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Committee Report: Valuations

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Hedge Fund Discounts

Quick, think about using deflated interests in hedge funds for tax-efficient transfers of wealth to heirs

Treasury Secretary Tim Geithner told Congress and the nation on Sept. 10, 2009, that the credit crisis was abating. But before the market fully recovers, individuals holding hedge fund investments should consider acting fast to take maximum advantage of potentially heightened valuation discounts.[1] Indeed, discounts for hedge fund interests may be historically large due to their unprecedented illiquidity. That makes this a unique moment to use deflated asset values in hedge funds to transfer wealth to heirs and minimize transfer taxes.

Blocked at the Gates

Estimates suggest that there were roughly 8,000 to 9,000 hedge funds in 2008, with about $1.8 trillion in funds under management.[2] The market crisis in 2008 left many individuals invested in these hedge funds dissatisfied with performance—and deeply frustrated with their inability to pull their initial investments out of the funds.

Although hedge funds outperformed the broader markets in 2008, most lost money, succumbing to the market's sell-off. As measured by the HFRI Fund of Funds Composite Index, hedge funds on average were down 21.41 percent for the year. But while many investors rushed toward the exits, their attempt to leave with their initial capital outlays often were blocked by a "gate"—the power given to hedge fund managers to limit the amount of withdrawals from the fund during a redemption period. Most hedge fund agreements contain a provision granting this power to prevent runs on the fund.

Redemptions can disproportionately impact investors who remain in a fund that become hobbled by imbalanced and illiquid portfolios. To treat both redeeming and continuing investors fairly, many funds at the time this article went to press were essentially deferring part or all of redemptions. Some funds were estimating, but not guaranteeing, 18- to 24-month time frames.

Here's the silver lining to that cloud: The uncertainty surrounding future redemptions means existing investments in gated hedge funds can be excellent assets to use in estate-planning strategies. The most attractive assets for gifting generally are those with a low current value but significant potential to appreciate, because the transfer cost is relatively low and the upside potential is relatively high. Clearly, many hedge fund investments today fit this description. Of course, just because a low-value asset has significant potential to appreciate doesn't mean it will, in fact, appreciate. Fortunately, certain estate-planning techniques are designed to capitalize on high appreciation yet impose negligible tax cost if that appreciation fails to materialize.

Valuation Discounts

The discounts for illiquidity can be substantial. But, in the past, hedge funds were relatively liquid. That meant valuation discounts haven't played as consequential a

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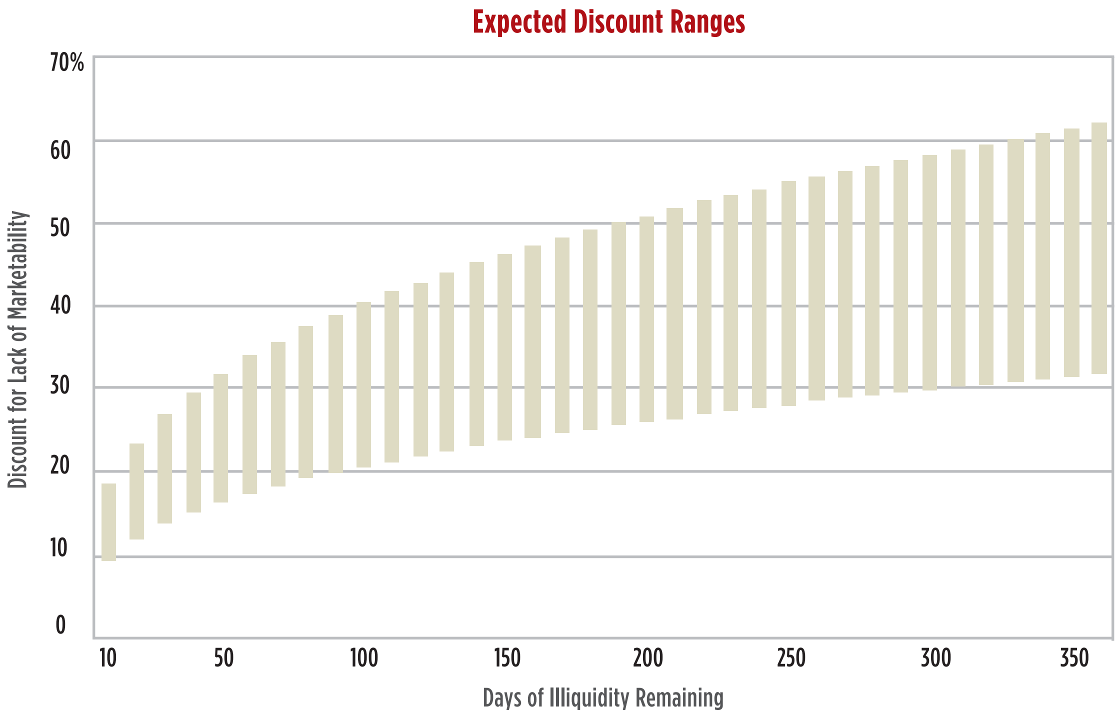
The Impact of Time on Discounts

The longer an owner is forced to hold an asset, the greater the discount



— LiquiStat database, Pluris Valuation Advisors, LLC

role in determining the value of the typical hedge fund interest as they have, for example, in valuing family limited partnerships, which are always relatively illiquid.[3]

Indeed, until recently, valuation experts believed that illiquidity discounts for the typical hedge fund interest were relatively low due to the moderate volatility evidenced by many strategies and typically short holding periods. The expected holding period, or time-to-liquidity, for a hedge fund interest is an important determinant of the illiquidity discount. The holding period is determined by how severe the impediments to liquidity are, whether in the form of limited redemption windows, "lockups" or gates.

Most funds require new limited partner (LP) investors to commit to lockups of one to five years from the date of investment, that is to say, the investor agrees to leave his initial investment in the fund untouched during that time. This arrangement has been the primary source of the illiquidity discount. Unless there is a significant period remaining before the lockup period expires, the hedge fund interest cannot be valued at the same level of discounts that commonly apply to family entities—that is, if we believe that a redemption request will be honored on schedule.

In more normal times and when there are no gates, once the initial lockup is over, most funds allow redemptions to occur either monthly or quarterly, with reasonable notice, which would suggest that the illiquidity discount should be relatively low.

But when a fund throws up a gate, the illiquidity discounts required to find a buyer can be severe. Very few investors would be interested in investing when the path to liquidity is uncertain and possibly lengthy, particularly if the fund will be attempting to liquidate a part of its positions in an unfriendly market environment. Note that a gate also can result in a lack of control discount as well as a lack of marketability discount because of the heightened uncertainty around what the hedge fund managers are going to do with the assets of the fund during the now-longer period of illiquidity.

The discount studies relied on by appraisers of illiquid assets generally evaluate the discounts taken in sales of restricted stock. On average, the discounts observed in these studies range from 20 percent to 30 percent[4] and the expected holding periods for the stock is commonly thought to be two years.[5]

The LiquiStat database[6] is the only illiquidity discount resource that provides reliable evidence on how discounts vary with time-to-liquidity[7] and it indicates that illiquidity discounts increase as a function of holding periods.[8] This expected result provides strong evidence that illiquidity discounts for hedge fund interests should increase in the current environment when expected holding periods are much longer than investors initially anticipated.[9] (See "The Impact of Time on Discounts," p. 43.)

Discounts and Risk

Valuation logic and the available data also show that the riskier the securities, the greater the illiquidity discount (in fact, the discount is often referred to as the liquidity-risk discount).[10] This presents a dilemma, as the most commonly used measure of risk is volatility and the volatility of the shares sold in most restricted stock studies is quite high, often around 70 percent to 100 percent.

The reported volatility of most hedge funds is quite low. But volatility may not be the best risk measure for hedge funds for two reasons: First, managers often intentionally smooth valuations when required to determine their own net asset values (NAVs) for infrequently traded securities.[11] Second, hedge fund returns are not normally distributed. Losses can come on suddenly and dramatically, creating what is known as "tail risk." Just think of all the news reports about hedge funds that reported very low volatilities up until the moment they actually melted down.

Clearly, valuation analysts seeking to determine illiquidity discounts for hedge fund interests are well advised also to consider alternative risk measures such as investment styles and strategies, the leverage employed in the fund, the leverage and riskiness of the underlying assets in the fund (think mezzanine tranches of collateralized debt obligations), and the illiquidity of the fund's assets.

Secondary Markets

Discounts are not just a theoretical construct. There's a secondary market in LP interests of hedge and private equity funds[12] and this market provides evidence that discounts reflect economic reality. Transfers of hedge fund LP interests generally require general partner consent, but such consent often will not be possible to obtain, especially when managers are doing everything they can to retain investments in the fund.

Secondary market discounts have varied widely over time. In better market conditions, some fund interests have even traded at premiums to NAV (if the fund was particularly attractive and hard to get into).[13] But in the current environment, virtually all trades are being significantly discounted.[14] Data from this market indicates there's been an average 44.8 percent discount during the second half of 2008.[15]

Secondary market discounts also may be a function of lags in valuing the NAV of hedge funds (in a negative market environment, implying that valuations belatedly catch up to market realities). Thus, these discounts may overstate the "pure" lack of control and lack of marketability discount. But if the hedge fund is subject to the same market and valuation dynamics (which is likely), this additional discount should apply to the fund interest as well. The data from the secondary market, together with the restricted stock data, provides key evidence for substantiating hedge fund interest discounts. (See "Slump in the Secondary Market for Hedge Funds," p. 45.)

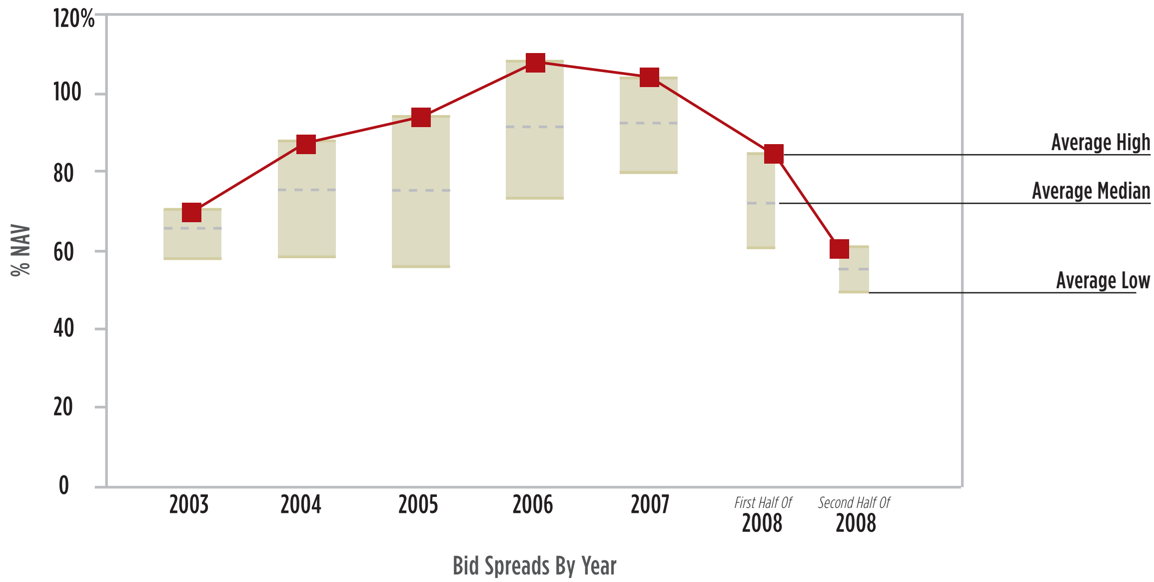
Benefits of Discounting

Valuation discounts work well in a number of estate-planning strategies but probably the most widely deployed use is the grantor retained annuity trust (GRAT)—an irrevocable trust designed to transfer future appreciation to individuals or trusts, typically children or other family members, in a tax-efficient manner. A grantor typically funds a GRAT with property that is likely to appreciate significantly. The trust pays the grantor an annuity, usually for two or three years. At the end of that period, whatever is left in the trust passes either outright or in further trust to the beneficiaries named in the trust (often the grantor's children). When the trust is funded, the grantor is deemed to make a gift equal to the value of the property the grantor transfers to the trust minus the present value of the grantor's annuity interest. Assuming the GRAT outperforms the interest rate used to value the grantor's annuity, the "excess" passes gift tax-free to the grantor's beneficiaries.

An important nuance of which advisors and their clients should be aware is that the effectiveness of a GRAT can be enhanced when the hedge fund interest is redeemed during the term of the GRAT. The payment of the annuity back to the grantor then is in the form of cash, which receives no discount, enabling the annuity to

Slump in the Secondary Market for Hedge Funds

There was an average median bid of 55.2 percent of net asset value (or a 44.8 percent discount) during the second half of 2008



— Vincent T. Cannon, "Secondary Markets in Private Equity and the Future of U.S. Capital Markets," Harvard Law School paper (available at www.law.harvard.edu/programs/olin_center/corporate_governance/prizes.shtml)

be paid off with a smaller portion of the GRAT's overall asset base. This "discount in and no discount out" will likely make the GRAT more effective by increasing the amount of assets passing to the grantor's beneficiaries.

Let's say a client transfers his interest as an LP of a hedge fund to a GRAT in May 2009. The NAV of the proportional interest in the underlying assets represented by transferred interest is $5 million on the date the GRAT is funded. Assume that the client is unable to withdraw his investment from the hedge fund because of the lock-up provision and the prospects of the gate provision being implemented. As a result of the client's inability to withdraw his investment from the hedge fund and the volatility in the market, assume that the LP interests contributed to the GRAT are valued at a 30 percent discount and are worth $3.5 million for gift tax purposes.

Assume also that the trust is a near zeroed-out GRAT, which is to say the present value of the annuity is near to equal 100 percent of what the grantor put into the trust so that there is only a small taxable gift upon funding. Based on applicable Internal Revenue Service rates at the time of this writing, the annuity payment to the grantor in each year of a two-year GRAT would be $1,813,284. Although the payments may be made with the hedge fund interest, assume instead they are made with cash received from the redemption of the hedge fund interests before the end of the first year of the GRAT. If the GRAT assets appreciate at 8 percent per annum (both before and after the hedge fund redemption), the value of assets transferred to beneficiaries at the end of two years is $2,060,370. So, more than $2 million is transferred free of gift and estate taxes.

This example assumes that market liquidity is restored within a year, which in many cases will prove overly optimistic. But keep in mind that because of the nature of near zeroed-out GRATs—mainly that there are very little taxable gifts made at the outset—there may be no downside even if liquidity does not return to the market.

Relatedly, if the hedge fund interest remains locked up at the time distributions are required, the benefit of the GRAT may be limited because discounts on the way in generally will be offset by discounts on the way out if returning hedge fund interest. This also could require an appraisal of the fund's value. In addition, a return of LP interest should have a deleveraging effect if the valuation at the time of the distribution is less than at the time the GRAT was funded. But even if liquidity returns to the market in year two of the GRAT, there will likely be some benefit to the initial discounting.

Now assume the same facts except that the assets contributed to the GRAT did not receive any discount. Therefore, at the end of the two-year period, only $443,958 is transferred to the beneficiaries. The discounts increase the effectiveness of the GRAT by over $1.5 million.

Additional Issues

Keep in mind that interests in hedge funds generally are not transferable without the consent of the fund's general partner. Thus, gifting is not entirely within the owner's control. Hedge fund investors should consult with their fund regarding their ability to transfer. Furthermore, hedge fund purchasers must be accredited investors and/or qualified purchasers, and so must the donees of any gifts of hedge fund interests. Investors should consult with their attorneys regarding the securities and tax law aspects of gifting hedge fund interests. They also should consult with their tax advisors regarding their individual circumstances.

Finally, any discount reflected on a gift tax return must be supported by a qualified appraisal to start the three-year statute of limitations running. Thus, a good appraisal can be worth its weight in gold in supporting a valuation discount against an IRS challenge. TE

—A version of this article originally appeared in materials provided to clients of UBS Private Wealth Management, a unit of UBS Financial Services Inc., which is a subsidiary of UBS AG.

Endnotes

1. Note that this article addresses opportunities for hedge fund investors rather than hedge fund principals. Although interests in hedge funds may present estate-planning opportunities for principals as well, the issues are more complicated due to the special valuation rules of Chapter 14 of the Internal Revenue Code and are outside the scope of this article.
2. Hedge Fund Research, Inc., *www.hedgefundresearch.com/*.
3. Although illiquidity is generally viewed as relevant to lack of marketability rather than lack of control, a change in liquidity can impact the lack of control discount as well. Consequently, this article simply refers to illiquidity discounts without classifying them further.
4. For a discussion of the shortcomings of traditional private placement (restricted stock) studies, *see* Espen Robak, "Lemons or Lemonade? A Fresh Look at Restricted Stock Discounts," *Valuation Strategies*, January/February 2007 at pp. 4-15, 46-47. The evidence indicates that discounts shown in private placement studies may be biased in an unknown direction and magnitude by factors other than the illiquidity of the shares.
5. Some analysts have argued that assets with holding periods that are a fraction of this should be valued at discounts which are a similar fraction of the averages of the studies. More recent and appropriate discount data may suggest, however, that discounts for shorter holding periods, while lower than for longer holding periods, can still be significant.
6. The LiquiStat database, by Pluris Valuation Advisors LLC, contains transaction data on illiquid equity securities, including restricted stock, warrants and options, and convertible debentures; illiquid bonds, including auction-rate securities and various securitizations; limited partner interests; bankruptcy claims; and shares in private companies. The database is further described at *www.plurisvaluation.com/site/liquistat.htm.*
7. Note that discounts increase rapidly at shorter holding periods and then the time-discount curve "flattens" for longer holding periods, which is the expected result. Theoretical papers have shown that the relationship between the holding period and discount ought to be steeper at shorter holding periods than at longer holding periods. Yakov Amihud and Haim Mendelson, in "Asset Pricing and the Bid-Ask Spread," *Journal of Financial Economics* (1986) vol. 17, p. 223, found a "clientele" effect where investors who place a high value on liquidity will tend to own short-term and highly liquid securities, while investors who place a lower value on liquidity tend to own less liquid securities.
8. For each transaction analyzed in the LiquiStat database, a time- and date-stamped restricted securities order was reviewed. This allowed a precise estimate of not only the relationship between trading prices for the liquid and illiquid shares, but also a precise determination of the remaining holding period.
9. The relatively steep illiquidity discounts for relatively short (as little as a couple of months) holding periods provide quite strong evidence that discounts taken for hedge funds in the past—even before the current crisis—were too low. This new evidence will likely lead to somewhat higher discounts even after the market environment has returned to normal.
10. The evidence from the LiquiStat database shows a clear relationship between common measures of risk and the size of the discount—with riskier securities trading at deeper discounts, c. p. (*ceteris paribus*, that is to say, all things being equal).
11. This was part of the "allure" of hedge funds, in general. Hedge funds were considered a unique (and uniquely appealing) asset class because fund interests exhibited very high Sharpe ratios, small ex-post volatility (few or no negative months), and were de-correlated from the traditional asset classes. This naïve view of hedge funds as low-risk investments has shown to be, at least, partly a myth. *See, for example*, Helen Avery, "Hedge fund valuation: Smooth returns from rough valuations," *Euromoney*, Aug. 1, 2007.
12. SecondMarket, *www.SecondMarket.com*, provides an open listing service for sellers of such interests, and an auction mechanism where buyers and sellers can discover price for a wide range of limited partner interests.
13. But such transactions were extremely rare.
14. Vincent T. Cannon, "Secondary Markets in Private Equity and the Future of U.S. Capital Markets," (Harvard Law School paper—winner of the Victor Brudney Prize for June 2008). Available at *www.law.harvard.edu/programs/olin_center/corporate_governance/prizes.shtml.*
15. Colin McGrady and Brad Heffern, "Secondary Pricing Analysis Interim Update," working paper, Winter 2008 (2009), Cogent Partners, Dallas.