More than one price for illiquidity

It is quite common for investors to adopt a fixed premium for illiquid assets. That is, if an asset is illiquid it needs to provide an x basis point additional return over comparable investments.

We think liquidity risk should be viewed as a continuum and, in general, should be proportionate to overall asset risk profile.

Key drivers of liquidity risk are:

- depth/variety of market participants. The greater number and variety of market participants the easier it is find a buyer. Clearly a listed market can be a very effective mechanism to achieve this – but non-exchange traded markets can also be highly efficient (for example, government bonds in Australia – which mainly trade outside official exchanges),
- access to information to evaluate the investment (and costs/complexity of information). For example, contrast a government bond with a property investment (where detailed legal and technical due diligence is required),
- subjectivity – are the cash flows fixed or do they depend on a forecast? How subjective is that forecast? Subjectivity – that is, dependency on the opinion or attitudes of buyers, will inevitably increase liquidity risk. However, it also highlights the inherent link between liquidity risk and market risk.
- Does it pay a yield/holding cost/financability. Current income can act as an anchor on valuations. Furthermore, for assets that are easily financed (for example, contrast a bond that can be bought using margin/repo finance versus a private equity stake) there is a potentially higher return on equity for liquidity providers (as they don't need to invest the full capital amount of the transaction).
- Maturity date/exit strategy. Does it mature for a fixed value (i.e. a bond) or do you ultimately need to exit through a sale strategy. Debt investments have free liquidity at maturity. What is the reliability of that exit strategy – i.e. a listed share you can sell on market versus a venture capital stake where exit depends on IPO markets or risk appetites in the VC market. What is the term/tenor of the investment – long-term investments tend to be less liquid (and their pricing is more sensitive to market sentiment)?

This highlights that illiquidity is not a fixed factor – it varies considerably based on the particular characteristics of an investment. In general, there is a correlation between overall risk profile and illiquidity – for example, debt is usually more liquid than equity.

It also highlights the inevitable interconnectedness between liquidity and market risk. For example, when equities crashed in the GFC was this due to 'market risk' because investors had reassessed the investment outlook or 'liquidity risk' because marginal buyers required larger and larger discounts to fair value to absorb selling activity.

For this reason, we would encourage investors to price liquidity on a continuum (or bucketed) approach where liquidity premiums are tailored to the specific liquidity characteristics of different investments aligned with the context of their specific fund strategy (e.g. defined benefit, pension, accumulation fund draw down requirements).

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