

Liquidity isn't Binary

According to Gary Weaven there are only two proven ways to outperform in investment markets. "One is to be able to forgo liquidity and get a premium for that," he says. "The second way is to be in investment markets that are not over-populated; that is, where there is not a whole lot of other players (Jimenez 2012). At one level this sage advice may sound simple, but in reality, the true complexity lies in judging whether you are truly being adequately compensated for illiquidity.

The idea that unlisted and alternative assets might offer higher risk adjusted returns, compared to their liquid/listed peers, is both broadly accepted and widely misunderstood.

The basic premise of the illiquidity premium is that illiquid assets need to offer their owners a higher return to compensate for their illiquidity and, hence, offer a higher long-term return.

While the concept is widely accepted, I am not aware of agreed estimates of how much this illiquidity premium is (or should be).

What is Liquidity?

Liquidity is the ability to convert an investment into cash in a short time at 'fair' value. That is, can you sell it quickly and realise its value. Investments that are not liquid cannot be sold quickly, involve significant selling costs, or require the vendor to discount the value of the asset in order to achieve a quick sale.

What Causes Liquidity (or Illiquidity)?

Liquid assets are those with a deep market, with a wide range of well-informed potential buyers/sellers of the asset, who are able to execute transactions quickly and in a low cost manner.

While it is easy to identify a liquid market – it is useful to think of the characteristics that promote liquidity. These are helpful for both assessing the liquidity of a potential investment, but also when structuring investments, as it is often possible to improve the liquidity of an investment through the contractual rights attaching to the investment.

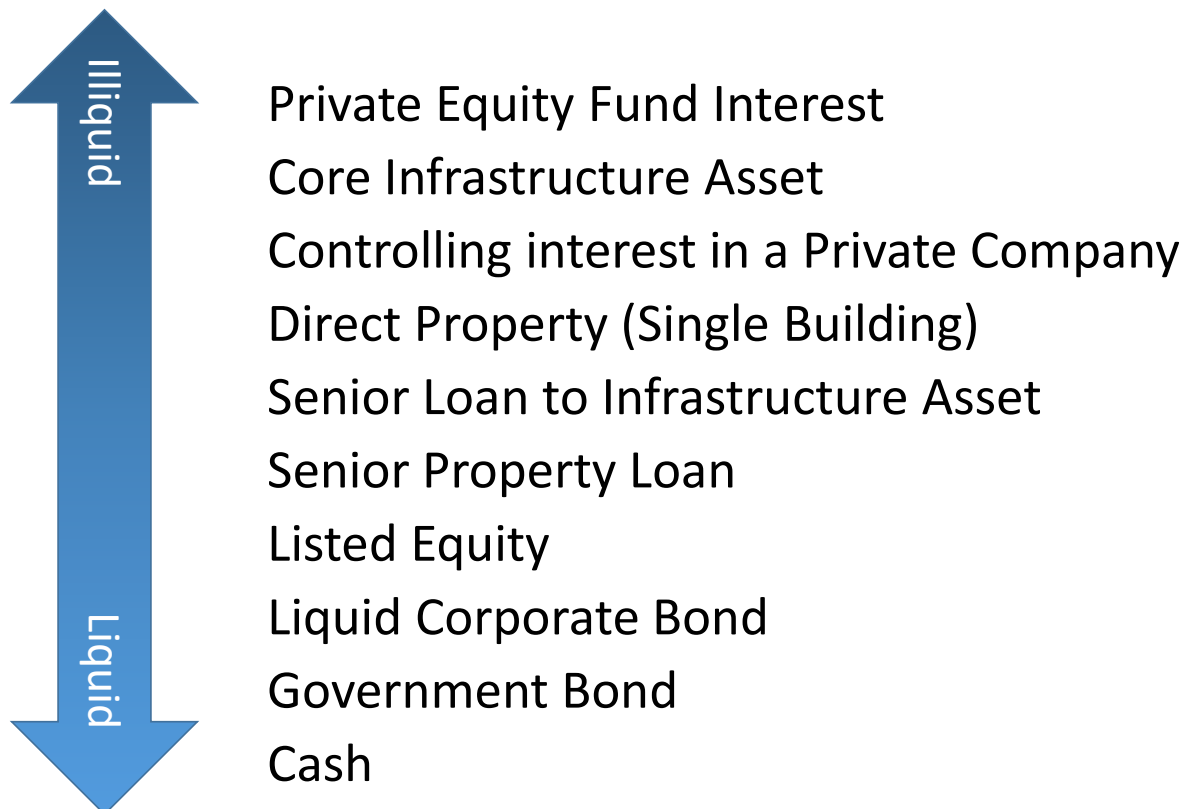
Drivers of liquidity:

- Time. Can the investment be bought or sold quickly?
- Cost. This includes both direct costs (stamp duty, transactions costs, other tax impacts etc.) as well as market impact costs. Even in listed markets, for institutional size stakes, these market impact costs (ie the amount your own trading moves the market) are often significantly larger than the direct transactions costs.
- Information/Governance rights/Complexity/Subjectivity. What information does a buyer need to assess an investment? Is that information freely available (for example, in listed markets through continuous disclosure obligations) or does a vendor need to arrange for time consuming and costly due diligence (datarooms, technical reports, etc)? How long does it take a vendor to assess this information? Is the material complex or subjective? Can the asset be easily benchmarked against other similar assets?
- Current Income/yield. Does the asset have current income or yield? Assets that pay an income tend to be more liquid. This may be because assets that pay an income tend to be less risky, or because the yield provides a yardstick for pricing (i.e. a benchmarking effect). An extreme opposite of yield are assets with outstanding capital commitments (for example, interests in private equity funds). These assets are extremely illiquid in adverse market conditions.

As you can see from the above, liquidity isn't binary – assets aren't either liquid or illiquid – there is actually a continuum of liquidity.

The following illustrates my view of the typical liquidity ranking of superannuation fund asset classes.





There are a few other points worth noting about liquidity:

- The liquidity premium – that illiquid assets earn higher returns – arises because illiquid assets are cheaper. That is they have lower prices that allow higher returns. It is not because something is illiquid that it magically gets higher earnings growth - it is because you paid less for it. This point seems lost on many market participants.
- The liquidity premium is likely to vary over time, with the discount narrow when there is a lot of capital seeking illiquid assets and wide in times of crisis and when capital is scarce. Some would argue that the illiquidity premium might actually be negative for some highly sort after sectors. For example, unlisted ports seem to be trading at higher EV to EBITDA multiples than their listed compatriots. This might be because the recent unlisted port sales have much better earnings growth prospects or risk profiles, or it might be the case that too much capital (which is restricted to unlisted assets) is chasing too few deals.
- Size matters – what is liquid for a small investor will not be liquid for a large investor. With the growth in \$50+ billion “mega funds” in Australia, I would question whether active holdings in any Australian asset – whether listed or unlisted – would really be that liquid.

Debt investments have free liquidity at maturity. For equity and other perpetual investments – realising your investment necessarily involves selling it. For debt investments, you are repaid in cash at maturity. This is free liquidity. It also means in a debt portfolio, by carefully planning your maturities, you can program in liquidity (even if the individual loans may not be that liquid).

