About Dorchester Capital Advisors: Founded in 2001 as a Fund of Hedge Funds by two former Hedge Fund managers to manage their own and friends' capital, Dorchester has evolved over the years. Through its primary multi-manager platform, Dorchester has been an early and ongoing investor with many Alternative Investment Funds. Since 2008, Dorchester is among the first firms to participate in size in the secondary market for Limited Partner Interests in Hedge, Credit, Private Equity, Real Estate, and other Alternative Investment Funds. Dorchester works with Limited Partners, Institutional Investors, Brokers and General Partners to proffer customized solutions as well, including investing in GP-led tender and buyout offers, fund restructurings, and fund level debt and preferred equity financings. Dorchester has invested in direct, carve-out and co-investments with General Partners, Limited Partners, and other investors. Dorchester believes it is one of the few firms with the requisite size, insight, analytics, sourcing, intermediate term capital, experienced personnel, and track record to be an important counterparty in this ongoing and evolving secondary market for Limited Partner Interests. Over the years, Dorchester has earned its reputation as a reliable and collaborative counterparty and Limited Partner.