The value of illiquidity

The case for alternative investments
Liquidity: does less equal more?

The advent of unorthodox monetary policy has led to asset price inflation in all the traditional asset classes. This in turn has created yield compression across all sectors of the bond and equity markets. Yield-hungry investors have been forced further out along the risk spectrum as their return requirements have not changed. With one third of developed market sovereign bonds offering subzero yields, investors have turned to more complex and less liquid assets. Besides the higher potential returns generated, we would argue that diversification and (in some cases) inflation protection characteristics, are compelling reasons for investors to have a significant allocation to illiquid assets.

The quest for higher income and risk-adjusted returns has lured investors towards a broad range of illiquid or alternative assets, such as, hedge funds, real estate, private equity and infrastructure. In return for accepting the risk of less easily tradable assets, investors have been rewarded with the so-called “illiquidity premium”.

Cash is king or is it not?
Most investors place a higher value on liquid assets compared to those which are illiquid. As a result, they demand a higher rate of return for assets which cannot be easily converted to cash at any time. In our view, this explains the illiquidity premium.

The illiquidity premium is justified if we consider the opportunity costs borne by an investor. By investing in an illiquid asset, investors are restricted in their ability to adjust their portfolio’s asset allocation to changes in market environment or liquidity requirements. In particular, when markets start to fall, illiquidity becomes a concern as investors may not be able to sell their assets quickly, and thus have to suffer prolonged losses. Under such a scenario, illiquidity tends to intensify as more investors try to sell while buyers remain thin on the ground. Furthermore, given the lack of transparency and complete data points, illiquidity also makes it challenging for investors to assess the potential risk-return profile of assets, and make an efficient asset allocation.

Information asymmetry
Digging a little deeper we can look into the drivers of differences in liquidity between markets to understand how this is likely to impact on an investment strategy. One of the key drivers of liquidity, we believe, is the degree of information asymmetry between market participants; in layperson’s terms, the degree to which price sensitive information is available to a privileged few or even one market participant versus markets where price sensitive information is available to all on an equal basis.

Regulated developed world equity markets offer, at least in theory, an even playing field which encourages investor participation and supports liquidity. By contrast there is significant information asymmetry in private markets. For example, in the case of private equity, corporate fundamental data are just as relevant as they are in valuing and analyzing companies in public equity markets. But due to the lack of market regulations, some market participants may have access to a much greater depth of information about the fundamentals, corporate strategy and economic performance on a given company or security than others. In turn, this information asymmetry may lead to market participants to be less likely to trade and provide liquidity.
During periods of market stress, the impact of asymmetric information as a key driver of liquidity becomes obvious. An example is the widening bid/ask spread in the interbank credit market in 2007, which dried up almost entirely in 2008. This was mostly because lenders believed that other market participants had non-public information about the credit rating of the borrower, and questioned the credibility of the market information.

**Alpha not beta the key driver in illiquid markets** Liquid transparency allows investors to safely follow passive approaches and gain cheap access to market performance, or beta. Conditions in illiquid markets are very different and require investors to rely on specialist investment expertise and fund manager skill, also known as alpha. Besides superior stock selection, alpha may also include, for instance, the ability to source favorable opportunities based on superior information and relationships.

On a side note, there has recently been a lot of bad press on the topics of fees charged by hedge funds. There have also been some prominent institutional investors who have terminated a number of alternative managers, mainly due to high fees. In our view, it’s not about whether fees are high or low, but instead are they fair? Are they justified? Alpha (excess returns) needs to justify the fees and there needs to be transparency with regards to where the fees are going to, i.e. a team of two people or expensive infrastructure and technology.

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Quantifying the illiquidity premium

UBS Hedge Fund Solutions (HFS) conducted a study of 234 hedge funds on the HFS platform to determine if there was a relationship between hedge fund performance and liquidity of the underlying investments. Using redemption frequency as a proxy for the liquidity of underlying holdings, the study concluded that each month of illiquidity on average translates to approximately 20 bps of additional return.

These findings are broadly consistent with a separate analysis of the investment histories of nearly 1,400 private equity funds over a 24-year period derived from the holdings of over 200 institutional investors. The resulting analysis showed private equity funds’ median return net of fees outperforming its public equity market counterpart (S&P 500) by over 3% per year.

Isolating the illiquidity premium

There may, of course, be other factors at work here other than a straightforward reward for embracing illiquidity. Indeed, even if we are able to say unequivocally that illiquid assets have outperformed over the long-term, and provide at least some empirical evidence of the scale of outperformance, attributing that outperformance precisely to illiquidity is not straightforward. After all, all asset classes are a collection of differing risk premia in varying amounts. Illiquidity is therefore intertwined with a host of other risk premia such as volatility and size. Further complicating accurate measurement is the fact that liquidity is not a constant, but multi-dimensional and variable over time.

Illiquidity: a rewarded risk

In our view, we believe that there is sufficient evidence that illiquid assets generate higher returns to justify consideration. We see the key focus for investors as the total potential return for all the potential risks – including illiquidity – within the context of each investor’s broader investment objectives and constraints. It has been suggested that illiquidity is “in essence a transfer of economic rents from illiquid risk avoiders to risk takers”. But for ‘risk takers’ who understand and can tolerate those risks, illiquid assets may offer attractive returns for the risks assumed. In our opinion, that should be a powerful catalyst for those investors who are able to take a longer term view to explore further what illiquid assets have to offer.

Whether or not the illiquidity premium can be precisely measured, the fact is illiquidity can be harvested.

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**Fig. 2**

Hedge fund liquidity (redemption frequency) vs annualized returns

![Hedge fund liquidity (redemption frequency) vs annualized returns](image)

Source: Blackstone: Barclays Strategic Consulting analysis based on data from HFR, BarclayHedge and HedgeFund.net. Lockup period is aggregate of hard lock, redemption notice and redemption frequency.

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Alternative investments: industry trends

Many pension funds (and endowments) have increased their allocation to alternatives given the low returns from fixed income investments and an ultra-loose global monetary policy. In 2014, the Government Pension Investment Fund (GPIF) of Japan announced the adoption of a new policy asset mix that allows for a maximum of 5% allocation to alternatives. Besides public pension funds, some university endowments have been investing in alternatives to enhance return since many years. A recent survey done by Preqin2 showed an overall positive trend in institutional investors’ plans for alternative investments in the long term.

Demand for alternatives has surged over the years and PWC estimates that total alternatives assets will grow to USD 13.6 trillion by 2020 (from USD 7.9 trillion in 2013) in their base case scenario3. Ultra high net worth individuals are also showing more interest for alternatives and are likely to become a more important source of capital in the future.

Institutional investors’ plans for allocations in the longer term2

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References

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