Secondary trading facilitates portfolio rebalancing which can add value

- Shares can trade at a premium to NAV, and the maximum recorded between September 2009 and March 2016 was 20.5%
- A large US public pension plan had a secondary deal in November 2015 that was worth a reported €2.8 billion
- At least 3% of capital raised will end up being secondary traded over the next five years
- Close to 25% of European non-listed funds have experienced secondary trading

Secondary trading means investors buying and selling shares in funds amongst themselves rather than via the fund manager. To use a simplistic analogy, secondary trading is like buying and selling a cloakroom ticket. The coat in the cloakroom does not change hands, the ticket does. The cloakroom ticket gets bought and sold even when the cloakroom is closed. The value of the ticket is whatever the buyer and seller deem it to be, rather than someone else's view of what the coat is worth. The last person to hold the ticket ultimately gets the coat.

Nobody likes queuing. Secondary trading means that investors in open end funds can spend less time queuing for redemptions or subscriptions. Secondary trades can happen at any price that the parties agree. Prices are generally set at net asset value (NAV), or at a premium or discount to NAV. Historically, 10% of trades were concluded at NAV. The other trades were at a premium (43%) or a discount (47%). The average premium of 2.9% is smaller than the average discount of -5.5%.

Secondary trading is a feature of both open end and closed end funds. The most straightforward secondary trade involves one seller and one buyer who exchange units in a single transaction. Much of the trading in closed end funds occurs when funds have five years or less remaining. Secondary trading is growing. The total market is worth an estimated €9 billion. Within Europe, secondary trading is more prevalent in the UK than elsewhere.

Secondary trading does not increase or decrease liquidity of the fund's underlying portfolio, but the investor's holdings are more liquid. Secondary trading may ease periodic liquidity pinches, thereby reducing the need for redemption queues and the other liquidity management techniques. For some investors, having more liquidity can be reassuring. For the reluctant real estate investor, there is one important psychological consequence – if liquidity is better, the fear of illiquidity should reduce.

Pension schemes, the main source of capital for non-listed real estate funds, can apply secondary trading to solve particular situations requiring liquidity, such as annuity buy-outs, merging with another scheme or transfers of large individual entitlements. Secondary trading also helps with the management of institutional portfolios.

Secondary trading is a useful portfolio management tool. Investors can exit closed end strategies that either have drifted from their original mandate or have become less desirable from the investor's point of view. Secondary trading facilitates portfolio rebalancing which can add value.

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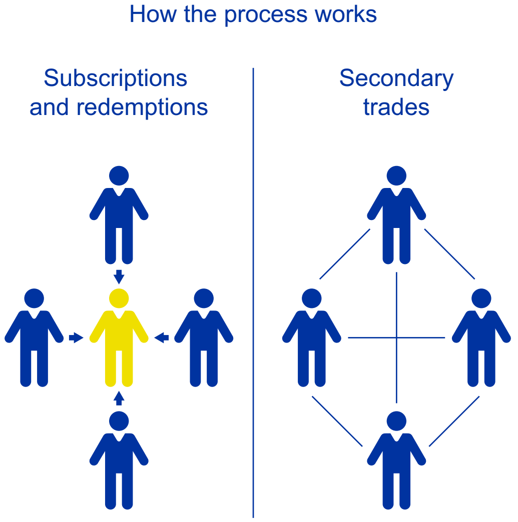
Rebalancing means regularly buying more of the assets that have just fallen in value, and taking profits in the assets that have just risen in value.

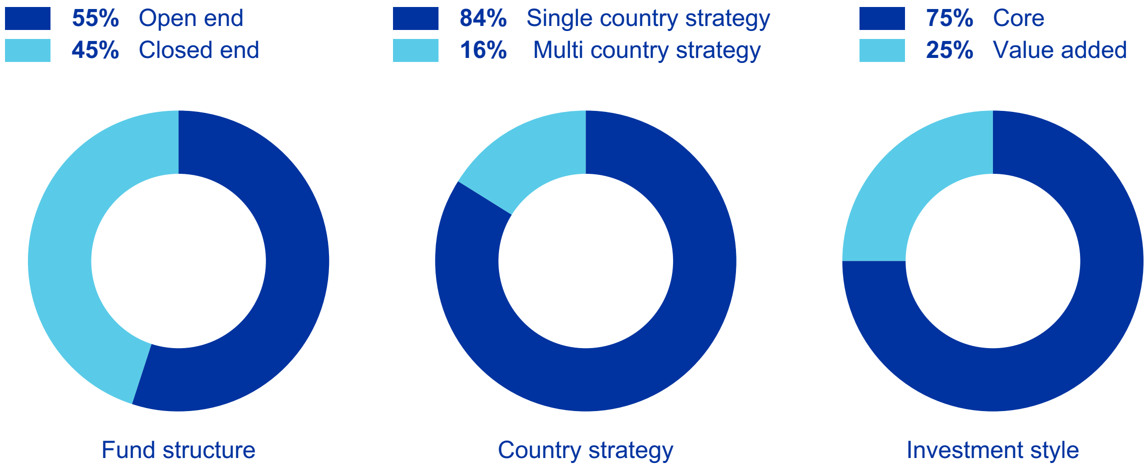
The availability of secondary trading opens the possibility of one specific investment strategy for investors in closed end funds: the inflection point strategy, which means trading shares in a closed end fund when the fund's J-curve turns positive. The risk profile of early stage and late state closed end funds is different, and having different investors for each stage can be beneficial.

Figure 1: Illustration of the subscription / redemption process and the secondary trading process



Key: figures in blue represent investors; the figure in yellow represents a fund manager

Figure 2: Structure, country strategy and style of funds that had secondary trading (as % of the funds that had secondary trading)



Source: PropertyMatch, INREV Annual Index