BlueBay
Asset Management

# Illiquid asset investor notes

**Our in-house experts share their views on the challenges associated with investing in illiquids, the impact of the pandemic and where potential opportunities lie ahead.**


ILLIQUIDS EXPERTS

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**Investors are often concerned by potential barriers around illiquid assets. Could a change of fund structure mitigate these issues?**

*Jean-Philippe Blua*

When we talk about investment barriers into illiquid assets, what's often being referred to are fund structures – closed-end versus open-ended funds. Different fund structures can make exposure to illiquid assets more accessible and potentially more dynamic. Typically, closed-end funds would lock investors in for the pre-agreed life of the fund, while investors can enter and exit open-ended funds dynamically.

As ever with liquidity, it all comes down to correctly aligning the liquidity term of the fund with the underlying liquidity of the assets. As we have seen with the recent debacle around real estate funds offering daily liquidity, the liquidity terms on exposures to 'illiquid' assets in open-ended fund formats have proven to be grossly inappropriate.

What I feel is more relevant when considering illiquid assets in open-ended fund structures is to clearly define what an illiquid investment is relative to the liquidity term of the fund, and as such, define what is an acceptable investment (or at least to what proportion).

What can be considered as 'illiquid' in a daily fund could be considered a standard asset in a quarterly liquidity fund.

Ultimately, some assets are simply not consistent with the format offered by open-ended funds. For example, direct lending loans – where specialised investment funds lend money to small and medium-sized enterprises – can be defined as true illiquids and are probably more compatible with the format offered by closed-end funds. The loans typically have a long maturity (5–7 years) and cannot be reduced in size or traded in order to allow investors to enter or exit the vehicle throughout the life of the fund.

**What are some of the other challenges associated with investing in illiquid assets and how can they be overcome?**

*Jean-Philippe Blua*

Investors should be offered clear documentation explaining the risks associated with investing in illiquids – the expected higher returns are naturally linked to risks inherent to the underlying assets.

But the overall challenge should sit with the asset manager, which can offer a fund structure that is appropriate for the type of strategy and the assets to be traded.

It is the manager's responsibility to ensure that a client's flexibility requirements are aligned with the overall liquidity profile of the fund and that all investors are treated fairly.

When meeting redemptions, it is particularly important that the liquidity profile of the fund remains unchanged and that when raising cash, the focus has not been to sell the most liquid assets in the fund, mechanically increasing the exposure to the less liquid ones.

*Mihai Florian*

Another nuance to consider is that illiquid assets don't have a linear investment profile, i.e. you can't invest all the money in one go, unlike with liquid strategies. Similarly,

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*Mihai Florian*

illiquid asset availability is not the same as with liquids. This is why you have drawn-down vehicles that invest as and when opportunities arise.

### Where do you currently see opportunities within private markets?

*Mihai Florian*

We see potential opportunities to achieve attractive yields while investing in high-quality credits in emerging market (EM) private markets. These are largely driven by the fact that even the robust EM corporates generally have limited sources of funding available to them. The scope to capitalise on this lies in three distinct areas:

1. Performing secondary loans: banks, which are still operating under stricter capital and regulatory constraints, are periodically looking to sell-down and recycle some of their EM corporate exposure. Although these are high-quality underlying credits, they can be picked up at a discount to par due to the banks' need to reduce positions quickly or because of temporary market dislocations.

2. New financings: lending that cannot be provided by the banking sector due to timing or structural complexities.

3. Stressed situations: loans that are trading at a deep discount but the underlying credit is still performing and we anticipate meaningful price appreciation.

*Adam Phillips*

In developed markets, special situations activity picked up significantly in 2019, particularly in the European mid-market. Due to the Covid-19 pandemic, the extreme market sell-off and subsequent rebound of European public credit, there was a lot of focus on the more liquid opportunities during 2020, which was entirely logical. We still believe that we are in the "eye of the storm", where governments and central banks have provided unprecedented levels of support and this has created a disconnect between financial markets and the real economy in a number of sectors.

### What impact do you think the pandemic will have on supply/demand in private assets?

*Mihai Florian*

Covid-19 has exacerbated some of the trends we were already seeing in the market for private EM assets. In the initial phase of the crisis, we saw banks accelerating their de-risking of EM corporate exposure, with some even exiting certain markets or sectors completely. In the second phase, we started to see a number of corporates that could not access the market looking to raise capital privately.

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*Adam Phillips*

I think certain sectors will take much longer to fully recover from the pandemic and some may never completely recover. Many companies are more highly levered now than they were going into the pandemic, with less liquidity and less ability to make healthy profits. As support measures are removed over the next 6–24 months, it is likely that we will see an increasing number of companies default on their debt obligations and be forced into restructurings.

We are expecting insolvencies and liquidations to rise over the next 24 months. Hence, we expect the special situations opportunity set to increase markedly over the next 2–3 years. We believe that the opportunity set will be particularly prevalent in the private markets, where banks could be forced to sell-down problem assets.