



Reputation management

Side pocket pros and cons debated

Side pockets are a portfolio management tool that can benefit both investors and managers alike. But having fallen from grace in the wake of the financial crisis, it is debatable whether they can regain their reputation as a viable liquidity management resource.

A number of high-profile UK CRE funds were revalued and suspended trading last week as a result of the UK's vote to leave the EU. Should the current market unease persist in the UK, it is likely that more funds – particularly open-ended funds with illiquid investments – will bring liquidity management measures into play. The use of side pockets is one such measure that has been touted as a potential – albeit extreme - option for managers (SCI 29 June).

“There are positive and negative implications of using side pockets,” says Oliver Fochler, managing partner and ceo at Stone Mountain Capital. “They are a legitimate tool and if a manager has been clear with investors from the start and it is in the fund's prospectus that this tool may be used, there shouldn't be a problem.”

Simon Thomas, partner at Macfarlanes, notes that he has, relatively recently, seen some of the larger, new-entry funds seek side-pocket capabilities. “Their use is entirely strategy-specific, but I'm not aware of any fund having used them except in the most distressed circumstances,” he says.

Side pockets are segregated accounts used by some hedge funds to separate illiquid or hard-to-value assets from the main fund. Investors that are active in the fund at the date of segregation are entitled to a pro-rata share of the investment.

The use of a side-pocket provision is usually strategy-specific. For example, a manager using a liquid strategy could use a side pocket to make a play on an illiquid asset. In this case, the illiquid asset would be put in the side pocket and not commingled with the main fund, with a view to returning the asset to the main fund once liquid or upon exit.

The financial crisis saw many side pockets being used defensively, however, and in some cases, illegally. Faced with highly illiquid markets, many fund managers used side pockets for assets that had turned sour, essentially allowing them to move those assets to a compartment of the fund and restrict investor access.

“Clearly there’s a potential conflict with the use of them,” says Kevin Scanlan, partner at Kramer Levin in New York. “A manager can put underperforming assets in side pockets and hold them there at cost, thereby avoiding the need to include any losses on these assets when determining the fund’s NAV and any performance-based compensation.”

As a consequence of their misuse during the financial crisis, it is now less common for managers to include side pockets in their documentation, unless there is a specific strategy in place and investors are fully supportive of the arrangement. The use of side pockets is also highly scrutinised by regulators, with the US SEC having successfully prosecuted a number of managers over the misuse of side pockets post-2008.

Fochler says that he is not aware of any enforcement on European managers under the AIFMD yet in connection with the use of side pockets, but suggests that a renewed financial crisis with increased investor redemption requests or maybe the revision of AIFMD could be trigger events that could result in enforcement action in Europe.

The valuation process for a side-pocketed asset depends on a fund’s investment prospectus. Some managers may mark the asset to cost; some may write the investment down to zero.

If the fund’s governing document states that assets are held in the side pocket at cost for purposes of calculating management fees and performance fees, then it generally doesn’t matter if there’s been a write-down or loss on that asset from a GAAP audit perspective, according to Scanlan. “It’s irrelevant because investors have contractually agreed that the manager can hold it at cost for purposes of the calculation of these fees in the absence of a realisation event of that investment,” he says.

Not all investors are able to participate in side pockets. For example, should an investor buy a share of the main fund, they would not share in the performance of the assets that were moved into the side pocket before their investment.

“As an investor, there is a degree of [opacity], as you don’t know how the side-pocketed assets are performing...they might be performing quite well,” says Fochler. “Some investors are not happy about this and rightfully, as the AIFMD requires a consistent valuation policy within the fund made transparent in its prospectus.”

Unless the governing documents of the fund otherwise specify, there is generally no contractual limit as to how long assets can remain in a side pocket. There is usually a fair amount of discretion given to the fund manager to determine when the assets are liquid enough to move back into the general account of the fund.

“In my view, as soon as something is taken out of a fund and side-pocketed, it is unlikely that it will be included again in the main liquid fund,” says Fochler. “Taking an asset out of the main fund must imply some level of distress. There is usually no way of return.”

Thomas adds: “There may well still be side pockets from 2008 consisting of securities that there will never be a market for. But that is an extreme scenario.”

For funds that do not have side-pocket capabilities, there are other liquidity management options in times of volatility. Funds have the ability to suspend redemptions, raise redemption gates or create synthetic side pockets (also known as liquidating SPVs), which serve the same purpose as a side pocket.

Scanlan explains that a fund either has or does not have a side-pocket provision in their governing documents. “It is not easy to add this authority subsequently, as this could be seen as an adverse move from an investor’s perspective,” he says. “Illiquid assets can be transferred to the liquidating SPV, either as a direct transfer of these assets or indirectly through the use of an economic participation right. The interests in the SPV would be distributed to redeeming investors.”

He continues: “Unless the investment strategy requires it, fund managers tend to focus less on having side-pocket authority nowadays. If you have the ability to distribute shares of a liquidating SPV, then you can get to the same place as a side pocket.”

Scanlan suggests that should funds face renewed liquidity problems as a result of events such as Brexit, he could see the need for increased focus on liquidity management. However, he adds that funds should already have an appropriate liquidity management programme and a robust valuation policy programme in place.

Thomas does not think Brexit would necessarily lend itself to a renewed usage of side pockets. “The markets are still open and liquid,” he says. “Added to that, since 2008 there has been a real focus on liquidity. Potential investors - and regulators - will want to make sure a fund has appropriate liquidity management in place. While a side pocket is a liquidity management tool, it should not be used as a mere afterthought by the manager.

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