Investment liquidity

Investment lockups investors should like

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Liquidity carries many meanings for institutional investors. Most critically for a majority of investors is the ability to access the investment's value at any time, whenever they ask for it. Another measure is the nature of the liquidity in the underlying asset class itself—how easy is it to monetize that asset without negatively affecting the valuation of that asset. It may also be viewed through the lens of transparency in prices, and if there is a market exchange-based valuation mechanism or robust price discovery mechanism. Investors need to evaluate liquidity on three dimensions:

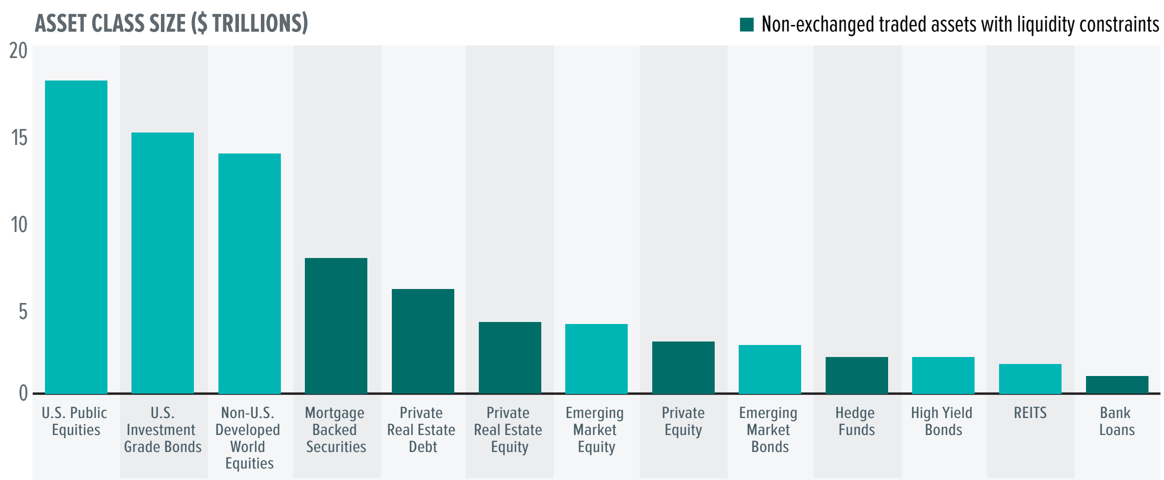
- Does taking illiquidity risk provide better risk-adjusted returns of my portfolio?
- Does the investment portfolio provide sufficient liquidity to meet ongoing investor cash needs?
- Are the underlying investments able to support investor liquidity demands?

Explore opportunities in less liquid asset classes

Again, most investors value liquidity. If offered a choice between two investment options, one offering a 10% annual return and accessible anytime cash is needed, and one offering a 13% annual return accessible in 10 years, many investors will choose the assets that are more accessible. Ultimately, liquidity provides the investor the chance to change their mind, either cashing out or reallocating investments to other securities.

However, additional returns are possible, and new markets accessed, if an investor is willing to give up a portion of investment portfolio liquidity. New investment options have become standard parts of investor portfolios, while traditional equity/bond markets have changed. Despite a U.S. economy that is two times larger than 1997, the number of public companies has declined, from 9,113 to 5,734. Many companies, especially tech companies, are remaining private for significantly longer. A well-diversified investor is going to likely need some access to more illiquid assets to be fully invested and capture the full spectrum of investment opportunities.

Exhibit A



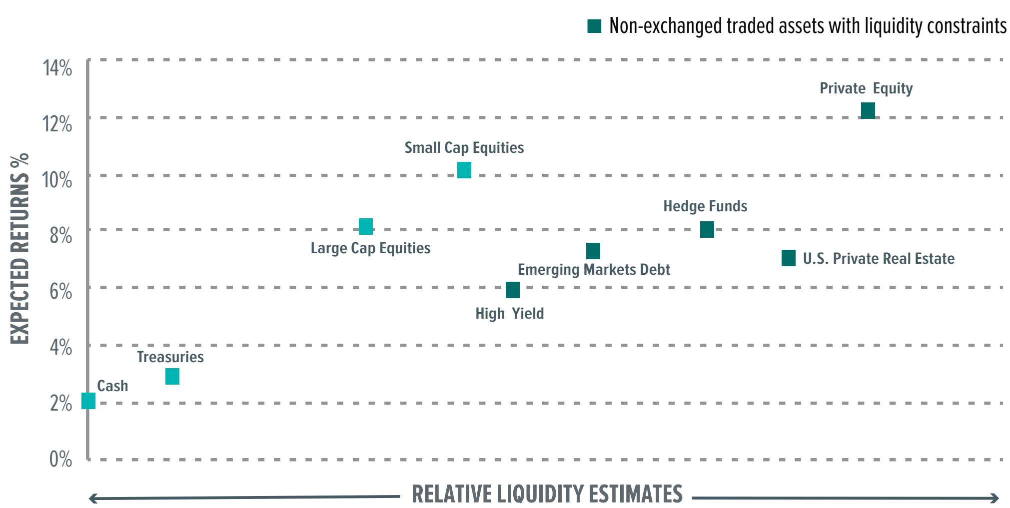
Source: Bloomberg.

The tremendous expansion of private investment pools and the consolidation of public markets have left certain investment areas the sole province of private investment. There are large asset classes that are not exchange traded and have associated liquidity constraints. (Exhibit A)

These additional asset classes provide significant portfolio benefits

- Take additional investment positions while positively impacting portfolio efficiency
- Adding an additional risk factor—illiquidity—for which an investor receives risk-adjusted compensation (Exhibit B)
- Further diversify portfolio with a long view, take opportunities to improve risk-adjusted returns
- Additional asset classes provide new avenues for managers to create alpha

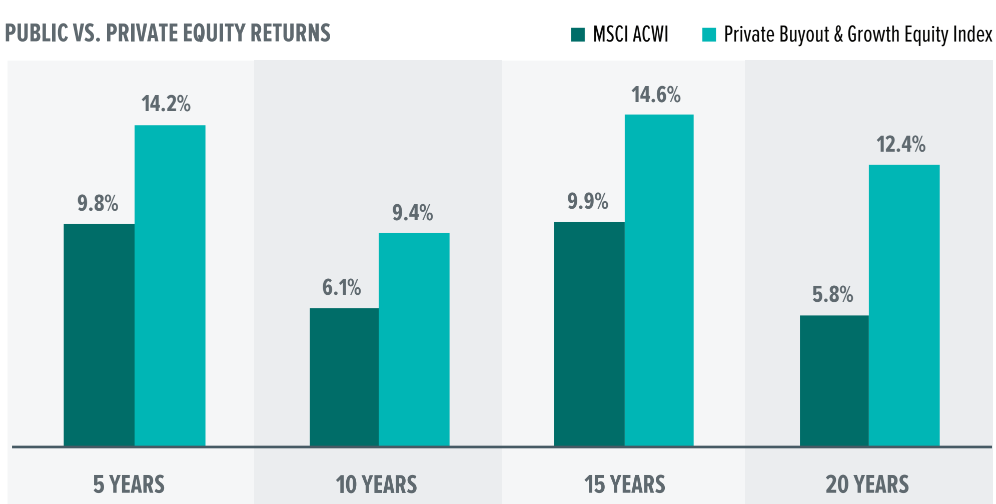
Exhibit B



Source: SEI Capital Market Assumptions and Illiquidity Estimates.

Therefore, investors can capture a liquidity premium available in illiquid assets for investors with long time horizons as compensation for locking up investments for extended time. Past results—such as historical returns on global private equity compared to global public equities—support the view that investors are compensated for taking the risks associated with reduced liquidity, enhancing risk-adjusted portfolio returns.

Exhibit C



Source: Standard & Poor's.

Investors can manage their liquidity needs

Many investors carry excess liquidity in their investment portfolio, and this excess liquidity comes with a potential opportunity cost. This excess liquidity is often due to a mismatch between investor's willingness to give up liquidity and their actual ability to tolerate illiquidity. Often these limitations are a result of investor discomfort with or difficulty in accessing certain illiquid asset classes. Rarely is the limiting factor the need for a significant percentage of available liquidity. For most investors, it's not difficult to address liquidity needs through careful allocation and management:

- Invest in daily priced, liquid investments covering multiyear withdrawal needs in deep and liquid market
- Maintain annual use (spending, distributions) in cash-like investments
- Access to a line of credit or external capital to smooth over spending and market scenarios

Depending on the annual spending or cash distribution needs and the implementation of the above risk management strategies, most institutional investors can manage 20% to 40% in illiquid assets with little impact on spending flexibility.

There can be an investment and asset liquidity mismatch

An often underappreciated aspect from investors, besides managing their own liquidity, is the potential mismatch between a fund's underlying investment, and the terms under which investors can redeem their investments. Can a fund manager effectively return capital whenever investors want to take it back? Liquidity, in a portfolio sense, is really more a function of group behavior. When a crisis hits, everyone invested may start looking for the exits, causing liquidation of these holdings at the worst possible time. An asset class that is not exchange traded is subject to reduced liquidity in times of market stress, and the process of price discovery could be disrupted. Investors attempting to exit these illiquid assets in challenged markets can lead to further reduced value as managers are forced to sell into a market with a shortage of buyers, making the remaining investors poorer in the process.

This happened during the financial crisis when many investors, some of them with short histories in alternative investments and suffering adverse portfolio shock, started selling their more liquid alternative assets. As a result, these alternatives suffered far more than expectations and investment models would have suggested. This black-hole effect refers to situations in which share redemptions causes a cascade of redemptions, as more investors sell their shares as asset values decline. When investing in an alternative, the portfolio needs to be constructed in such a way that it has sufficient redemption restraints to control liquidation in such downside scenarios.

Investors should be willing to provide gating, and in some cases long lockups, to limit the liquidation or asset drain of a fund made of low liquidity assets, forced to sell in a period of market challenges. These restrictions can contain what could potentially be a transitory loss in value, and limit the black-hole effect of cascading redemptions. In the end, *liquidity* is simply another risk factor like volatility that needs to be managed and diversified.

A key component is contractual restrictions that prevent illiquidity from having an outsized negative impact of valuation under adverse conditions. Rather than being concerned about lockups and gating, investors should welcome them for portions of their portfolio subject to varying levels of liquidity depend on market conditions.

It's important to manage illiquidity concerns in a number of ways. SEI works closely with its clients to construct portfolios in a way that provides adequate liquidity over a full market cycle. We also make sure investment strategies are set up correctly so that fund-level restrictions (locks, ques, gates) are properly aligned with the strategy and clients goals. Also, asset managers must take practical active measures to minimize common risks found within each of these strategies. This ranges from direct/secondary PE investing, vintage-year diversification, core/opportunistic real estate, and collateral manager diversification.

Meet investor goals with proper planning

Minimizing liquidity risks is about two sometimes offsetting strategies:

- Maintaining sufficient truly liquid assets (either cash, cash-like or deep market assets)
- Maximizing returns while minimizing portfolio volatility

Investors need to take advantage of excess liquidity while maximizing available returns, and in doing so make sure their investment strategies, fund constraints and asset class characteristics are in alignment. Illiquidity can be effectively managed through prudent investment decisions and appropriate planning. Investments safeguards, including restricted liquidity, investment gating, and period lockups, while constraining investor access to capital, provides needed protection in periods of financial distress.