CLEARPOINT

clearstead

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GRANT GUYURON, CFA, SENIOR MANAGING DIRECTOR

THE ILLIQUIDITY CONUNDRUM

BY GRANT GUYURON, CFA, SENIOR MANAGING DIRECTOR

INTRODUCTION

In the investment world, liquidity is a broad and frequently used term. For investors, what matters is that they are able to liquidate investments for spending or reallocation at any given time and that they are not forced to take meaningful losses to do so. If an individual needs to withdraw money out of his or her investment account to fund living expenses in retirement, the funds must be available. If a hospital has to fund a capital project or a foundation has to pay grants, they must be able to convert their investments to cash.

Over the last several years, we have noticed many investors taking steps to increase returns by taking more risk: more equity market exposure, more credit risk, and less portfolio liquidity. That increased use of illiquid investments is expected to continue according to a recent survey conducted by Pitchbook (a financial data company focused on private market investments) – investors expect their allocation to illiquid strategies to increase from 30.9% to 32.5% in the next 24 months[1]. Reducing liquidity is not necessarily bad or imprudent, but it is essential that proper liquidity and safety are built into a portfolio to meet the needs of the investor. This article will explore the concept of portfolio liquidity and how to balance risk and return.

CLEARSTEAD SPONSORS ROUNDTABLES ON TOPICAL INVESTMENT ISSUES

Clearstead has sponsored two Roundtables in the past six months, one on Discretionary Investing of Institutional Portfolios (often known by the acronym OCIO or Outsourced Chief Investment Officer), and the second on Environmental, Social, and Governance Investing of Institutional Portfolios (also known by an acronym, ESG).

Our next Roundtable is scheduled for September and will consider Next Generation Investing. We expect the discussion to include aspects of succession strategies for family-held businesses, wealth transfer strategies and ESG investing.

Our Roundtables feature a panel of outside experts led by a moderator. The moderator asks pertinent questions, which are answered and discussed by the panel. The panels also include a Clearstead shareholder who is a subject-matter expert. Our audiences are clients and friends of the firm, who learn as much as we about these important topics.

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DEFINING LIQUIDITY

The most basic and succinct definition of liquidity is that it is the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price. For asset allocators, liquidity can also be segregated into vehicle liquidity and security liquidity. Vehicles (i.e. mutual funds, hedge funds, private equity funds, etc.) may offer daily, weekly, monthly, quarterly, semi-annual, annual, or no liquidity at all. The liquidity of fund holdings can vary significantly for different types of assets as there are meaningful differences between U.S. Treasury bonds, corporate bonds, publicly traded U.S. and international equities, real estate, and private companies. Publicly traded stocks and bonds can be traded on exchanges or over the counter (OTC) daily, with numerous buyers and sellers transacting fairly efficiently; this translates into reasonably stable pricing for most sellers assuming a "normal" day in the market. A building or private company does not have the same type of market in which to transact and can take significantly longer to sell with a much less predictable price.

WHY GIVE UP LIQUIDITY?

So why give up liquidity? One answer is to try to generate greater returns. Two examples would be private equity and direct lending. The table below illustrates the trailing returns of these indices, which demonstrate meaningful historical outperformance over the long-term:

INDEX	1 YEAR	3 YEARS	5 YEARS	10 YEARS	ANALYSIS PERIOD*
Cliffwater Direct Lending Index	9.33%	8.89%	9.09%	9.95%	9.63%
Credit Suisse Leveraged Loans Index	5.58%	5.43%	4.35%	5.85%	4.73%
Excess Return	**3.75%**	**3.46%**	**4.74%**	**4.10%**	**4.90%**
Cambridge PE Index	18.37%	14.58%	13.47%	12.11%	14.21%
MSCI World Index	11.84%	14.18%	9.89%	9.18%	7.91%
Excess Return	**6.53%**	**0.40%**	**3.58%**	**2.93%**	**6.30%**

*July 2004 – September 2018

Sources: Zephyr StyleAdvisor, Cambridge Associates, Cliffwater

The indices and returns are shown for illustrative purposes only. Index performance returns do not reflect any management or transaction fees. Indices are unmanaged and cannot be invested in directly. The performance data shown represents past performance. Past performance is not indicative of future results. The indices shown represent actual performance results for the periods listed. No representation is being made that a client invested in these indices or strategies will achieve the performance results shown. This information has been obtained from sources believed to be reliable, but its accuracy or completeness is not guaranteed, nor should serve as the basis for any investment decision.

As seen above, compared to leveraged loans, direct lending strategies have delivered nearly 5% of annualized excess return since July 2004. Similarly, private equity has outperformed global equities by 6.3% annually over that same time period. Such private strategies may have terms of 10 years or more (credit funds are often modestly shorter), so investors require an illiquidity premium over public markets to lock up their capital – this has been the case for many private strategies, historically.

While returns are the primary driver, there are illiquid strategies that also exhibit lower volatility on a "mark to market" basis than their publicly traded counterparts. For example, the value of a private equity portfolio may not fluctuate as much as a publicly traded equity portfolio because the underlying holdings are not priced as frequently. For example, mutual funds are priced

Summaries of these Roundtables are posted to our website www.clearstead.com. If you would like more information or would like to attend a Roundtable discussion, please call Monica Fletcher, Marketing Associate, at (216) 621-1090 ext. 147.

Clearstead Announces New Shareholders

We are pleased to announce that the following individuals became shareholders of Clearstead on April 1, 2019:

- Tracy Jemison
  Senior Managing Director
  Private Client Group
- Terry LaCorte
  Managing Director
  Client Services Group
- Maureen Leneghan
  Director
  Client Services Group
- Dave McClearn
  Director
  Client Services Group
- Ted Robbins
  Director
  Private Client Group
- Kathleen Thompson
  Controller

We continue to expand the number of employee shareholders; of our 78 employees, 33 own shares in the firm. All shareholders must make a financial investment in our firm, so becoming a shareholder is both a recognition of outstanding work and personal commitment to Clearstead.

daily and exchanged traded funds (ETFs) are priced on an intra-day basis, while private equity funds are priced quarterly. Given the swift shifts in market sentiment that occur on any given day, week, or month, public equity markets can be more exposed to volatility. For a foundation or endowment, the pricing stability of private market holdings may be beneficial when it comes to calculating and budgeting the annual spend from the portfolio.

Additionally, there are many semi-liquid or illiquid investments that provide quarterly or periodic distributions of capital as a result of income or realized gains from sales. A limited partnership that offers an option to receive distributions from income helps to offset a perpetual investment. Meanwhile, a mature private equity program can become self-funding, in which distributions from older, more mature investments can fund capital calls from newer commitments.

SOME THINGS TO CONSIDER

There are certainly some negatives to consider as well, including fees, single strategy risk, and liquidity. Private strategies can be much more expensive than their publicly traded counterparts, particularly when a general partner's carried interest is factored in. Many private equity funds still charge a 2% management fee on *committed* capital and 20% carried interest above a return hurdle rate (typically 8%). The 2% management fee is expensive early in the fund life if the fees are levied on committed rather than invested capital because capital is often drawn over a five year period. For example, if an investor commits $10 million to a private equity fund, they might pay $200,000 in fees year-one but only have $1 million called in that first year; in this example, the first year of fees amounts to 20% of invested capital! Funds that charge fees on *invested* capital are becoming more common and are more favorable to the investor. Later in the fund life, carried interest for a strong performing fund becomes a much bigger part of the equation. Imagine a fund that returns 20% (gross), with an 8% hurdle rate, and no "catch up provision." If the general partner collects 20% carried interest, that amounts to 20% of 12% (20% - 8%), which is 2.4%. Distribution of cash can also vary by fund, with some utilizing a "European-Style" waterfall in which distributions are measured based on the aggregate portfolio performance (more beneficial to the limited partners), and others utilizing an "American-Style" waterfall in which funds are distributed on a deal-by-deal basis (more beneficial to the general partner or fund manager). Therefore, fee structures of illiquid strategies should be carefully considered, but the top managers often command more favorable fee structures and can reward investors with outsized results.

Single strategy risk is also an issue to consider. During the 2008 global financial crisis, we witnessed multiple hedge funds and private strategies lose a significant portion of investor capital because of poor investments and high use of leverage. This applied to private equity, real estate, and hedge fund strategies alike. While not common and often tied to the economic cycle, single strategy risk speaks to the need to identify top managers and to diversify among them, their underlying strategies, and across vintage years for private investments.

Lastly, the illiquid nature of many investments is a key factor. It is important to distinguish between illiquid investment vehicles and illiquid holdings. For example, some fund structures (e.g. limited partnerships) have limited or no liquidity to limit the impact of investor cash flow on their investment decisions. In a daily liquid vehicle (e.g. mutual fund and ETF) an investor can redeem shares on a daily basis, and the fund may need to sell securities to meet the cash withdrawal request. In such vehicles, the liquidity of the underlying securities is important because it can have a meaningful effect on execution price. Most private strategies do not offer redemptions, so limited partners might be required to sell their positions in a secondary market should they require liquidity. Hedge funds and open-ended real estate strategies generally offer periodic redemptions, but most also have the ability to restrict outflows by "gating." In such a situation, investors are not able to access their capital for a period of time. I will note that many hedge funds invest in highly liquid securities, so the mismatch in liquidity between the risk of being gated is highly dependent on the strategy.

For publicly traded securities, including stocks, bonds, derivatives, and currencies (and mutual funds and ETFs that hold them), investors can access their money upon request, but the value is based on the liquidity of that particular market on a given day. One example of a less liquid market would be that of a thinly traded stock; an investor trying to sell quickly might have to make large price concessions to move quickly out of the security. The old adage of "something is only worth what someone else will pay for it" applies in this case.

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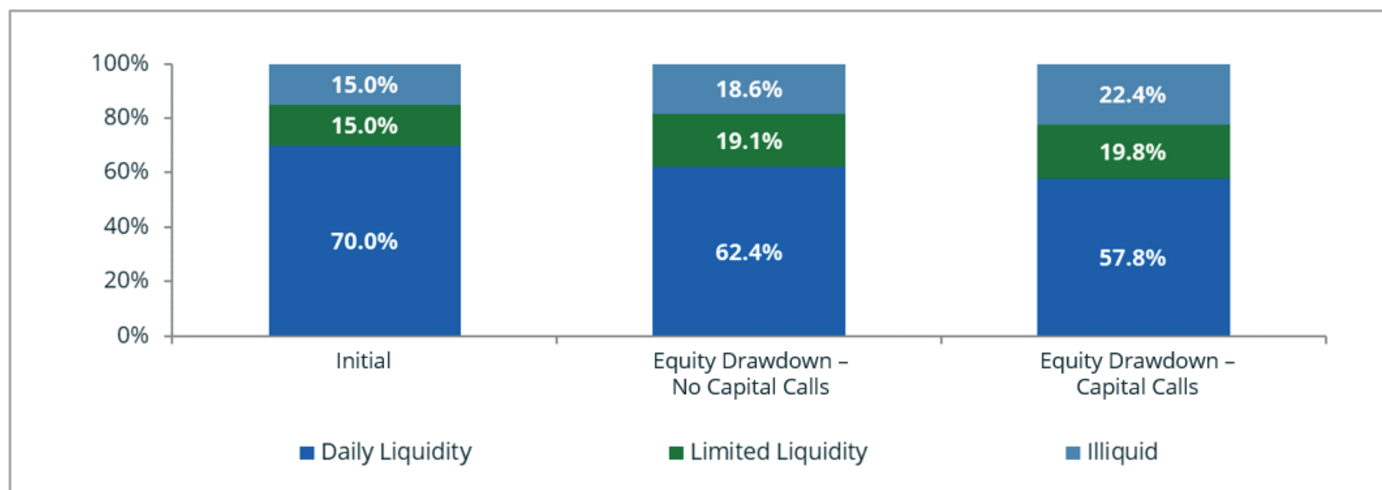
BALANCING LIQUIDITY NEEDS WITH RETURNS

If an investor determines that illiquid investments are worth pursuing, how much should be allocated to such strategies, what is the potential benefit, and what can they do to offset the risk? To answer these questions, it is important that investors have a strong understanding of potential cash flow needs and develop safeguards for potentially dire situations. It is also important to understand how one's allocation to illiquid investments could change in a difficult market – stress testing is a valuable exercise in understanding portfolio liquidity. If an organization or individual has low and predictable cash flow needs from the portfolio, a higher allocation to illiquid strategies may be warranted. For mid-size portfolios with less predictable cash needs, it is important not to overcommit to illiquid strategies. The example below illustrates the potential variation in asset allocation resulting from equity market volatility and portfolio spending:

Liquidity Schedule



Information provided is intended to be general in nature, is provided for informational purposes only, should not be construed as an advertisement or recommendation. The performance data shown represents past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented. The actual returns used in this hypothetical example are index returns representing allocations to various asset categories from October 2007 to March 2009. There can be no assurance that the results shown could have been achieved. The intent of this hypothetical example is to demonstrate how the max drawdown performance of each asset category index would affect the allocation to liquid and illiquid types of investments. For purposes of this example, our chart is assuming that less liquid investments could experience less volatility since illiquid investments are more difficult to value during declining markets than liquid investments, such as public equities and fixed income.

The underlying indices for the asset categories used in this example are as follows: Global Equities – MSCI ACWI (net), Private Equity – Cambridge PE Index, Real Estate/Real Assets – NCREIF Property Index, Absolute Return – HFRI Fund of Funds Composite Index, Core Fixed Income – BBg Barclays US Aggregate, Opportunistic Fixed Income – CS Leveraged Loan Index, Cash - ICE BofAML US 3-Month Treasury Bill. The methodology used was to reduce the initial dollar allocation to each asset category (index) by the max drawdown performance of the time period to demonstrate how the liquidity allocation to each asset category would change under the scenarios of (1) no capital calls and (2) having to sell liquid asset categories and investing into illiquid asset categories. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

We stress tested a sample portfolio based on the drawdowns that were experienced during the 2008 global financial crisis. During that period of time, global equities, represented by the MSCI World Index, declined by 49.3% from peak to trough[2]. We assumed spending would occur from assets such as core fixed income and cash, which generated positive returns during that time period (from 2007-2009). The result was that the less liquid part of the portfolio grew as a percentage of the portfolio because the values are not marked down by as much as the public equity markets. In this example, the weighting of illiquid and limited liquidity assets increases by a combined 7.6% at the market's trough in March 2009. However, it is likely that, in such a scenario, many private strategies would find excellent buying opportunities and would therefore call capital from limited partners for new investments. Capital calls that come at a period of market distress can further increase the allocation to illiquid vs. liquid strategies (12.2% in the scenario we modeled).

There are a couple of important points that can be derived from this: 1) it is important to model expected cash flows related to private strategies and stress test different market environments, and 2) there should be sufficient liquidity and safety built into a portfolio to meet the spending needs of the investor and weather equity and credit market drawdowns.

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One strategy that we utilize with clients is the establishment of a short-term liquidity bucket that can be used for private strategy capital calls and portfolio spending. This bucket typically consists of short duration investment grade fixed income and cash. Should an investor need to spend or fund capital calls during a time in which the equity and credit markets have sold off, it enables the investor to avoid selling into a distressed market and buys time for a recovery. Also, this bucket can be a holding place for any distributions of invested capital received from private investments – this facilitates the self-funding private equity programs referenced earlier. Additionally, given that short-term yields are generally higher than they have been in the last 10 years, there is not nearly the opportunity cost of holding a small portion of assets in cash as there used to be. At Clearstead, we also perform cash flow and liquidity modeling each year for our clients to evaluate potential flows, allocations, and changes to the liquidity structure of their assets. This work is important to make sure there is sufficient liquidity to meet whatever needs the client may have.

CONCLUSION

Illiquidity is a risk that should be evaluated and accounted for in portfolio construction. Whether investors are weighing an increase in credit exposure or building a private equity program, it is important to understand sources of liquidity within the portfolio at all times.

Illiquid strategies can offer enticing return potential but should be approached with caution and diligence. Not every investor should have exposure to private equity, hedge funds, or private real estate. For those with the ability to give up liquidity and access top managers, utilizing illiquid strategies can meaningfully enhance portfolio returns and diversification. For those that cannot, even strategies that invest in publicly traded securities can have illiquidity risk. Thus, it is critical that investors build in a proper allocation to more stable and liquid strategies (e.g. cash, government bonds, and investment grade credit) to account for expected and unexpected cash needs from the portfolio.

With careful planning, analysis, education, and guidance, investors can solve the liquidity conundrum and construct an optimal portfolio to meet their needs.

Sources:

(1) Pitchbook, 2018 Annual Institutional Investors Survey.

(2) Source: Zephyr Style Advisor. October 2007 to March 2009.

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Performance data shown represents past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.

MARKET BENCHMARK RETURNS

March 31, 2019		1M	3M	12M	YTD
US Large Cap	S&P 500	1.9%	13.6%	9.5%	13.6%
US Small Cap	Russell 2000	-2.1%	14.6%	2.0%	14.6%
Developed Intl	MSCI EAFE	0.6%	10.0%	-3.7%	10.0%
Emerging Intl	MSCI Em Mkt	0.8%	9.9%	-7.4%	9.9%
Real Estate	NAREIT	4.2%	16.7%	19.5%	16.7%
Core Fixed	BarCap Agg	1.9%	2.9%	4.5%	2.9%
Short Fixed	BarCap 1-3Yr	0.7%	1.2%	3.0%	1.2%
Long Fixed	BarCap LT G/C	4.7%	6.5%	5.2%	6.5%
Corp Debt	BarCap Corp	2.4%	4.9%	4.9%	4.9%

Source: Bloomberg

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