More Illiquidity Please

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The full article may be accessed here.

Central Issue of the Paper

It is common practice for investors and consultants to establish return, volatility and covariance assumptions for all their asset classes, and to use these to produce a raft of portfolio return and risk statistics. A key assumption underpinning this kind of analysis is that portfolios can be rebalanced to target, even after large market drawdowns. One of the key benefits of diversification comes from the idea that we can rebalance from assets that have performed well into those that have not, and then reap the benefits as they mean revert to their long-run returns. However, that assumption is out the window if no one's buying.

"Modeling Illiquid Assets within Multi-Asset Portfolios" by Daniel Baxter addresses the concerns that investors may have in incorporating illiquid assets into multi-asset portfolios, while simultaneously laying out an investment process to take advantage of the benefits that can come from owning illiquid assets.

Approach Employed by Paper

The experience of the Financial Crisis highlights that investors should consider the following when modelling illiquid asset classes:

- Breaking the nexus between the fund size and the percentage allocation to illiquid asset classes.
- Incorporating cash flows: Capital calls and distributions, along with growth and income, need to be factored into portfolio modelling.
- Incorporating unfunded commitments into portfolio modelling and stress testing.

Breaking the Nexus Between Fund Size and Percentage Allocation

Assuming an illiquid asset class's weight is fixed as x% of total fund size does not always make sense, as the overall portfolio value can change day-by-day with market moves or cashflows, while illiquid asset values may only be updated once per quarter and can take months or years

to rebalance. Instead, investors should be able to identify which of their asset classes are illiquid and allow their portfolio weights to be determined by how the value of those asset classes move relative to the overall portfolio.

Incorporating Cash Flows

An existing portfolio of illiquid asset class investments will have cash inflows (capital calls) and outflows (income or capital distributions) that need to be considered, especially when stress testing. In the early years of the authors analysis, both the private debt and infrastructure asset classes were drawing capital from pre-existing commitments, while private equity and private real estate are returning capital. These assumptions are easily visualized in the authors proprietary platform; and this split between growth and income for returns, could allow the investor to forecast their total portfolio volatility.

Incorporating Commitments

Finally, another important fact the author points out is the need to forecast and incorporate unfunded commitments. Existing commitments can be incorporated into portfolio modelling using the cash flow approach described in detail in the paper (link above). A more interesting application of commitment modelling involves estimating the correct size and pace of future commitments. To maintain illiquid asset classes at their target weights investors continually need to be thinking about the right amount to commit or redeem from their illiquid asset classes.

Findings of the Paper

Investing in illiquid asset classes is not a simple endeavor, yet many investors adopt overly simplistic approaches to modelling them and incorporating them into multi-asset portfolios. Key elements that investors should consider for illiquid assets include breaking the nexus between fund size and portfolio allocation, cash flows, and how commitments/redemptions will impact future asset allocation and liquidity.

Incorporating these three elements into a multi-asset portfolio model, especially in conjunction with the ability to stress factors such as fund returns and cash flows, provides a much more robust way to estimate portfolio risk.

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