Illiquidity Risk Premium – does it exist and if so, how can Pension Funds capture it best?

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Some of the graphs/pictures are not available online

Zurich, 11 March 2013

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Structure of my Talk

• Introduction

• Illiquidity Risk Premium

• Harvesting Illiquidity Risk Premiums

• Conclusion
Illiquid assets are assets which **cannot be readily converted into cash**, in contrast with liquid assets, assets which are either in the form of cash, or easily convertible into cash.
Introduction
Definition

• Illiquid assets do **not trade often** and therefore **can’t be sold quickly without a discount**.
  – Usual example is real estate, however even large blocks of stocks are illiquid.

• This infrequent trading means that observed prices may not represent recent transactions, in which case the prices are stable. As a result, volatility measures are biased downwards. (Jorion (2010)).

• Except for “plain vanilla” public equities and fixed income, **most asset markets are characterized as illiquid**.
  – Swiss covered bond market for example has an annual turnover of less than 10%. Put simply, per year only 10% of the covered bonds are traded.
Introduction
Some important aspects around liquidity

• «Liquidity Dries Up»
  – Many normally liquid asset markets periodically become illiquid. E.g., during the 2008 - 2009 financial crisis, the market for commercial paper – usually a very liquid instrument – experienced “buyers’ strikes” by investors unwilling to trade at any price.
  – Those illiquidity crisis occurs often with financial crises, i.e., when asset prices plummet. Then investors sell what they perceive to be risky investments and purchase safer investments, i.e., high grade treasuries. This phenomenon is called «flight-to-quality» or «flight-to-liquidity».

• Over time, liquidity has improved dramatically
  – Through electronic trading, decimalization, transparency, more market participants, and competition (de Jong and Driessen (2013)).
Illiquidity risk premiums compensate investors for the inability to access capital immediately. They also compensate investors for the withdrawal of liquidity during illiquidity crises (Ang (2013)).
Illiquidity Risk Premium
Harvesting Illiquidity Risk Premiums

• There are **three ways for a pension fund to capture illiquidity premiums:**
  – “Passive” allocation to illiquid asset classes, like real estate
  – **Liquidity Security Selection:** Selecting illiquid securities within an asset class, like small caps in a large cap mandate
  – **Dynamic strategies** at the portfolio level, like countercyclical rebalancing mechanism (“increasing the percentage of illiquid asset during liquidity crisis”).

• Economic theory states that there should be a premium for bearing illiquidity (Demsetz (1968)). However, there are also models that show that illiquidity washes away with individuals (some individuals are constrained, some are not…).

• As a consequence, it is an empirical question...
Illiquidity Risk Premium
Conventional View Across Asset Classes
Illiquidity Risk Premium
Flawed View? (1)

• Conventional view might be flawed:
  – «Illiquidity Bias»: historical returns are unreliable (Survivorship Bias, no mark-to-market through infrequent trading, Selection Bias).
  – Ignoring risk: illiquid assets contain far more risks than illiquidity risk.
  – There is «no market portfolio» and «no market index» (e.g., no investor has the same returns as the KGAST Real Estate Index).
  – No separation between risk factors and manager skill
• So even empirical analysis cannot answer the question that there are illiquidity risk premiums in a satisfactory way.
• Nevertheless, there is the belief that there is a premium across and within asset classes.
Illiquidity Risk Premium
Flawed View? (2)
Harvesting Illiquidity Risk Premiums
“Passive” allocation to illiquid asset classes

• Recap: not clear if a higher return of an «illiquid» asset class is due to an illiquidity risk premium or another risk factor.

• **Typical approach of institutional investors** if they want to invest in illiquid asset such as real estate, private equity etc.

• However, there are several drawbacks:
  – The higher the percentage of illiquid assets, the **lower the flexibility** (remember Harvard Endowment Fund during the financial crisis!).
  – Illiquid assets **complicate tactical asset allocation**.
  – The more investors invest in such illiquid assets, the smaller the illiquidity premium (Ben-Rephael, Kadan und Wohl (2012)).
  – Most illiquid asset investing comes with **agency problems** and therefore needs more monitoring and controlling.

Source: Beber, Driessen, and Tuijp (2012)
Harvesting Illiquidity Risk Premiums
Liquidity Security Selection: Within an Asset Class

• Many empirical studies show that illiquid stocks outperform more liquid stock (also a typical strategy of active managers):
Harvesting Illiquidity Risk Premiums
Dynamic strategies

• Since the illiquidity risk premium is time varying, a dynamic strategy is **buying additional illiquid assets in stress time** (“Warren Buffet’s strategy”).
  – The easiest way is a **rule based countercyclical rebalancing mechanism**.

• Critics argue that rebalancing is more an asset management strategy and in fact it requires some liquidity. However, such a strategy **provides liquidity**.

• However, this can be tough since increasing the allocation of a more illiquid (and therefore more risky) asset is **difficult and might need a lot of patience**.
Conclusion

• Illiquid asset should have a higher return than comparable liquid assets. However, it is a compensation for risk.

¬ So be careful with illiquid asset investing!