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Illiquid Assets

IAPF Investment Committee
2014

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Who is this most relevant to

	Very Relevant	Somewhat Relevant	Not Very Relevant
Large DB Schemes	x		
Small DB Schemes	x		
Large DC Schemes	x		
Small DC schemes			x

Background

When we refer to the liquidity of an asset we mean the ease with which the asset can be converted into cash. It is a measure of how quickly the asset can be sold. Illiquid assets are those which cannot be readily sold. Property is the classic example of an illiquid asset.

Liquidity is often considered to be a desirable feature of an investment asset. However, an investor may receive an additional return for accepting a reduced level of liquidity and this is known as a liquidity premium.

It is widely accepted that there is a premium available for illiquidity in financial asset markets. Although the size of the premium is not quantifiable (and opinion varies widely as to what is an appropriate premium), it is not insignificant. If investors with a long-term horizon can afford to take on illiquidity/ give up liquidity and in return generate additional return, then they should do so. Put simply, if you can lock up your money for an extended period of time you can get quite well paid for that.

Issues to Consider

- Liquidity is a continuum with cash being the most liquid asset and an asset such as property being at the other end of the scale.
- Liquidity for a particular asset is not fixed. It can disimprove (or even disappear) in times of market stress.
- The bid-offer spread for a traded asset is a good indication of liquidity in that market. A narrow spread indicates that there is good liquidity and vice versa.
- Within an asset class there is also a range of liquidity available, e.g. highly liquid US large cap equity versus non-US small cap equity.
- Private markets by definition are less liquid that public markets; therefore investors expect to receive a premium over public markets for the associated illiquidity.
- Illiquidity is an important consideration for investors because, all else being equal, they should pay a lower prices for and/or demand a higher return from less liquid assets.
- For mature pension funds with greater cash outflows, which will typically be funded from the

more liquid assets, the denominator effect may have the unintended consequence of increasing the illiquid asset allocation overall. This also applies to closed funds with no new cashflow.

- Cash flow projections become more important in respect of illiquid assets as the maturity profile of a pension scheme increases over time.
- Funds may find themselves in a liquidity trap where they are forced to sell illiquid assets into distressed markets (as happened with the US endowments who had large P/E and hedge fund allocations).
- For this reason, an allocation to illiquid assets will generally remain low in a portfolio.

Summary

Illiquid assets can have a role to play in a pension fund's asset mix as they can offer:

- Enhanced return premia
- Exposure to previously inaccessible asset classes (with different return and risk drivers)
- The benefit of diversification and lower correlations
- Potentially lower volatility (as some assets are less likely to be marked to market)
- Some duration matching to pensioner liabilities (although this is not recognised by regulators).