Summary: "The Secondary Market for Hedge Funds"

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Hedge funds have attracted much attention recently, both in the financial press, and from academics seeking to explain their high returns. Assets under management in the sector have grown from around 40 billion U.S. dollars in 1994 to around 1(1/2) trillion in 2007, with reports of institutional investors flooding into the market. The literature on hedge funds has identified that a large proportion of their returns can be explained by standard risk factors such as the market, and option-factors such as lookback straddle options (see Fung and Hsieh (2001, 2002, 2004), and Agarwal and Naik (2004)). Despite this, the best (and worst) hedge funds exhibit statistically detectable alpha persistence (see Kosowski, Naik and Teo (2005), and Jagannathan, Malakhov and Novikov (2006)).

A recent, important strand of the literature on hedge funds has studied how investors in hedge funds affect, and are affected by their performance. Authors have found that liquidity restrictions in hedge funds such as lock-up periods, redemption notice periods, and minimum investment requirements are associated with high alphas, especially in those funds which invest in illiquid underlying assets (see Aragon (2005)). This suggests that preventing investors from pulling money out at inopportune moments helps hedge funds to better plan their investments, and to more flexibly manage illiquid portfolios. It has also been noted in the literature that hedge fund flows appear to behave rationally, chasing high past alphas. However, this alpha-chasing generates declines in future alpha, perhaps on account of capacity constraints in the industry (see Fung, Hsieh, Naik and Ramadorai (2007), and Liang, Wermers, Ding and Getmansky (2007)).

These results on the behaviour of hedge fund investors are intriguing, and suggest that performance and hedge fund flows are intimately connected. However, many

questions remain. What are the main factors considered by hedge fund investors when they decide to invest? What determines the prices they are willing to pay to get in and out of hedge funds? Do they behave rationally when making these decisions? While there may be benefits to hedge fund managers from imposing lock-up and redemption restrictions, are investors deterred from investing in hedge funds that impose them, or do they cause investors to demand lower prices for entry to highly restricted funds? Does the prospect of high performance cause investors to pay more? Are hedge fund investors well-informed about future performance? Do high management and incentive fees scare investors away from some hedge funds?

This paper analyzes a new dataset of transactions between 1998 and the present, from Hedgebay, one of the only known venues for secondary trading of ownership stakes in hedge funds, to help answer these questions. Transactions are conducted at the end of the month, at premia and discounts to the net-asset-values of funds -- these premia vary both over time and in the cross-section of hedge funds. I find that the premia are negatively related to the length of the redemption notice period, and the level of management fees in funds. However, premia are positively related to measures of past fund performance. The relationship with performance is not merely with past performance. I consider the forecasting ability of transactions premia for future hedge fund returns, and find that high (low) transactions premia negatively (positively) forecast the future performance of hedge funds, over and above performance persistence. Finally, I find an interesting fact: the average monthly premium is highly correlated with the closed-end-fund premium for US mutual funds. This finding suggests that there may be some deeper structure underlying different markets for managed investments, a possibility that warrants further investigation.