

Illiquid assets – portfolio "must have"? Or "mirage"?

Dominic McCormick | Select Investment Partners | 26 November 2015

The case for and against illiquid assets is hotly debated. Indeed, other than fees, the battle between industry funds and retail super funds has been heavily fought around significantly differing levels of exposures to the main illiquid asset classes such as private equity, infrastructure, direct property and private debt.

Illiquid investments promise some attractive potential benefits:

1. A potential illiquidity premium – i.e. a higher expected return compared to listed/liquid assets;
2. Diversification benefits for portfolios because the return drivers of illiquid assets may differ from those for listed/liquid assets; and,
3. Reduced volatility compared to listed assets because of how illiquid assets are priced.

What's not to like? Of course, these "benefits" do come with some provisos.

The illiquidity return premium comes with no guarantees and can vary widely over time. It depends not only on the pricing of the illiquid assets themselves but that of comparable listed assets.

In addition, the diversification and related lower volatility benefits of illiquid assets are sometimes exaggerated and may simply reflect a different valuation approach. Specifically, such assets are usually only priced infrequently (monthly, quarterly or even annually) using some pricing model and/or with a high degree of subjectivity. Further, lags in such valuation approaches can exaggerate the lower correlation that illiquid assets have to other asset classes.

The inclusion of illiquid assets in a portfolio therefore tends to result in lower "reported" volatility, even if this is not fully representing the true underlying volatility of the asset. Still, lower reported volatility can provide some real and perceived benefits to investors. In certain circumstances, well selected illiquid assets can be a valuable building block to constructing an absolute or real return focused portfolio. Alternatively, the lower volatility of illiquid assets may allow some funds to take higher risk than otherwise with the rest of their portfolio, potentially leading to higher long-term returns.

While there is some controversy around these "benefits", there is a strong case that all long-term investors should at least consider including illiquid assets in their investment universe. This is particularly the case for portfolios being managed on a long-term basis only with little impact from, or risk of, net capital withdrawals or need to price on a very frequent basis. Typical institutional examples are endowment funds and sovereign wealth funds that also have the scale to gain greater control over the assets they invest in directly or through co-investment.

Challenges arise however, when considering some of the practical aspects of including illiquid assets – particularly through more conventional pooled investment vehicles.

In particular, structural efficiency and investor equity problems can arise because of the conflict between the long-term nature and valuation challenges involved with illiquid assets in a world where many funds are offering investors near instant liquidity. The managed fund and superannuation system that Australia has created gives a high priority to offering investors easy and quick access to their funds. But, such vehicles are far from ideally structured to house illiquid asset exposure efficiently and fairly for all investors.

In attempting to have the best of all worlds, we risk creating a model that may break under stress – and at the very time investors can least afford it.

Some of the experiences we've had with less liquid assets over the last decade or so have also helped to refine these views.

The problem with illiquid assets in today's superannuation and managed fund structures is twofold.

Firstly, their illiquid nature can cause significant problems for funds that suffer sustained or major net cash outflow, or where this illiquid component becomes excessively large in portfolios due to market movements. Certain funds experienced this during the global financial crisis. Of course, some diversified/super funds have extremely reliable cash inflows such that this is unlikely to become a problem for the foreseeable future. Indeed, for some funds, the problem is allocating enough to illiquid assets. However, even for these, regulation or circumstances can change unexpectedly. Some funds seem very complacent on this issue. This complacency was highlighted recently with one industry superannuation fund CIO quoted as saying the fund would "never" divest its unlisted infrastructure assets. Perhaps funds need to begin considering their approach to illiquid assets in a world where they are in net cash outflow, as this will eventually be the case for some.

The other more neglected issue relates to investor equity in relation to the appropriate valuation of the illiquid investments. For funds that are offering daily or weekly applications and redemptions (and switches), the valuation of illiquid assets is crucial, especially if they are a large component of the portfolio. After all, at any point, you may have investors that are taking a very short-term view (redeeming or switching within days) versus those that intend to hold for many years. Yet the illiquid assets are priced at one supposedly "fair market" value.

For example, the current sale price of an illiquid wholesale unlisted fund (in the secondary market) investing in infrastructure or private equity is rarely the same as its Net Asset Value (NAV) or carrying value. Sometimes it is higher (for example, mature private equity portfolios pregnant with upcoming exits) but more often than not it is lower.

The valuation issue is complicated because the secondary market for many of these illiquid funds is sporadic with very infrequent trading. In any case, standard practice seems to be for funds to ignore such secondary sales for their own fund valuation purposes, unless the fund itself is the actual seller.

Moreover, if funds purchase an asset in the secondary market at a discount to NAV – say 10% or 15% – the general practice is to immediately revalue that to the fund's NAV, booking an immediate gain. But is this fair to all investors? Are exiting investors then being overpaid?

We are not talking about distressed sales here. Often, that secondary sale has been pursued for portfolio rebalancing or investment outlook reasons and may have taken months to organise. Arguably, that secondary price is the best representation of the current "market price" for the asset. Yet our experience is that very few funds use secondary market pricing, preferring instead to use reported NAV. Only in a very liquid secondary market does that pricing seem to come into the equation. And it is hard to find reliable guidance from regulators on these issues.

The funds' argument, of course, is that they are long-term holders and the NAV better reflects that long-term value of the asset. After all, these funds can meet any immediate redemptions or switches from current cash or more liquid assets. However, even these rationalisations do not gel well with the reality that some investors may be switching in and out of the fund based on valuations that clearly do not reflect what that asset would actually sell for today.

Obviously, this inequity only becomes a major problem for the fund if illiquid assets are a very large component or when there are massive cash outflows and/or the movement in market valuations (including currency hedges) leads to illiquid assets becoming a much larger part of the portfolio. This situation can lead to a self-reinforcing negative cycle whereby large exposure to problematic illiquid assets leads to further redemptions that further exacerbate the problem. Some funds will be forced to impose gates or freeze redemptions at that point with exits available only at deeply discounted values. Some funds are yet to fully repay capital from the GFC, eight years on.

The common argument is that with very small weightings in illiquid assets (say 3% to 5%), the impact of such investor equity issues and cash flow risks are minimal. That is clearly true. But, if a fund becomes subject to very large and continuous redemptions that weighting can grow quite quickly. Adverse market movements in the liquid component can also compound this.

Certainly the case for allocations above such small weightings is strong only for those funds with a high degree of certainty about future net cash flow. Some daily priced funds in the retail space where there is less visibility of cash flow have determined that the maximum allocation to illiquid assets is zero. It is hard to argue against this. Such funds emphasise the additional flexibility they have in asset allocation compared to funds with high weightings to illiquid assets.

Retail investors and advisers need to think not only about the actual allocation to illiquid assets in a fund but the robustness of the fund's cash inflow position. Indeed, they may need to better understand the time horizon, motivations and position of the other investors in the fund.

Of course, some retail investors and advisers invest in illiquid funds that clearly define themselves as illiquid (such as property syndicates) and fully accept that they cannot exit until a date well into the future. At least these promoters of investments are being very clear about their illiquidity rather than promising liquidity that may not always be there.

So far, we have implied there is a clear distinction between illiquid and liquid assets. However in the real world, liquidity and illiquidity are not black and white concepts. Rather, there is a spectrum. Indeed, one of the big problems in the GFC was that assets perceived as liquid become illiquid in the crisis – think mortgage funds, hybrid property funds, high yield funds, and fund of hedge funds. Such problems will emerge again, although it will likely be different asset structures next time.

One possibility for investors is to consider listed fund structures that invest in illiquid assets. REITS and infrastructure funds are obvious examples that are already well used in portfolios. But, increasingly, there are listed funds that invest in other illiquid assets such as private equity, private debt and certain less liquid hedge fund strategies. Negatives with the listed fund structure are that the lower volatility and low correlation benefits of the unlisted asset may be reduced due to the impact of market sentiment. There is also the question of whether such listed assets underperform over time, partly because fees are often higher. On the positive side, listed vehicles offer liquidity and the ability to be opportunistic in buying and selling the fund as its pricing relative to underlying NAV changes, offering an ability to add to returns versus NAV alone. Of course, even some of these listed funds are not very liquid themselves, especially if small and/or at times of market stress.

While most large ETFs have a reputation for always being liquid, recently there have been increased concerns about potential liquidity problems in some of the underlying assets of certain fixed income ETFs given declining liquidity in some parts of the fixed interest markets (especially corporate and high yield bonds).

Clearly, illiquid assets offer some real challenges for investors and advisers.

Key points to consider when investing in illiquid assets include:

1. Don't invest in any illiquid assets directly without a long-term investment horizon and a high likelihood that the investor's circumstances will not change such that they need access to the investments in a shorter time frame.
2. Make sure there is an adequate return premium for investing in illiquid assets.
3. If investing in a pooled fund that holds illiquid assets but offers investors frequent liquidity, ask questions about the risk of significant outflows and the unitholder structure of the fund.
4. Don't overestimate the "low volatility" and "low correlation" aspect of illiquid assets given these may be heavily driven by the valuation process rather than the inherent fundamental characteristics.
5. Investors confined to listed assets only could consider gaining exposure to some illiquid asset classes via listed fund structures despite some additional complications (limited choice, high fees, discounts/premiums, etc.)
6. Don't simply accept the conventional wisdom as to what is defined as liquid and illiquid, today. Qualitatively or quantitatively stress test the liquidity of all assets for a much more hostile market environment.

To emphasise the last point, in certain extreme circumstances liquidity of even the most liquid assets can disappear. The words of John Kenneth Galbraith come to mind"

"Of all the mysteries of the stock exchange, there is none so impenetrable as why there should be a buyer for everyone who seeks to sell. October 24, 1929 showed that what is mysterious is not inevitable. Often there were no buyers, and only after wide vertical declines could anyone be induced to bid... Repeatedly and in many issues there was a plethora of selling orders and no buyers at all."

– John Kenneth Galbraith, 1955, The Great Crash

On that cheery note – Happy Christmas and have a great 2016!



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