

The effects of the debt crisis and economic slowdown are reverberating in the financial system. Their ultimate impact on the secondary market of hedge funds remains unclear. At Shelley Capital we take the view that the pricing of illiquids is likely to become more difficult and that cash-flow expectations will be delayed at best. Against this uncertain climate, clients might consider transacting while they can.

While our market has become more sophisticated over the last three years, some forced selling might be in the cards for the estimated \$60-\$90 billion of remaining illiquids "out there". This is because slow, orderly liquidation might give way to a preference for cash in hand in view of the deteriorating outlook and given the uncertainty of price realisation in three or four years' time. A bird in the hand may be worth more than two in the bush...

Whilst we observe little change so far, a prolonged period of turbulence would inevitably affect the pricing of illiquid hedge fund holdings. To cite a few factors:

1. Cash-flow expectations may be significantly reduced, resulting in lower IRRs for buyers at current prices.
2. An uncertain macro backdrop would exacerbate the inherent difficulty of valuing hedge-fund secondaries. Additional provisioning at fund levels might therefore crop up.
3. The resulting strain is likely to affect most classes of hedge-fund illiquids. The PE features of most side pockets, for instance, make them directly correlated to the corporate sector, while ABL funds would suffer similarly from deteriorating credit conditions.

All of these factors are likely to exert pressure on discounts and lead buyers to focus more on the entry than the exit price. The next few months will therefore be critical in determining what the future holds. In the meantime, Shelley's level of activity remains high. We are nearing the end of round two for the sale of a complex \$200m portfolio comprised of several vehicles. Our ABL portfolios, too, are attracting renewed interest with the appearance of new buyers, while a couple of new sales mandates are in the pipeline.

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