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Third Quarter 2020: The Illiquidity Premium

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Tradeoffs abound in all aspects of life, including investing. With the Federal Reserve and other Central Banks pumping liquidity into the capital markets, rates have fallen and bonds are providing less income than in the past. Investors have begun to look for ways to replace that income stream and it would appear that some illiquid investments have ramped up their efforts to attract new investors. What do we mean by illiquid? Liquidity is a measure of how easily one can convert an asset into cash. Generally, the more buyers and sellers, the greater the liquidity. For example, most stocks trade every two minutes or so on the major stock exchanges. We consider stocks, exchange traded funds, and most mutual funds to be liquid assets. An example of an illiquid asset would be real estate where the number of buyers and sellers will fluctuate over time, especially when one considers the specifics of an individual property.

We at REDW Wealth have seen a rise in the marketing of illiquid investment vehicles. These vehicles are technically mutual funds, but trade only once per quarter. Moreover, the fund will only make 5% of the shares available for redemption. As a hypothetical example, fund ILIQX raises $100 million by selling 100 million shares at $1.00 per share. The fund invests in private companies that pay dividends. For the sake of this illustration, ILIQX prices itself monthly at $1.00 per share and offers quarterly redemptions, but only makes 5% of the fund available for redemption in any given quarter. As long as total redemptions are five million shares (or less) at each redemption date, then every shareholder who wants to sell should be able to sell. However, if 10 million shares are submitted for redemption in a single quarter, then the fund would pro-rate the redemption and only fulfill half of the shares tendered. Beyond our hypothetical example, some private equity and private real estate investments are even less liquid, with lock-up periods of anywhere from one to five years, only after which do quarterly redemptions become available.

Historically, the returns of illiquid assets have been promoted as being higher than more liquid asset classes (stocks or bonds), but it is hard to make a categorical statement, as each investment vehicle provides its own return history. Additionally, data on returns is hard to come by and harder still to verify, as one simply has to take the word of the firm. However, in a recent conversation with a private equity firm, they said the annualized return of their private equity portfolio was 19.2% per year (net of fees) for the years of 12/31/2009 through 12/31/2019. If we assume that their numbers are reliable, then we could compare their return to the annualized total return of 13.1% for the S&P 500. One should ask oneself if the illiquidity premium of 6.1% per year is worthwhile. Some illiquid investments tout themselves as providing a higher yield or interest rate than do more liquid invests which can be very tempting in the present low interest rate environment. Here are some considerations:

1. How much of your wealth can you afford to be unavailable? Are you ready to reduce the trading days of your portfolio from about 200 to four? Are you prepared for the potential period for exiting your investment to be 4 to 5 quarters or more? One might say yes, especially if the expected dividend is much higher than what is available from other investments. However, will you still feel that way when the markets are in disarray like in February of this year or late 2008? Will you feel that way if the expected dividend is not realized? As in all areas of investing nothing is guaranteed. We would deem these questions about your attitude about risk to be the most important.
2. Are you ready for lack of transparency? Many of these illiquid invests provide a price only once a month. While this practice can have a veneer of price stability, but it is only a veneer. Furthermore, our experience has found that information on the actual investment projects can be hard to assess. With less liquidity there tends to be less transparency.
3. Are you ready for the tax ramifications? Even if you have professional tax help, some of these investments are slower in producing their tax information, which can delay the filing of your tax return.

At REDW Wealth, we seek to help our clients navigate the financial waters. We are ready to help you consider these investments and their implications both positive and negative. Feel free to contact your Relationship Manager if you have questions.