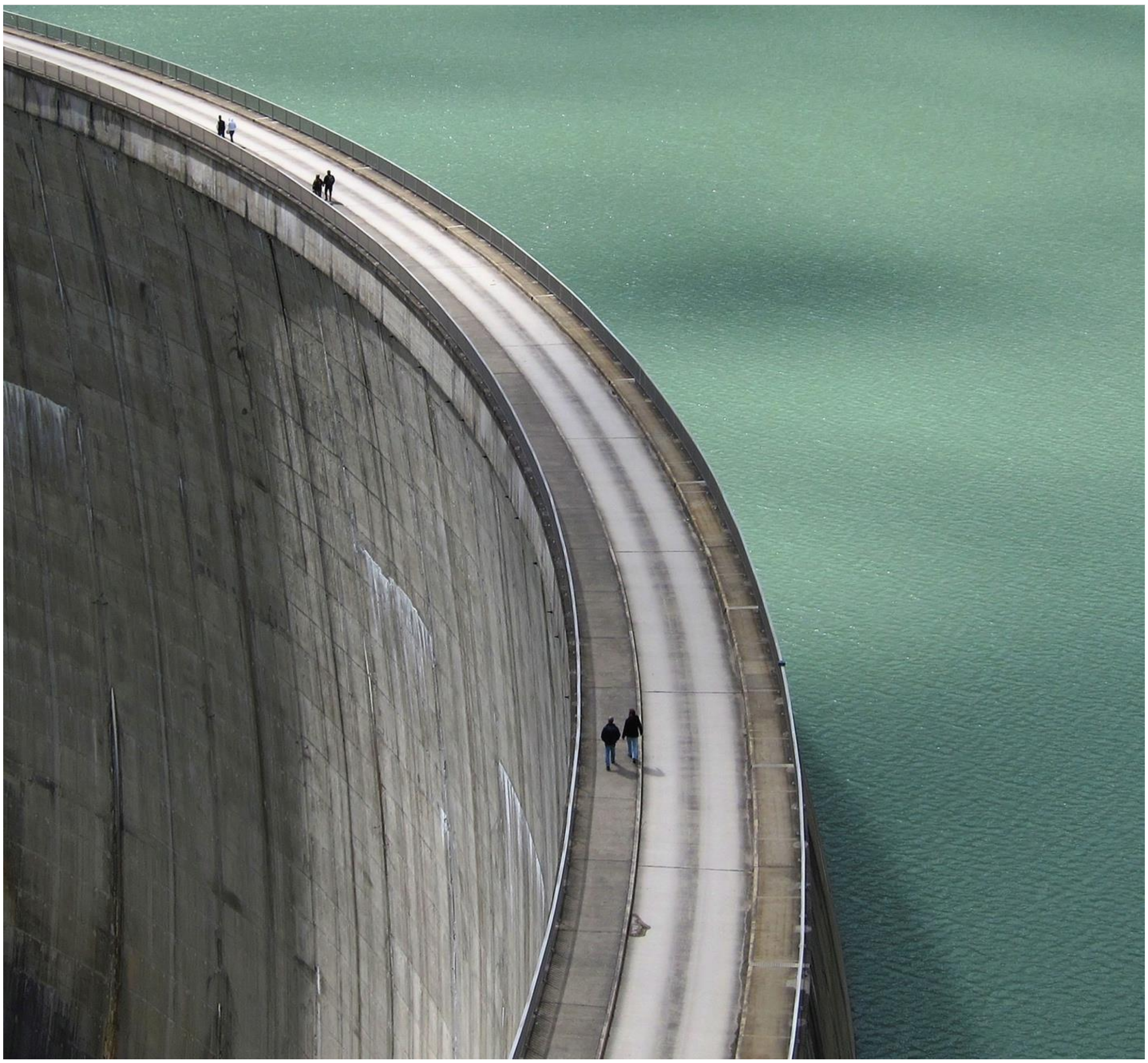
BROADRIVER INSIGHTS

The Case for Illiquid Strategies



The Case for Illiquid Strategies

Overview

The rationale for adopting longer-duration illiquid alternatives is an important consideration for many investment portfolios. Due to the innate liquidity and duration premiums present in these investments, long-term illiquid opportunities carry the potential to generate higher returns than their more liquid counterparts.

A recurring theme in investor discussions is an aversion to illiquidity in prospective alternative investments, particularly in the context of a longer-term fund. Often, this is a perfectly reasonable inclination as many investors face high (or highly uncertain) liquidity needs, and many have short-duration liabilities for which long-term lockups are wholly inappropriate. However, the general preference for investment liquidity seems to have permeated much of the investor universe, including many who should be taking the opposite approach. Investors with an appetite for illiquid alternative investments have the opportunity to generate excess returns through exposure to a liquidity premium and duration premium in these longer-term strategies.

Liquidity Premium

Alternative investments produce excess returns through various sources. In some cases, these returns are generated through exploitable demand- or supply-side dislocations, or inefficiencies in niche markets. In other strategies, expertise plays a crucial role in producing true alpha, again particularly in niche markets. Most commonly, a liquidity premium acts as the key driver of return in alternative investments. To simplify vastly:

$$r_{\text{Alternatives}} = \beta + \alpha_{\text{Liquidity}} + \alpha_{\text{Other}}$$

- β captures the portion of return corresponding to the investment risk in a perfectly efficient market;
- α_{Other} captures any potentially exploitable deviations from perfect market efficiency; and
- $\alpha_{\text{Liquidity}}$ represents the additional return attributable to liquidity premium, separated from α_{Other} for the sake of this discussion.

This liquidity premium results from reduced demand for illiquid investments, particularly from those investors who have liquidity concerns. In order to compensate for the lower demand, these assets must offer a higher return to attract investment capital. Investors with liquidity concerns may hold highly liquid liabilities, such as demand deposits or open funds. They may also be exposed to unpredictable liability outflows, like insurance products with uncertain behavioral assumptions. Additionally, these investors may also be subject to a regulatory regime that incentivizes liquid investments or penalizes illiquid ones. As more investors avoid a particular illiquid investment, there will be a greater reduction in overall demand, resulting in a lower price and a higher return – that is, a higher $\alpha_{\text{Liquidity}}$.

It is important to note, however, that many investors do not fit the profile just described. For example, pensions have highly predictable long-term liabilities, and endowments tend to have very long investment horizons with modest ongoing cash needs relative to their portfolio size. Investors who are not subject to substantial liquidity concerns should be actively seeking illiquid investments that others tend to shy away from. In some cases, an investor may not bear any costs of illiquidity, and still derive the full benefit of the $\alpha_{\text{Liquidity}}$ term. This liquidity premium is made available by the reduced demand from other investors as the market's "natural" or "efficient" source of capital for illiquid uses.

Those who seek liquidity optionality from a pool of illiquid underlying investments – for example, by seeking an ability to withdraw at any time from a fund of illiquid investments – effectively forgo the opportunity to earn the liquidity premium. Under an efficient and transparent pricing strategy, investors should be explicitly charged a cost for insistence on liquidity. This is clear and explicit in the difference between the low interest earned on a checking account from which withdrawals can be made at any time, compared to the interest on a CD issued by the same bank. The same logic pertains to a pool of illiquid investments: managers should represent a return that does not include the benefit of $\alpha_{Liquidity}$, as they need to allow for the possibility that they may have to sell the underlying assets to return withdrawn capital.

However, the liquidity cost may instead be implicit. The manager may represent a “base case” forecast of return that assumes no liquidity strain or penalty, effectively betting (or hoping) that no premature sale of assets will be required. However, any scenario in which an investor actually exercises their option to draw liquidity from the pool may force liquidation of the underlying assets, which would bring a reduction in value of the investment, and a return that fails to meet the forecast that was initially portrayed.

Duration Premium

Duration premium for longer-duration alternatives can complement the liquidity premium. This premium results from a similarly reduced demand, in which many investors, averse to duration risk, may have strict mandates or preferences for shorter terms on their alternative investments.

However, it is important to note that with any expected reinvestment of proceeds in the future, as when a portfolio backs a long duration liability, shortening the duration of alternative investments ***increases*** duration risk.

This is straightforwardly true in the academic sense – the calculated DV01 (or any other duration risk metric) of the investment portfolio, already lower than that of the liabilities, would be reduced further by the choice of shorter-duration investments. This has also played out consistently in practice over the past decade. Rates, especially middle and long tenors, have trended down, while expectations of “normalization” have proved unfounded. Realized reinvestment rates for investment managers have trended down with them, for example, in the form of declining portfolio book yields for many insurance companies. With a shorter duration alternatives allocation, higher yields provided by alternatives are forgone and more reinvestment is required into the already weakening environment.

Referencing back to illiquid investments, there are two key connections to draw. First, liquidity premium can increase with duration, as the aversion to illiquidity is compounded by the longer term over which the investment must be held. This is exactly what an allocator with manageable liquidity risks, and a sufficient investment horizon, should be actively seeking as a reliable source of alpha.

Second, forcing too low a duration cap on a pool of illiquid investments imposes a cost, analogous to the cost imposed by forcing a liquidity option. This cost arises either by obliging the liquidation of illiquid investments at fund term, or by limiting the investment options in the space, or a combination of the two. Though such costs may not be presented explicitly, they will be borne out by the investor.

Conclusion

Longer-duration illiquid alternatives are an ideal fit for many investment portfolios. Investors with a good understanding of their portfolios’ liquidity needs, and an appropriate time horizon, should actively seek out the liquidity and duration premiums these investments can offer. As many market participants expect low nominal returns across traditional asset classes, investors who seek to increase their exposure to illiquid investments benefit from diversifying their drivers of returns in a challenging environment.

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