BlueBay
Asset Management

The liquidity ladder: Choose your rung, measure the risk

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As pensions face a tougher return landscape – and for some defined benefit ('DB') plans, an underfunded status – getting extra yield beyond traditional investments becomes more important.

Alternative investments, alongside introducing diversification, can often benefit from capturing an illiquidity premium absent in traditional investments.

As the industry adapts to a shifting return landscape, the way we view portfolio liquidity may need to evolve too, and with it, the role of alternative investments in pension funds as defined contribution ('DC') structures become the norm.

Liquidity: *The ability to convert an asset into cash.*

Illiquidity premium: *The extra return that a market participant requires in order to give up their ability to unwind a position during a stipulated time period.*

PART I: LIQUIDITY BASICS

If liquidity were a hierarchical ladder, on-the-run US Treasury bonds would perch on the bottom rung, carrying barely any liquidity risk, as sizable positions can be unwound with little impact in most circumstances.

A few steps up the ladder we find publicly traded securities bought and sold in thinner volumes in exchanges, such as smaller capitalisation equities or equities in peripheral markets.

On the top rung are private assets. These encompass everything not traded in an organised market, spanning real estate, infrastructure, direct lending, private equity and venture capital to artworks and other collectibles. While most of these areas have been penetrated by sophisticated investors, the latter are not normally considered part of the institutional investment world, due to the lack of cash-flow generation and subjectivity of valuations.

If liquidity were a hierarchical ladder, on-the-run US Treasury bonds would perch on the bottom rung while private assets sit at the top

The variance in the liquidity levels of different assets and the resulting illiquidity premium is a function of several factors:

- Type of asset – in many cases, equities are more liquid than corporate bonds, as there is typically one type of equity issue per company, opposed to multiple debt issues.
- Trading venue – a centralised exchange that brings together a larger volume of market participants can generally pool greater volumes and allow for better price discovery than bilateral market systems.
- Size of trade – the hunt is on for the sweet spot. Markets can have minimum commissions or lot-size conventions that make it uneconomical to trade below a certain size. Additionally, in some circumstances, particularly during moments of thin liquidity, it can become more expensive to trade over a certain amount.
- Number of market participants – the lower the number of participants, the scarcer the liquidity and higher the illiquidity premium.
- Ability of market makers to warehouse inventory – recent regulation has limited the ability of investment banks to hold assets in inventory during their market-making activities. This means that whenever a transaction is executed, there is a preference to have a ready counterparty – the asset cannot be held as a 'hot potato' while the bank finds a counterparty.
- General risk appetite – this is a dynamic factor and explains why liquidity and its premium fluctuates. When markets become more volatile, especially to the downside, investors may retreat due to the increased perceived risk in holding an asset, which results in reduced liquidity.

PART II: PORTFOLIO CONSTRUCTION IMPACTS

We believe the best way for investors to tackle liquidity should be via an asset-liability matching approach. But this is easier said than done.

The issue is, there is always uncertainty around the liability schedule – different investors have different requirements.

When a fund invests in an asset, the manager must be conscious of the liquidity being offered. Funds generally take one of two formats, which have different liquidity implications:

1. Closed-ended – where the fund portfolio is liquidated and proceeds returned according to pre-specified rules, and the investors typically commit capital at an earlier stage. It can in some cases have a 'permanent capital' vocation.

2. Open-ended – an evergreen format where the fund allows new investors to come in and current investors to get out, as long as they follow a pre-determined procedure.

For a closed-ended fund, the key conditions are the schedule of repayments and – if any – periodic dividends.

For open-ended funds, the main variables are the subscription and redemption frequencies (which can oscillate from daily to multi-year), the notice periods they should be notified with and any limits to the amount to be redeemed, or penalties attached.

Whereas the closed-ended fund manager has more leeway to dig into illiquid opportunities thanks to stricter capital commitment terms, the open-ended manager must tread more carefully.

The open-ended fund manager not only faces the issue of having enough cash to let redeeming investors out and be left with a portfolio which is not unbalanced, but also having assets that are liquid enough so that the valuations used for letting investors in and out are a true reflection of the executable value of the portfolio.

Leverage creates an additional complexity component – whether from borrowed money or borrowed assets. In both cases, the manager must know when the lender can reclaim its capital or assets back, or change the conditions under which the borrowing happens, as they will have to respond to those requirements too.

One example of this is the 'short squeeze'. This is when many investors hold a short position in a stock, then the stock is called back or a rally means that stop-losses are hit; the situation is compounded by the short sellers trying to buy the stock back to cover their shorts on a thin volume basis, extending both the rally and their own losses.

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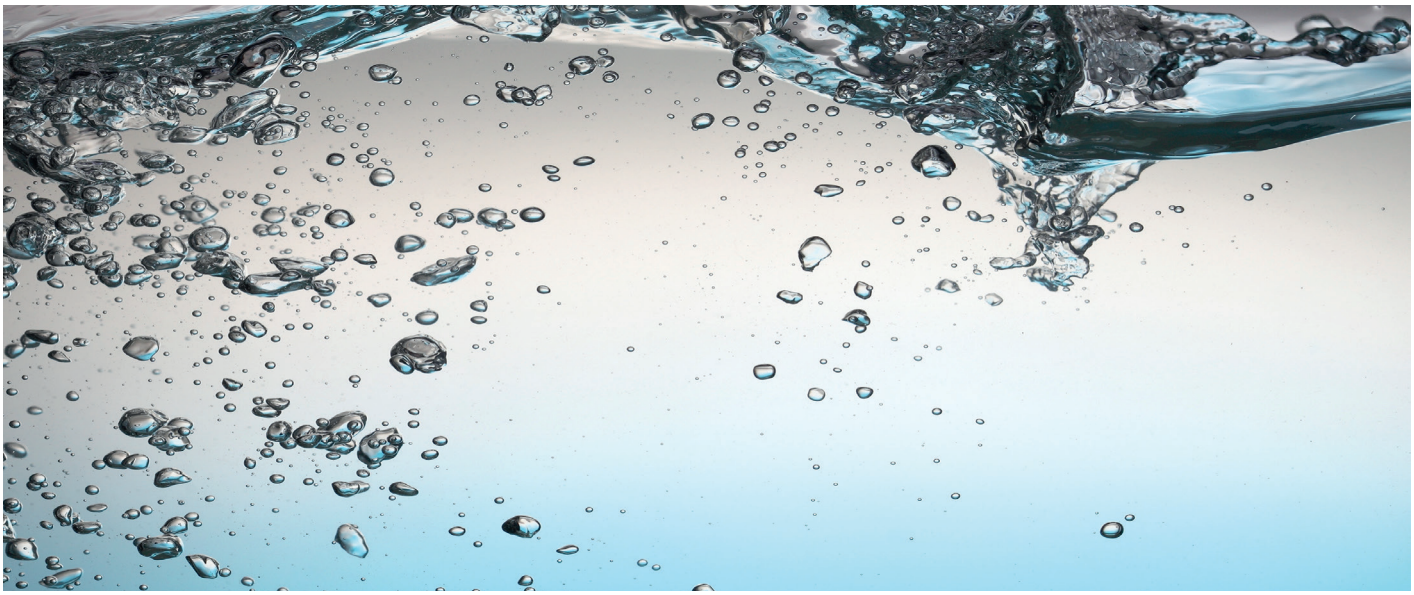

PART III: UTILISING LIQUIDITY IN ALTERNATIVES

When considering liquidity in the case of pension plans, things are different again. Whereas pension funds normally enjoy larger maturities in their liabilities, their situation differs greatly depending on the vintage of their demographic construct.

Pension freedom have also added to the complexity, as beneficiaries may be allowed to move their pension assets to another plan.

The differences between defined benefit ('DB') and defined contribution ('DC') schemes are also notable.

One key difference is the fact that DB schemes are anchored to promised compensation and to the balance sheet of a sponsor, making investment decisions reasonably dependent on the past returns of the scheme.

The British case is of special interest. The automatic enrolment scheme deployed by the government in 2012 has introduced many workers to the pension complex, especially younger generations. This, coupled with the need to disconnect the company finances of the sponsor from the funding level of the pension scheme, has instigated a shift to DC schemes.

Pensions freedoms have also added to the complexity, as beneficiaries may be allowed to move their pension assets to another plan.

The liquidity impact

From a liquidity standpoint, the transition from a DB-dominated environment to one where DC is the prevalent option may come at a cost for beneficiaries, for two reasons:

1. The UK DC market favours offering beneficiaries daily liquidity investment choices.

2. The need to cater for the ability to 'transport' pensions from one provider to another.

Regarding point one, the UK Government has started a consultation process on how to fit less liquid assets into the DC landscape, so we expect that more flexible investment solutions will appear in the medium term.

In addition, intermediate 'collective defined contribution' (CDC) schemes are at an early phase in the UK. These models, structured along similar lines to those existing in the Netherlands, provide an intermediate solution between DB and DC, with a target – rather than a promise – of benefits, and a separation between the scheme's and the sponsor's estate.

Harnessing the power of illiquids

One key ability of pension scheme beneficiaries is staying power – due to the inability of beneficiaries to access their pension pot before retirement.

Illiquid investments, which predominantly feature in the 'alternatives' category, provide a way of monetising this staying power. What is required now is for pension scheme regulators to enable a mechanism for scheme beneficiaries to capitalise on the illiquidity premium offered by alternatives.

Liquidity is a complex, multi-layered issue and investors should look into the systems that managers have to monitor and manage the associated risk. When implementing a blended asset class strategy with the aim of increasing diversification and smoothing the return pattern, managers must be sure that their portfolio has a structure compatible with the whole funding construct – investors, cash and asset borrow – of the fund.

If liquidity gets more challenged, when applying any limitations to investor withdrawals, the fund manager must be pro-active and transparent with the investor. Whereas a limitation in withdrawals can prevent fire-sales of assets and be a blessing in disguise, it is also a limitation of investors' rights – albeit one that should be clearly outlined in the legal documents.

Due to the delicate nature of the issue, fund boards and other corporate governance elements need to assume a strong role. It is for this reason that independent board members, who are truly independent and not just the 'yes men' of the manager, and the presence of voting rights in the corporate structure of the fund, are so important.

As alternatives become more popular allocations, particularly in the fixed income sector as traditional government bond securities struggle to deliver in today's low interest rate environment, and direct lending opportunities open up as banks consolidate and restrict their lending remit, the importance of considering liquidity becomes increasingly prevalent.

When an alternative strategy is implemented in a liquid structure such as UCITS, the manager must put a larger emphasis on liquidity when considering the instrument selection through which to implement a trade.

Even in the case of less-liquid funds, opting for a less liquid instrument ties the hands of the manager in case of wanting to implement corrective action, but when we are managing a liquid product, honouring commitments to investors takes priority.

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