Why should investors consider illiquid investments, asks **Kyran McStay**

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Much is made of the importance of liquidity for investors. The reality, however, is quite different. The concept of liquidity is like an illusion and an overbearing focus on it does not serve investors well.

Investors who value liquidity too highly frequently overpay for liquid investments which then locks them into lower than expected returns over time. This is the first illusion of liquidity.

This conclusion is amplified by the work of Carl Richards which highlights the "behaviour gap" of the typical investor. The behaviour gap is the difference between the market index return and the actual return realised by investors. It arises as investors buy when markets are rising and sell when markets are falling.

In fact, according to Vanguard founder John Bogle, the father of passive investment, the average equity mutual fund investment gained 173 per cent from 1997 to 2011, but the average equity mutual fund investor earned only 110 per cent because of adverse market timing decisions. In listed markets investors can control market timing, but as the eminent investor Charles Ellis noted, "evidence on success with market timing is impressive and overwhelmingly negative".

Herein lies the second illusion of liquidity. Investors generally use the flexibility liquidity affords them against their long-term financial interest. Recent insights on behavioural investing point to the benefit of adopting simple rules to help offset impulsive behaviour. Commitments to long-term well-conceived though illiquid investment strategies have the benefit of protecting investors where they would otherwise be inclined to behave impulsively.

The third illusion of liquidity is that listed markets are liquid. Liquidity is not an absolute. Liquidity in listed markets can evaporate in times of heightened market uncertainty with the result that price volatility is magnified and prices reflect values of forced sellers. Investors need only look at the number of instances where there has been a 10 or even 20 per cent short-term drop in equity markets to realise that securities prices are a poor reflection of long-term prospects. Unfortunately, equity prices only reflect long-term values on an average basis and market volatility means that there is a lot of volatility or noise around the average.

False promise of listed investment vehicles

The development of investment vehicles that purport to provide investors with access to illiquid assets such as private equity through listed investment vehicles gives rise to the fourth illusion of liquidity. Investors relying on others willing to take them out of their illiquid investment at times of market stress will be disappointed with the prices on offer, which (as history has repeatedly shown) will generally imply a significant discount to the net asset value reported by the private equity manager.

They do no better than as if they were forced sellers of the illiquid asset. Listed markets provide no easy bailout mechanism for investors in illiquid assets. Nor do they provide investors with any greater clarity or transparency on the underlying portfolio of investment to assist in their investment process.

Often it is quite the reverse with listed vehicles where the investment strategy can be driven by a host of other considerations or where it can be negatively impacted by over-commitment or leverage.

Allocating to alternative assets through listed vehicles is a seductive way to achieve diversity, but it is little more than checking the box asset allocation. Portfolio volatility remains high and the benefits of out-performance are doubtful.

The allure of illiquidity

Enough on the illusion of liquidity! What of the allure of illiquidity as a source of investment opportunity?

Investors are anxiously seeking alternative avenues to generate returns. Lax monetary policy, zero interest rates and quantitative easing have resulted in a liquidity bubble in bond markets and contributed to higher valuations in equity markets despite the less optimistic outlook. Too often investors seek additional returns by taking on additional risk.

In the current environment, the logic of investing in less liquid investments becomes compelling. Investors willing to accept a degree of illiquidity in their portfolios can minimise the impact of overpaying for liquid securities. Meanwhile, serious investors with an edge in research and due diligence can reasonably expect to be rewarded with outsized returns by investing in market segments where the light shines less brightly.

Private equity is a major market segment for investors willing to contemplate illiquidity in their portfolio. Clear evidence exists that returns net of fees comfortably outstrip listed equity indices (let alone mutual fund returns). Over the last 15 years, the private equity buyout index has returned 16 per cent per annum, outperforming public equities by 6 per cent. There is little sign of this trend being reversed and for good reason, given the strength of the private equity investment process.

Private equity firms take control positions in the companies they buy so that they can influence their investment outcomes, and their long-term investment horizon means that they can trade through periods of short-term volatility.

They aim to invest in a manner where they do not become forced sellers. The private equity manager determines market timing, not the investor, depending on the performance of each asset.

Private equity valuations are significantly less volatile than public equities.

David Swensen, the Yale Endowment chief investment officer, and pioneer of the use of illiquid investments in long-term investment portfolios, notes that while the lower volatility and diversification benefits provided by private equity "stems from infrequent valuations accorded illiquid assets, some of the lack of correlation results from value-added strategies that private equity firms pursue".

When it comes to investing in illiquid assets the advice is clear. Do so where the expected returns exceed those available in listed markets and only if you have a long-term investment horizon. Take limited risk with the managers you select and only back established players with transparent investment structures.

Diversify your exposures by manager and vintage of investment. And, thereafter, enjoy the financial and psychological benefits of being involved in markets that offer the prospect of outsized investment returns with lower reported volatility of returns.

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