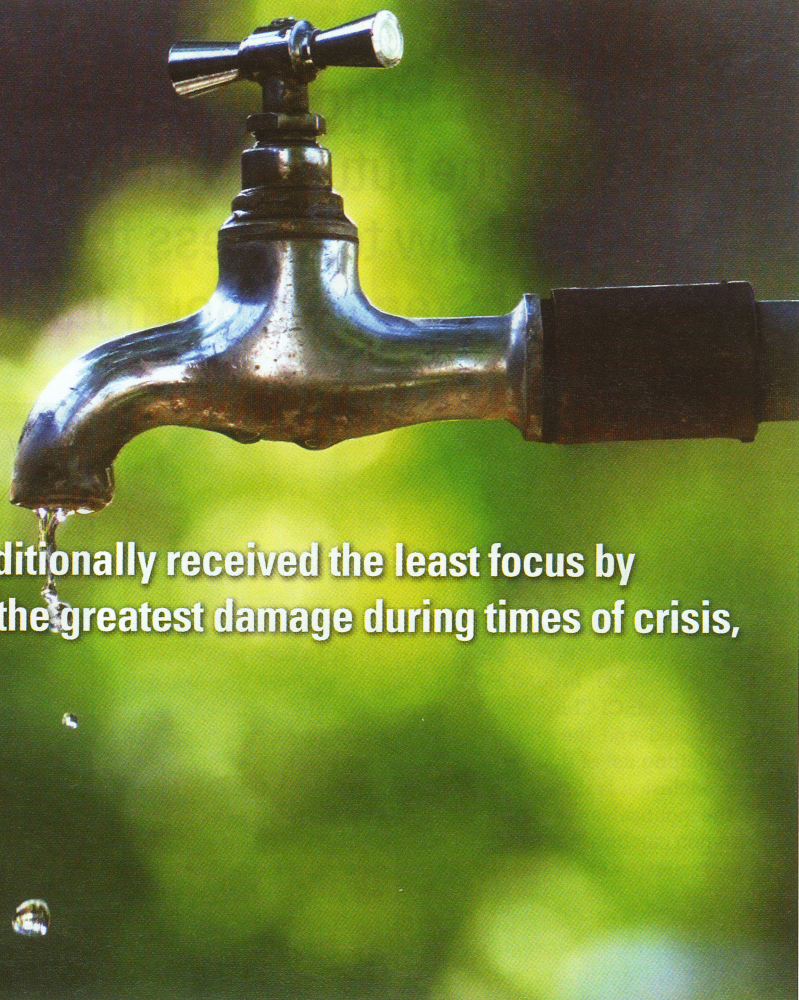


# Turning the tap on liquidity

Liquidity risk management has traditionally received the least focus by investors, yet it has often inflicted the greatest damage during times of crisis, writes DENNIS MOTHONEOS.



**B**efore the Global Financial Crisis, a number of findings in financial economics posited that stock and bond returns are primarily driven by their sensitivity to a small number of risk premiums. Reflecting this, Australian and New Zealand institutional investors applied these findings to constructing portfolios, increasingly diversifying within and across asset classes.

Initially, investors attempted to diversify across the risk premiums identified in the work of Fama and French – value and size. Investors sought to extend the single factor Capital Asset Pricing Model to a three factor model by diversifying across managers investing in small cap stocks and stocks with high book to price ratios (usually called ‘value’ stocks). A momentum effect called a ‘growth factor’ identified by Carhart was added to the three factor model to make a four factor asset pricing model.

Consequently, many institutional investors have selected strategies incorporating momentum, small cap and value drivers in order to build diversified portfolios. Since then several other increasingly granular risk premiums, such as quality or management risk, have been suggested in the literature; and to some extent, have been incorporated into various asset pricing models and portfolio construction approaches.

This had led some institutional investors to build and manage multi-asset class portfolios within a unified framework, providing exposure to several types of risk

premiums, expected to be rewarded at different times.

To diversify further, some investors targeted previously unidentified or difficult to access risk premiums in so called alternative assets such as private equity and hedge funds. One such risk premium was the liquidity premium. Of course, there were reasons other than the liquidity premium that encouraged investors to buy private equity.

One was the expectation of earning excess returns above public equity (usually estimated between 300–500 basis points), assuming they selected top quartile performing private equity funds. Another was a diminution in agency risks due mainly to higher debt ratios. It should be noted that the indices used to build these excess return estimates often suffer from selection biases (survivorship and backfill) and managed pricing – often making returns appear artificially higher and risks lower.

Liquidity or the lack thereof, is probably the one factor that has traditionally received the least focus by investors; however, it has often inflicted the greatest damage during times of crisis. The GFC was no exception.

The growth of a secondary market of fund interests (which remains only a fraction of total private equity commitments) was anticipated to provide sellers and buyers of private equity a mechanism to transact. However, the recent stand-off – whereby sellers were unwilling to sell at significant discounts to NAV and buyers were unwilling to buy un-

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less at significant discounts to NAV – indicates a lack of depth in this market at present.

Uncertainty on the part of buyers in relation to substantial undrawn commitments and unclear company growth prospects, no doubt was a contributing factor. Some investors sought a compromise in buying listed private equity but they also tended to trade at a significant discount to NAV during times of crisis leading to similar issues as in the secondary market.

More seriously, institutional investors realised – which became more apparent during the GFC – that allocating to private equity also exposed them to a host of other risks such as refinancing, valuation and vintage year risk. The inherent information asymmetries of private equity made it difficult to gauge the financial and operating position of the underlying portfolio companies. Uninformative pricing, infrequent valuations, insufficient investment or advances in technology meant that investors may not have been sufficiently aware of and are prepared to buy these risks without being able to satisfactorily manage them.

Besides, limited partnership (LP) agreements were probably

too restrictive and costly to change general partnership (GP) behaviours in providing more information; particularly, during a time of crisis. Limited liquidity and a reduction of distributions also hampered efforts to take advantage of attractive opportunities, which appeared due to the extreme market volatility.

Investors seeking to exploit the liquidity premium in private equity were often buying a premium they could increasingly obtain in more liquid asset classes and largely without the added risks. Additionally, the liquidity premium in publicly traded asset classes made available regular pricing/valuation and improved disaggregation and aggregation facilitating more precise risk monitoring compared to private equity and hedge funds.

Improvements in public company corporate governance and the incorporation of performance fees in funds managed by public equity managers have probably reduced agency risks, helping to mitigate some of the benefits of private equity.

Over the last 12–18 months, many Australian and New Zealand institutional investors have had to deal with a confluence of factors impacting the liquidity of their overall portfolios. Responding to this, they are likely to target a higher level of overall liquidity in future, prompting a more targeted approach to total illiquids/alternatives and potentially fewer or smaller commitments to private equity.

If investors stick to the principle of diversification across risk

premiums they may seek an illiquidity premium from public markets. Others accustomed to exploiting the liquidity premium in private equity are likely to demand higher compensation in the form of return or provision of information than before compared to public equity for the added, and somewhat difficult to identify, downside risks identified above.

Investors are realising that diversification within and across well-known asset classes – including what are often called alternative assets – introduced or amplified a number of risks that were difficult to manage. The deleterious impact of the GFC on portfolio returns has acutely refocused the attention of institutional investors on liquidity and its place in the risk management process. ●



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