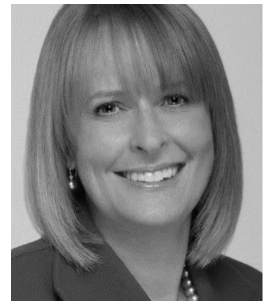
Alternative Investments

STATE STREET GLOBAL ADVISORS

In Praise of Illiquidity

Asset allocators generally demand that illiquid assets deliver a return premium over liquid counterparts in order to earn their place in portfolios. It's implicitly assumed that illiquidity is a negative attribute for which investors need to be compensated. We have a couple observations related to this assumption.



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First, we wonder about the basis of comparison. Typically, private equity is evaluated on its ability to outperform publicly traded equity indices. The benchmark or evaluation measure is usually a spread plus the return of the S&P500 or the MSCI World on a *buy-and-hold basis*. By calculating the benchmark in this way, it also surrenders the timing option. Both the asset and its benchmark are illiquid, and therefore there is a no rationale for an illiquidity premium.

Now some may argue that a public equity benchmark does offer the option to sell, even if we are measuring it on an illiquid basis. And, certainly when committing to an illiquid fund or asset, allocators effectively surrender an option to time their exit. Our second observation is to query whether that liquidity "option" has positive or negative value.

To determine the value of this "option", we look at how investors use the liquidity that publicly traded equities afford. Research firm Dalbar has a methodology that derives average investor returns from mutual fund and ETF flows. They find that in the 20 years from 1998-2017, the average investor has earned +2.6% annualized, dramatically underperforming most asset classes on a buy-and-hold basis. Over the same period the S&P500 annualized +7.2%, a 60/40 portfolio earned +6.4%, bonds generated +5.0% and EAFE returned +5.7%. Based on Dalbar's data, actual asset allocation decisions cost investors approximately 380bps a year in returns compared to a standard 60/40 portfolio.

Some might argue those results are driven by retail investors and not emblematic of what institutional investors' behavior. To determine the actual impact of institutional investors' timing decisions, we turned to the Center for Retirement Research's (CRR) database of public plans' asset allocations. The data spans from 2001 to 2017. Over that time frame, a constant allocation to equities, as proxied by the S&P500, would have generated a +5.83% annual total return. Based on the public plans' actual weightings to equities at the beginning of each year and the returns of the S&P500 in the same year, the timing-adjusted returns for these plans were +5.37%.[1] The liquidity "option" cost these investors -46 basis points per year.

We applied the same methodology to the CRR database's private equity category, using the Cambridge Associates Buyout & Growth Equity index for private equity returns, which are reported on an after-fee basis.

[1] Given the limitations of the data, we assumed that the weightings to equity remained static throughout an entire year, that actual equity holdings earned returns equivalent to the S&P500, and that no fees were charged.

Over the 16-year period covered by the CRR database, a constant allocation to private equity generated a +7.93% annual return. Factoring in actual allocations, the alternatives return was +10.71% per annum. Allocation decisions, which are driven in part by the asset class's inherent illiquidity, contributed an annualized +278 basis points.

The outcome in real estate is similar. Using the CRR database for allocations and the Cambridge Associates Real Estate Index for returns, a constant allocation to real estate for the 16 years from 2001 to 2017 that the CRR data spans produced an annualized +6.26% return, whereas adjusting for the actual annual allocations generated a +7.30% return. Allocation decisions and the asset class's inherent illiquidity contributed +104 basis points per year.

Consistent with research on investing behavior, these outcomes are not surprising. Illiquidity forces a buy-and-hold approach. Just as most dieters don't want the "option" of having snacks around the office, because the presence of the snacks makes it more likely they will indulge, so too investors often succumb to the temptation to sell if they have the option and the current outlook is bleak.

Investment Implications

When constructing portfolios and evaluating allocations to illiquids, investors should compare equivalent measures. Private equity and real estate fund returns include the impact of buying and selling investments, while an S&P500 index measure presumes constant holdings.

Additionally, S&P500 index returns do not include the impact of fees, whereas the indexes of closed-end funds do. For an institutional investor in a collective trust passively replicating the S&P500, the impact of fees on publicly traded equity allocations will be minimal. However, if the S&P500 measure is standing in for an allocation to active, long-only equity funds, fees can have a meaningful impact on performance. When evaluating illiquid allocations, investors should be sure to look at their own experience and evaluate on a like-for-like basis.

Of course, we don't want to minimize the cash flow needs of asset allocators' institutions. While exercising one's liquidity option has not been a return-enhancing endeavor, there are other reasons why sponsors require liquidity, most notably to meet the obligations of their institutions. In determining allocations to liquids and illiquids, institutions should evaluate how much illiquidity their institutions can handle from an operational perspective, as well as the performance of their various asset classes. Each investor's time frames, liability streams, and risk tolerances vary; one size does not fit all.

In sum, there is a performance advantage to the discipline that illiquid assets impose. By measuring on a like-for-like basis and incorporating the impact of behavioral influences, while also considering operational requirements, investors can build more suitable and more optimal portfolios.

Glossary

Illiquid asset is one that can't be turned into cash quickly or without losing value.

Marketing communication

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