

Investment Considerations in Illiquid Assets



Sameer Jain

Chief Economist and Managing Director, American Realty Capital

1. Introduction

Investing opportunity sets in inefficient market cycles tend to vary. Often, given market anomalies, they come to reside for extended periods in less liquid instruments such as distressed debt, private equity, certain types of loans, or in the securities of firms experiencing turnaround situations. These securities, because they are difficult to price (due to limited market participants, infrequent transactions, complex structures, or highly uncertain future performance), offer potential for excess returns over the risk free rate. Investors who have the ability to buy and hold these securities may thus stand to profit.

2. Structural Illiquidity

Hedge funds, for example, vary in the degree to which one can redeem one's interests. A typical hedge fund share agreement stipulates the share redemption policy for its funds. A redemption policy may generally have the following provisions that restrict investors from redeeming their shares:

- **Lockup Period:** Not all the initial money allocated to the fund can be withdrawn for a certain period of time. After the initial lockup period, investors can only redeem their shares at certain periods. Lockup periods range from three months to three years although not all hedge funds impose lockups. For those funds that do impose lockups, the typical lockup period is one year. Private equity, private real estate, and some credit structures can have lockups that are even longer, as much as seven to ten years. During this period, investors can receive some of their investment back in the form of distributions, but are restricted from receiving the remaining principal back except at a discount or via the secondary market.
- **Redemption Frequency:** After the lockup period, investors in hedge funds may redeem their shares. However, the redemption process is not continuous and investors can only redeem at certain points in time. The periods which investors are allowed to withdraw funds are controlled by the redemption frequency. For instance, if the redemption frequency is three months, an investor can only withdraw funds every three months after the lockup period has expired. This translates into a maximum of four withdrawing events each year. Redemption frequencies can range from daily to annually. However, not all hedge fund managers impose redemption frequency restrictions.
- **Redemption Notice:** Investors are generally required to give advance notice before any redemption. This minimum notice period is known as redemption notice. Redemption notice periods range from 30 days to one year, although the most common periods notice periods are 30, 45 and 60 days. Some hedge funds do not impose a minimum redemption notice period.

Example: Quarterly liquidity with 45 days notice requires the investor to notify the fund 45 days prior to the quarterly redemption date. If the redemption date is March 31, the investor must notify the fund on February 15 to redeem.

- **Gate Provision:** Hedge funds may limit the amount of withdrawals on a specific redemption date called a "gate." Gates can range from 5% to 15% and are imposed to slow redemption outflows in times of severe

market stress. Gates can be imposed as a percentage of a fund's net assets or as a percentage of a client's invested assets. Gates are important to some hedge fund strategies that have more illiquid underlying positions.

3. Compensation Demanded for Illiquidity Varies

Fundamentally, the varying degree of tradability means that rebalancing a portfolio with illiquid assets is not, as it is assumed in standard asset allocation models, an option that can be continuously exercised. Investing in assets that restrict trading such as a private equity or real estate fund carries costs; it restricts an investor from rebalancing the portfolio, restricts ability to respond to unforeseen cash flow requirements, and curbs ability to take advantage of topical investment opportunities. What this means is that investors have to be compensated for these limitations on top of the market risk premium.

We stress, however, the cost of illiquidity is very different for different investors; while some individual investors may need quick access to their capital, others with very long horizons for investment may not, and they therefore ought to collect an illiquidity premium.

We assert that illiquidity requires a return premium. As a corollary, in order to entice investors into illiquid assets, it will be necessary to offer either return enhancement or risk reduction relative to liquid assets. This premium arises from two sources.

1. The first source is that illiquidity limits investment flexibility – the ability to rebalance the portfolio at will in response to new information about investments. The undesirable consequence of this is that there is greater uncertainty in overall portfolio volatility and return, as compared to the investor's original target. In other words, over time, an investor's actual risk-return profile may differ from their original target due to illiquidity constraints.
2. The second source is that illiquidity reduces investor flexibility – the ability to respond to new investor circumstances and preferences. This has implications and trade-offs for investors who need to decide how important flexibility is, given individual circumstances, and balance decisions against return and volatility.

It is important to be aware that the illiquidity premium is not solely a function of an investor's individual situation. The premium is not a stationary amount and tends to fluctuate with time. It tends to increase during times of market stress and abate when markets function normally. Less risk averse investors with longer investment horizons can therefore collect this premium, which in essence is a transfer of economic rents from illiquid risk avoiders to risk takers.

4. Issues with Illiquid Investing

Investors may have current and future spending requirements, which dictate some absolute maximum level of illiquidity, for example, the need to make a major purchase within the next ten years. After taking into account identifiable spending needs, investors need to consider a variety of issues, some of which are highlighted in the following section.

1. Making tactical calls: like all asset classes, illiquid asset classes exhibit return cycles. Prudent investors who are tolerant of illiquidity should invest in a range of asset classes that includes both liquid and illiquid assets. Because illiquid assets cannot be traded (except at great cost), it is practically impossible to react to new and relatively unfavorable information about them. This applies at the aggregate asset class level: investors cannot reduce private equity or real estate allocations in the short to medium-term. If investors believe

that tactical (or medium-term) asset allocation can add value, they will be restricted from undertaking this activity with the illiquid portion of the portfolio.

However, illiquidity can be a benefit for investors. During tumultuous markets, asset prices become disconnected from fundamental values and bid/ask spreads may gyrate violently. Investors in liquid assets are sometimes prone to instinctively react to market movements and make hasty selling decisions at precisely the wrong time. In such cases, being locked-in (i.e., given a lack of exit opportunity) may be a blessing in disguise.

2. **Portfolio rebalancing:** because illiquid assets cannot be easily rebalanced, it is difficult to maintain a target risk-return profile. This means that the risk-return profile will drift for extended periods of time, to some extent beyond the investor's control. If illiquid assets outperform liquid assets, they become a greater proportion of the portfolio, which might increase overall portfolio risk beyond target levels. While corrective action may be taken in the liquid portion of the portfolio to reduce overall risk (e.g., selling public equities), that may also have unfavorable consequences such as reducing diversification and incurring taxes.
3. **Changing portfolio risk profile:** some investors may not want to maintain a constant portfolio risk profile (which implies selling outperforming and buying underperforming asset classes). These investors may have a higher (lower) tolerance for volatility as their overall wealth increases (decreases). If the value of their portfolio drops sharply, these investors will have difficulty reverting to a low-risk portfolio if they are heavily invested in illiquid assets.
4. **Liquidation time:** the trading difficulty of illiquid asset classes applies to both the fund and the underlying investments. Some assets such as credit products take longer than others to liquidate given higher search costs and contracting frictions. As a result, short-term returns may not be reflective of a manager's future performance. In times of market stress such as when liquidity dries up, managers may reflect negative performance due to mark-to-market or paper losses, but ultimately realize significant profits when they exit their positions. Due to the latency in liquidation, an investor's overall portfolio volatility may be higher than target level portfolios. In this sense, illiquid assets have much more specific risk than liquid asset classes.

In some cases, it makes sense to have a longer redemption period, one that allows for asset disposal at the right prices as opposed to being a forced seller. Restricting liquidity in such cases actually helps protect investor interest.

5. **Unexpected Spending Requirements:** When investors with large illiquid asset holdings encounter unexpected spending requirements, they have two main options. They can sell down the liquid portion of the portfolio (with consequences as described earlier), or they can borrow (which increases their overall risk profile and incurs borrowing costs). Borrowing costs will depend on the specific circumstances of each investor.
6. **Change in Risk Tolerance:** If investor circumstances change due to unforeseen events it may be difficult to reflect the changes in the portfolio if there are large holdings in illiquid assets.

5. Conclusion

Illiquid assets can provide a return premium and risk reduction characteristics that can enhance an investor's overall wealth objective over the long term. By investing in illiquid assets, investors can further distance themselves from short-term market shocks and exogenous noise that may detract them from their long-term portfolio risk/return profile.

Additionally, illiquid assets may provide investors with a return premium through alternative investment sources and opportunities, which one cannot participate in through liquid markets. These opportunities include various forms of credit investments like going long or short corporate and sovereign credit, real estate, venture capital, and leveraged buyouts.

However, alternative asset liquidity constraints impose costs and risks to investors. In addition, investors are limited in their ability to make tactical decisions, reallocate their positions and meet unforeseen liquidity events. In the long-term, many investors are not able to make consistent tactical calls on markets. They tend to follow markets; often buying when markets are peaking and selling when markets are in a trough. Being locked in to an illiquid strategy often shields investors from their own biases and leaves the work of investing to professional money managers.

Whereas some of the variation in the public markets should be reflected in corresponding private markets, private markets do not behave in lockstep with their public market counterparts. One reason for this uniqueness is that the asset liquidity risk differs across public and private markets. However, this discrepancy can also provide investors with an additional source of return that cannot be realized in liquid markets.

Illiquid investments are required to deliver a return premium because they increase the uncertainty of accessible wealth over the investment horizon. Uncertainty is increased beyond the forecast volatility of the asset classes as a whole because of the inability to rebalance, higher specific risk, inability to react to new information about investments, and inability to respond to modified investor circumstances. Because illiquidity limits investment flexibility, investors will tend to drift away from their targeted risk-return profiles for substantial periods of time. This means the range of portfolio volatility and return will be greater than would be experienced with an all-liquid portfolio. In principle, one may be able to quantify the premium arising from limited investment flexibility, although these estimates will vary widely.

By considering the factors described above, one can suggest reasonable ranges for illiquidity based on an investor's particular circumstances. However, investors need to understand the costs and risks associated with making investments in illiquid alternative investments based on their personal circumstances and liquidity needs.

Author Bio



Sameer Jain serves as Chief Economist and Managing Director of American Realty Capital, an investment services firm expressly focused on the alternative investment industry. Mr. Jain's executive management and multifaceted responsibilities at American Realty Capital, include risk management, firm strategy, and direction development, as well as the analysis and evaluation of alternative investments. He has 18 years of industry experience during which his responsibilities have included formulating investment strategy, developing risk management practices and asset allocation models, creating thought leadership, and assessing and engaging real estate, private equity, and hedge fund managers. Prior to joining American Realty Capital Mr. Jain headed Investment Content & Strategy at UBS Alternative Investments, where he was also responsible for all illiquid investing across the platform. Prior to UBS, Mr. Jain served at Citi Capital Advisors Alternative Investments and SunGard System Access. He has written a number of academic and practitioner articles on alternative investments, many of which are available in the public domain at ssrn.com.

Mr. Jain is a graduate of Massachusetts Institute of Technology and Harvard University.