# Guest Contributor: What's the Cost of Liquidity? The Illiquidity Premium and Alternative Investments

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When it comes to investing, what does the average person most likely think of? Stocks. Bonds. Perhaps mutual funds. Most individuals are very familiar with these *liquid* assets – assets that can be traded for cash at market price with relative speed and ease. As such, many portfolios are largely comprised of these investments.



Alternative investments, such as private equity, venture capital and real estate funds, however, are often avoided by investors, due in large part to their illiquidity. Illiquid assets tend not to have a secondary market and cannot be traded for cash as easily as their liquid counterparts. For many, this makes alternatives "too risky." After all, emergencies happen, opportunities arise, and investors who need cash are stuck if their investments cannot be readily sold.

Many investors place a high value on the utility of cash and liquidity, and they pay a high price for it. Not only do those investors who rely too heavily on liquid investments expose themselves to all of the emotional volatility of traded markets, but they also miss out on the premium that illiquid alternative investments often yield.

## What is the Illiquidity Premium?

The illiquidity premium is the higher rate of return that an investor can expect to earn by accepting the risk of holding illiquid assets. As the saying goes, “cash is king,” and that’s certainly true for the average investor. Because of this, they demand an extra return for those assets which may be more difficult to sell. Additionally, holding on to these illiquid assets results in an opportunity cost for the investor, as they can limit an investor’s ability to rebalance their portfolio when circumstances change or new information arises.

But the illiquidity premium is not just a hypothetical, “nice-to-have” idea for investors; it is observable. One of the most famous examples of the illiquidity premium in action is David Swenson’s “Yale Model.” When Yale hired Swenson as their chief investment officer in 1985, the Yale endowment was worth approximately $1 billion. As of September 24, 2020, it was $31.2 billion. How did Swenson do this? He shifted funds away from domestic equity and fixed income and moved toward real estate, private equity and hedge funds. In essence, he moved from liquid assets to illiquid assets.



But, perhaps a multi-billion-dollar university endowment does not resonate with the average individual’s portfolio. In that case, UBS Hedge Fund Solutions recently performed a study of 234 hedge funds on their platform in an attempt to determine the correlation between performance and the liquidity of the underlying investments. They discovered that each month of illiquidity results in approximately 20 basis points of additional return.

Along the same lines, a separate study observed by the UBS researchers found their results to be consistent with the investment histories of nearly 1,400 private equity funds over a 24-year period derived from the holdings of more than 200 institutional investors. As demonstrated by this analysis, these private equity funds achieved a median annual return net of fees of more than three percent higher than the S&P 500. Assuming a seven-year lifespan for the illiquid investment, this outperformance would equal 21 percent in simple terms.

## Additional Potential Illiquidity Benefits

The illiquidity premium is not the only potential benefit of illiquid assets. As they generally have little to no correlation to the volatile public markets, illiquid assets offer the opportunity for strong diversification, as well as exposure to unique investment areas, such as commercial real estate, oil and gas and other markets to which the average individual investor often lacks access to or is simply unaware of, and, as illiquid investments are rarely bought and sold, they help to avoid the regular transaction costs and maintenance fees of a heavily traded liquid portfolio.

Illiquidity also helps to mitigate market volatility and can aid in minimizing losses in a down market. In the public markets, an individual investor may easily be gripped by fear, either of loss or of missing out, and buy high and sell low. Since illiquid investments are by their nature more difficult to sell, they can serve to protect investors from the emotional swings of the market that can often destroy an individual's hard-earned wealth.



What's more, the SEC's recent expansion of the accredited investor definition allows more people the opportunity to invest in alternatives than ever before, and, with advances in technology like blockchain and tokenization, it could be possible that even illiquid assets could become more liquid in the future.

Liquid assets will always have a place in the average investor's portfolio, but many are missing out on the potential gains that alternative investments can experience due to the illiquidity premium. For those investors with applicable goals, a long enough timeline, and a certain amount of risk tolerance, illiquid alternative investments can play an important part of a sound investment strategy.

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