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Illiquid Investments: Challenges ahead

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Illiquid investments should appeal to pension funds because of their long-term benefits, but are opportunities equal?

Key points

• The additional return on illiquid investors is a reward for bearing illiquidity risk
• The value of instruments listed on the stock exchange is determined on a mark-to-market basis
• Market liquidity can change quickly

The calculation of asset management fees for illiquid investments is complex Illiquid investments are expected to yield greater returns over the long term. This additional return, by comparison with liquid investments, is expected to compensate the investor for bearing the illiquidity. Such expectations are intuitively understandable and undisputed in economic theory.

The range of illiquid investment possibilities is enormous and new products are constantly being developed. It is argued that occupational pension schemes in particular, with their long investment horizon, are best suited to bear illiquidity risk. Before any investment, however, the following illiquid investment properties should always be analysed and discussed:

• Illiquidity premium and strategy
• Form of implementation
• Valuation
• Market crises
• Fees and charges
• Monitoring.

Illiquidity premium and strategy

The illiquidity premium has been studied and demonstrated in academic papers. Retrospectively demonstrating the existence of the illiquidity premium is difficult because critical market information is not available precisely illiquidity.

Estimating the illiquidity premium for the future presents additional challenges. First, the amount of the premium depends on the demand for and supply of illiquid assets. The greater the number of investors prepared to invest in illiquid assets, the lower the expected premium. This gives rise to cycles. Second, illiquid investments are geared to a long investment horizon and therefore go through many of these cycles. The timing of investments and divestments therefore takes on special significance. Third, account must be taken of the management costs, which are significantly higher for illiquid investments.

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On the one hand, illiquid assets must be viewed against a pension scheme's commitments, and on the other, in the light of other asset investments. In addition to strategy optimisation, it must be borne in mind that investing in illiquid assets reduces future strategic flexibility. The higher the share of illiquid investments, the more difficult it becomes to adjust allocation.

Experience shows that strategic adjustments are discussed following unexpected events. These include partial liquidations, market downturns or changed employer risk preferences.

Form of implementation

With the exception of direct real estate investments, illiquid asset investments almost invariably take place through collective investment vehicles. Owing to the long investment horizon of the underlying investments, these are mostly structured as closed-end funds.

Typically, investor capital commitments are called up and invested initially. The first distributions generally take place after a few years, until all investments are liquidated at maturity. This places considerable demands on the investment concept. Unwanted underweights or overweights can only be avoided through comprehensive planning and chronologically overlapping investments in various investment vehicles.

Besides classic closed-end funds, there are also open-end funds. These vehicles have unlimited maturities and investment planning takes place within the fund. Subscribing to such a vehicle means buying into existing investments, which are left to other investors upon redemption. The time horizon of the underlying investments and the (possible) length of time the investor remains in the fund are therefore not coextensive. On account of these transactions, the setting of a fair market price is critical.

If, in addition, several investors simultaneously wish to redeem their shares, there is a danger that the underlying investments may have to be liquidated. For reasons of equality, the fund is closed in such cases in order that the investments can be liquidated in an orderly fashion.

Valuation

In the case of instruments listed on stock exchanges, the value of investments is determined on a mark-to-market basis. Naturally, no market price can be observed for illiquid assets and value must be determined on the basis of valuation models (mark-to-model). This process gives rise to a margin of discretion and to substantial uncertainty. This is exemplified by the valuation of venture capital investments, in other words companies that are often only at the development phase.

A further complicating factor is that the valuations of investment vehicles are available only with a time delay, generally one quarter. The uncertainty surrounding the current value of the investment is therefore inevitable. Valuation according to the mark-to-model method produces specific statistical properties. In analysing these investment categories and setting the investment strategy, the statistical data for illiquid investments must first be analysed and perhaps adjusted.

Market risks

Liquidity can change quickly during market crises. Under normal conditions, liquid investments can become illiquid during periods of stress. Experience shows that in crisis, investors take refuge in liquid and safe assets so as to be able to make the appropriate shifts in the portfolio.

Generally speaking, illiquid assets can be rapidly disposed of, but only at a discount. In normal market circumstances, the discount to the net asset value (mark-to-model) lies in the range of 5-20%. During the financial crisis, these discounts exceeded 50% at times.

Fees

Unlike conventional asset management mandates with transparent fee models, the calculation of asset management fees for illiquid investments is complex. Using the fee model, it is attempted to set incentives for the manager of the illiquid investments such that they match the investor's targets as closely as possible.

Usually, the most important elements of this fee model are the performance fee and the settlement of fees on the basis of effective capital commitments (that is not on invested assets). Moreover, other elements are built into the fee model (for example, high water mark and catch-up), which, owing to their complexity, will not be further described.

Yet another complication is that for multi-layered collective investment vehicles (fund of funds), fees are deducted using various models. Before any investment, it is essential to understand the fee model and to calculate fees that will result under various scenarios.

Monitoring

The lack of market information, chronologically delayed valuations and varying investment volumes over time represent a monitoring challenge. Moreover, neutral information regarding the underlying investment is most often unavailable. The upshot is a marked information asymmetry between investor and asset manager in the case of illiquid investments.

The monitoring of asset investments is a fiduciary duty of the supervisory body. Owing to complexity and the lack of possibilities for direct comparison, illiquid assets warrant careful attention. It is recommended that an analysis of illiquid investments be conducted periodically, in addition to the routine monitoring of asset investments, usually on a quarterly basis.

It is clear from experience that the use of a single key indicator does not adequately reflect the complexity of illiquid investments. Therefore, besides calculating modern performance measures such as 'public market equivalent', traditional indicators (for example, internal rate of return, multiples) should also be ascertained. In so doing, effectively booked cash flows serve as a neutral basis of calculation that is not distorted by fees or foreign currency effects.

Lastly, it is important to interpret and discuss the key indicators as well as the inferences drawn from them. This creates a basis for the long-term management of illiquid assets. Long-term management usually takes place through further capital commitments, the retention of new asset managers or through secondary market transactions.

On average, illiquid investments can be expected to outperform, even though such investments are bound up with challenges. In addition to the general properties of the investment category, the specific implications of illiquidity must also be analysed and discussed before making an investment. Once an investment is made, monitoring must be organised to allow for the long-term management of the illiquid investments.

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