HillsonConsulting

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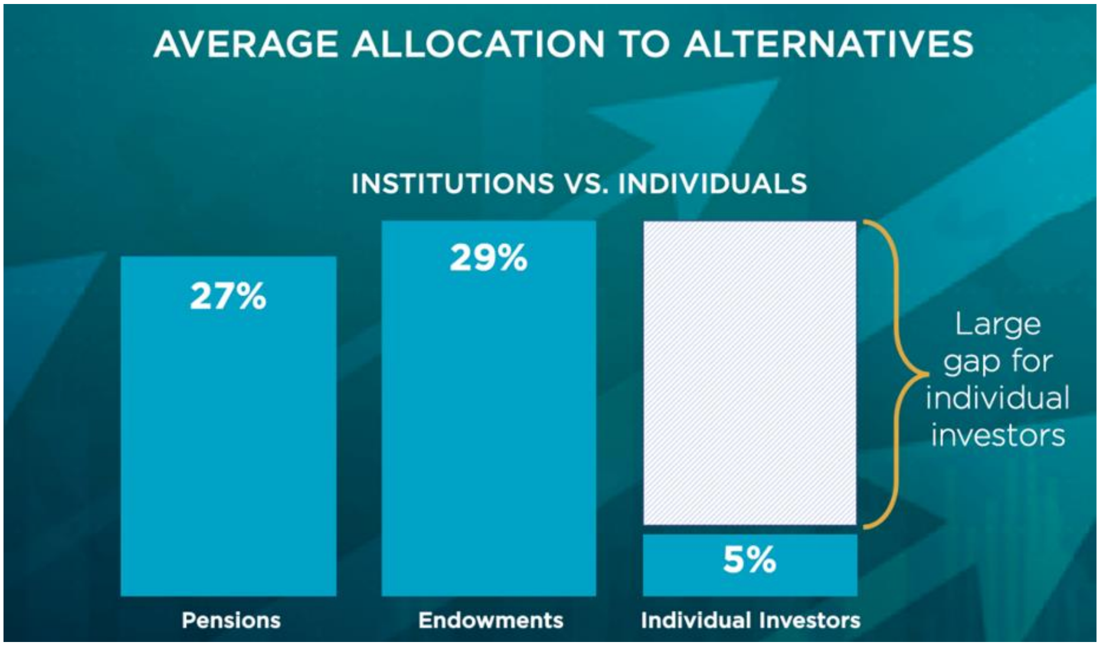
Illiquidity doesn't have to be your enemy

By Richard Hillson

One of the most common conversations I have with advisors and clients is about liquidity … or more precisely, illiquidity. It might be the number one perceived "terror" in the alternative investment space. It is only a scary proposition if the advisor or client has not planned correctly. For the sake of brevity, for this discussion, illiquid also includes less liquid assets. By this we mean assets where capital is tied up for 3-5 years or more, or there are penalties for early redemption.

The table below shows average allocation to alternatives, comparing institutional investors vs individuals. I am not saying illiquidity is the only reason more individuals do not allocate more to alts, but it is a big part of the reason. Please note, as this is a few years old, I believe the individuals number has increased but still lagging far behind institutional investors.



Average Allocation to Alternatives[1]

Let's look at the pros of liquid assets. **Flexibility**. Pretty short list.

Now let's examine the argument for a percentage allocation to illiquid assets.

Stupid decisions

Well planned allocations to illiquid investments prevent stupid, impulsive decisions. One of the most recent examples is the early Covid dip where many investors panicked; sold; mis-timed; and were left wishing they had not acted rashly. A strategic allocation to illiquid assets prevents this emotional reaction investing and avoids anyone trying to time the market, which even the smartest guys in the room do not always get right. It also takes away the day-to-day stress and panic which daily or even hourly position status checking creates.

Valuations

Illiquid assets are usually valued privately rather than publicly. Net Asset Value (NAV) is often used to value assets within a private fund or vehicle. Nothing is perfect in the valuation world, but a real asset-based calculation, rather than a public market sentiment overreaction/underreaction definitely has the potential to be more objective than subjective. This is particularly compelling if the appraisal is through a third party, not, sponsor management.

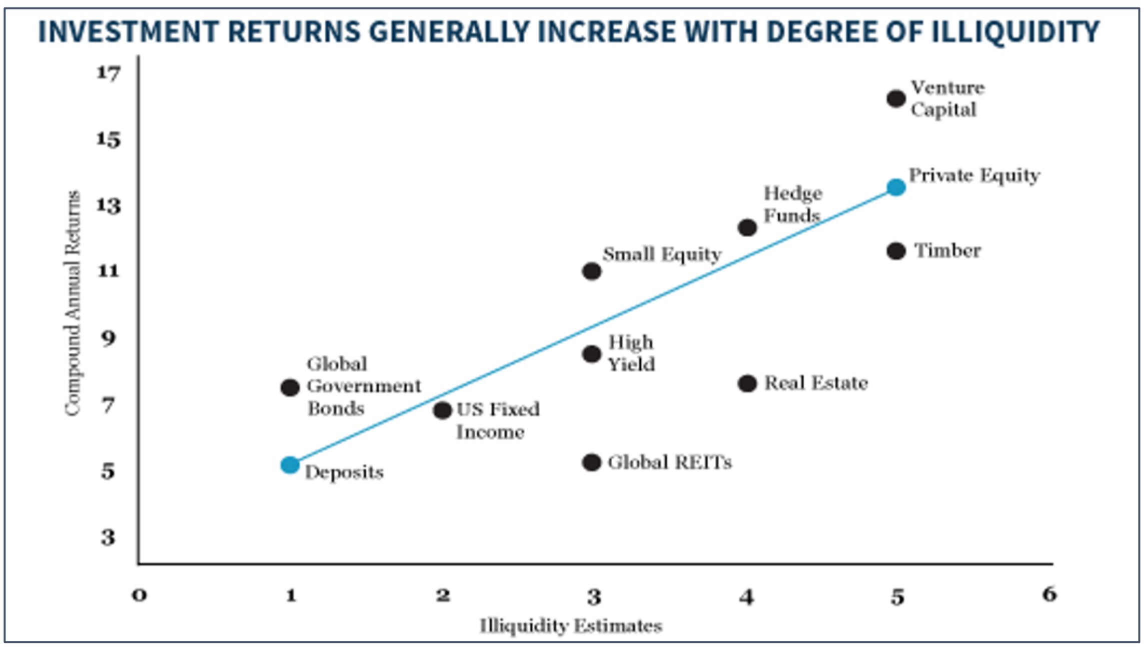
[1] Global Pension Assets Study 2016, Willis Towers Watson; National Association of College and University Business Officers 2016 Study (Equal-weighted Average); Money Management Institute, "Distribution of Alternative Investments through Wirehouses," 2016.

Illiquidity premium

Let's take a basic hypothetical example. A public REIT and a private REIT are both offering 3% yield and are identical other than liquidity. Which one do you allocate to?! 99% of investors go for the public liquid REIT.

So how does a private and illiquid REIT compete? Offer a higher yield. How does 6% sound? This is the illiquidity premium.

If an advisor allocates client funds solely into liquid assets, they are leaving money on the table, fact! I am by no means advocating for tying up 80% of assets into less liquid products but a percentage of assets in securities with an illiquidity premium will raise the average return of the portfolio. If an advisor is doing their job correctly and planning time horizons; emergency funds; life events etc. then they know what percentage of capital can be tied up for a period of time and can capitalize on the higher returns available.



Investment Returns Generally Increase with Degree of Illiquidity[2]

[2] "Expected Returns" by Antti Illmanen, 2011 as cited in "Private Capital, Private Opportunities" by Blackstone. © Michael Kitces, https://www.kitces.com/blog/capturing-an-excess-return-premium-for-illiquidity-is-a-privilege-not-a-right/.

Retirement accounts

I had this conversation with my friend Kyle Kadish, from AGES at a conference recently. His explanation was so eloquent that I asked to him summarize it for the purposes of this article.

"Investors and savers contribute to IRAs and 401k's to grow their net worth tax-efficiently; the tax-free or tax-deferred growth comes with the stipulation of reaching a certain age. A qualified account's inherent illiquidity structure neatly matches some illiquid investments' illiquidity nature. For investors with a longer time horizon, as they continue to accumulate wealth, or those seeking higher income due to the illiquidity premia with certain investments, a qualified account could be the right place to source funds for the illiquid investment.

- *This should not change any suitability, net worth, or income requirements of an investment.*
- *Investors and advisors should always keep RMD age limits in mind when allocating to illiquid investments through a qualified account."*

- Kyle Kadish, AGES Financial Services Ltd., Member FINRA/SIPC/MSRB Advisory services offered by Trust Advisory Group, Ltd., a Registered Investment Advisor, 444 Washington St, Suite 407, Woburn, MA 01801

Reinvestment risk

"Reinvestment risk refers to the possibility that an investor will be unable to reinvest cash flows received from an investment, such as coupon payments or interest, at a rate comparable to their current rate of return. This new rate is called the reinvestment rate."[3]

Careful and successful financial planning requires predictability of cash flows, particularly if these cash flows are matched to liabilities. If I invest into a 5% 1-year bond-type structure and the interest environment changes, perhaps I should have invested into a 5-year product which may well have offered me a premium at 6%. We can all play the gambling game of what happens if interest rates increase but I will take predictability over speculation all day. Illiquid investments eliminate or at least mitigate this risk.

Redemptions

One additional point which deserves consideration is that of redemptions. This was addressed by Freddie Lait, managing partner of U.K.-based Latitude Investment Management LP.

[3] Jason Fernando, "Reinvestment Risk," Investopedia, March 30, 2021, https://www.investopedia.com/terms/r/reinvestmentrisk.asp#:~:text=What%20Is%20Reinvestment%20Risk%3F,is%20called%20the%20reinvestment%20rate.

"Illiquidity is a risk which has been mispriced over the past 10 years as quantitative easing programs have flooded financial systems with cash, and regulators have allowed funds to run liquidity mismatches in their portfolio."[4]

The problem arises with this mismatch when investors get skittish and a fund cannot meet their redemption demands. This is certainly a consideration for interval funds or other semi-liquid options but most of the sponsors in this space are illiquid until exit. It certainly makes sense to push this point in any due diligence conversations where limited liquidity is offered, the ability of the sponsor to meet a max redemption demand.

"There's price for liquidity, and that typically equates to lower returns. For many alternative sponsors providing liquidity essentially means money is sitting on the sideline not earning a premium or in other words there's a "dead money," component. I believe most investors given the option of having all of their money working for them or only a portion would choose the former if they are fully educated on the investment. While it's certainly nice to have liquidity available, illiquidity helps to remove emotions from the equation." - Todd Woodhead, EVP Capital Markets, Walton Global.

In summary, an allocation to illiquid investments **HAS** to be a consideration for advisors and their clients. Even at a 10-20% level, this leaves more than enough liquidity for unexpected events, emergencies etc. If an advisor is not making these allocations, they are not only leaving money on the table but are not delivering a high-level service to their clients. If a portfolio is 100% liquid, has the advisor really done their job properly in medium and long term planning and has understand the cash flow requirements for their client?!

Richard Hillson

Hillson Consulting is a boutique investment consultancy founded by financial services entrepreneur Richard Hillson. The company helps independent advisors enhance and improve their offerings and drive revenue through alternative investments. HC also works with product sponsors to help them with education and access within the independent RIA channel.

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With thanks to Ashlyn Burns, Spencer Mark, and Nick Pratico

[4] Tom Bradley, "Why illiquid investments are all the rage and what you need to know about their risks," Financial Post, February 13, 2020, https://financialpost.com/investing/investing-pro/why-illiquid-investments-are-all-the-rage-and-what-you-need-to-know-about-their-risks.