For Investment Professionals only

Investment Insight

Understanding the Illiquidity premium

November 2017

The value of investments will fluctuate, which will cause fund prices to fall as well as rise and you may not get back to the original amount you invested.

If conventional wisdom holds true, investors can expect to earn a premium when investing in illiquid assets. The term 'illiquidity premium' has become synonymous with investing in private debt, but it is important investors fully understand what an illiquidity premium is in order to determine whether they are getting paid enough. William Nicoll, co-head of Alternative Credit, looks at why investors may be compensated more for illiquidity and what the illiquidity premium really is in practice.

Liquidity matters, but it's not king

Liquidity preferences will be different for every investor. Those with long investment horizons are perhaps better positioned to embrace illiquidity in their pursuit of better risk-adjusted returns. This is because most illiquid assets derive their value almost entirely from cashflows that are well suited to supporting an institutional investor's stream of liabilities.

Many pension schemes across Europe are finding it hard to balance liquidity while creating the returns needed to meet their objectives. Being able to trade an instrument immediately or having cash or liquid asset reserves can be valuable to schemes that face high volumes of short-term cashflow demands. For the average scheme, most pension payments are due relatively far in the future.

So while liquidity is important, it is only one component used in the broader risk-reward framework through which asset classes are evaluated. The risk of capital loss is one of the major perceived risks of investing in illiquid or less liquid assets, but labelling something as liquid and relatively less risky as a result of this, is somewhat of a misnomer. This is because all markets can face liquidity problems.

Illiquidity is a rewarded risk, but measurement is not scientific

Investors require higher expected return as compensation for taking on extra risk that could result in capital loss. When liquidity risk is present, this compensation is referred to as an 'illiquidity premium'.

An illiquidity premium is intended to compensate an investor for the added uncertainty of tying up capital for longer periods of time and the risk that the illiquid asset cannot be sold quickly enough (within a reasonable time period) to prevent or minimise a loss. Or if credit quality deteriorates, selling is not a remedy.

As private debt tends not to be widely held or regularly traded; many forms of private debt are considered illiquid. Private debt instruments are typically held to maturity and can pay a premium over similarly-rated public bonds to compensate for their lack of secondary trading opportunities.

Measuring an illiquidity premium can present its own challenges. For many private debt assets, a comparable or similarly-rated public asset may not always exist. Private debt deals may be classed as 'one off' due to the esoteric nature of the underlying asset or that the level of complexity involved means that there are no direct comparisons available in the public market.

Isolating the part of the expected return of an investment that is explained by illiquidity can be difficult as returns tend to reflect more than liquidity risk.

Deconstructing the illiquidity premium – more than the sum of its parts

In our experience, an illiquidity premium captures premia other than illiquidity that command incremental return, these being, a complexity premium, a supply-demand premium and an execution premium. Together these form what is commonly referred to as the illiquidity premium.

- ***Complexity:*** Any premium paid is often more reflective of the complexity or structure of the deal than illiquidity. Private and illiquid credit assets are typically less well-known and can be esoteric in nature, involving greater work for the lender to both understand the credit upfront and monitor the investment on an ongoing basis.

- ***Supply and demand:*** Any premium that a transaction offers will more likely reflect a lack of competition to lend. Certain characteristics of the investment may limit the pool of lenders willing to do the transaction, while regulation may dampen demand for certain types of debt financing; for instance development financing is not viewed as Solvency II-friendly. A lender with the resources in place to understand and value the credit can potentially benefit as a result of being the only lender present at the negotiation table. Also, the ability to reliably execute on a deal may mean certain lenders are selected over others.

- ***Execution:*** Any premium earned on an investment can be due to lower loss-given default that results from successful deal creation, structuring and execution deriving from active management. While this cannot be measured upfront, it is still valuable.

The degree to which complexity, imperfect competition and effective execution combine to generate these incremental returns will be different for each opportunity as the private and illiquid credit universe spans a diverse range of maturities and risk/return profiles. Not all investment opportunities are complex, and creation will perhaps play a bigger role for bilateral debt arrangements than for syndicated debt arrangements.

Three things investors need to understand about investing in illiquid assets:

1. ***An illiquidity premium is variable.*** Like liquidity, illiquidity premiums can also vary over time. Investors may command a higher premium for investing in less familiar assets or in areas where there are high operational barriers to entry. This premium may normalise over time as markets become more commoditised and greater investor interest causes pricing advantages to ebb away.

2. ***Not all illiquid assets will earn a premium.*** It is important for investors to understand that not all illiquid assets will necessarily earn one. Interest in various markets and assets can ebb and flow and premia can distort and even disappear if many market participants become motivated buyers. On occasion, illiquid assets are so sought-after that their illiquidity premium is actually negative.

3. ***A buy-and-hold approach is essential.*** An illiquidity premium accrues over time with regular coupon payments, so to maximise how much premium is earned, we believe it is best to hold the investment to maturity. As it is often harder to seek repayment of or to sell a private debt investment, these investments will need to be held to maturity. In return, investors should expect additional security and /or protection from covenants to compensate for not being able to sell the investment if things do not go as planned.

Concluding remarks

Investing in private and illiquid debt could help investors generate the returns they require over the long term. Markets are constantly evolving and the best opportunities are often found in non-standard, complex and underserved markets, which require a high degree of expertise and experience to navigate. Giving managers the latitude to dial up and dial down exposures can allow them to go where the value is and realise the benefits from a range of opportunities across the spectrum.

By accepting lower liquidity, an investor can potentially secure higher risk-adjusted returns, stable cashflows and stronger investor protections. Investors will need to determine how much of this premium is on offer at any given time to ensure that they are sufficiently rewarded.

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