The case for illiquid investments

Willis Towers Watson

The case for illiquid investments

Pension schemes and other institutional investors are increasingly looking at illiquid and private market opportunities. Part of this increased take-up is a growing awareness that some of the challenges traditionally associated with illiquid assets may not be as testing as previously thought. Illiquid assets can be critical to many investors looking to help deliver their required returns in a challenging environment; if you are not among them, it may pay to consider being an early adopter.

Most commentators would agree that returns are hard to come by right now thanks to historically low yields in many public markets. Following a long positive run, the scope for further growth in mainstream assets also looks more limited. Meeting the investment objective in this environment might therefore mean increasing market exposure, or relying more heavily on active managers, neither of which are without their risks.

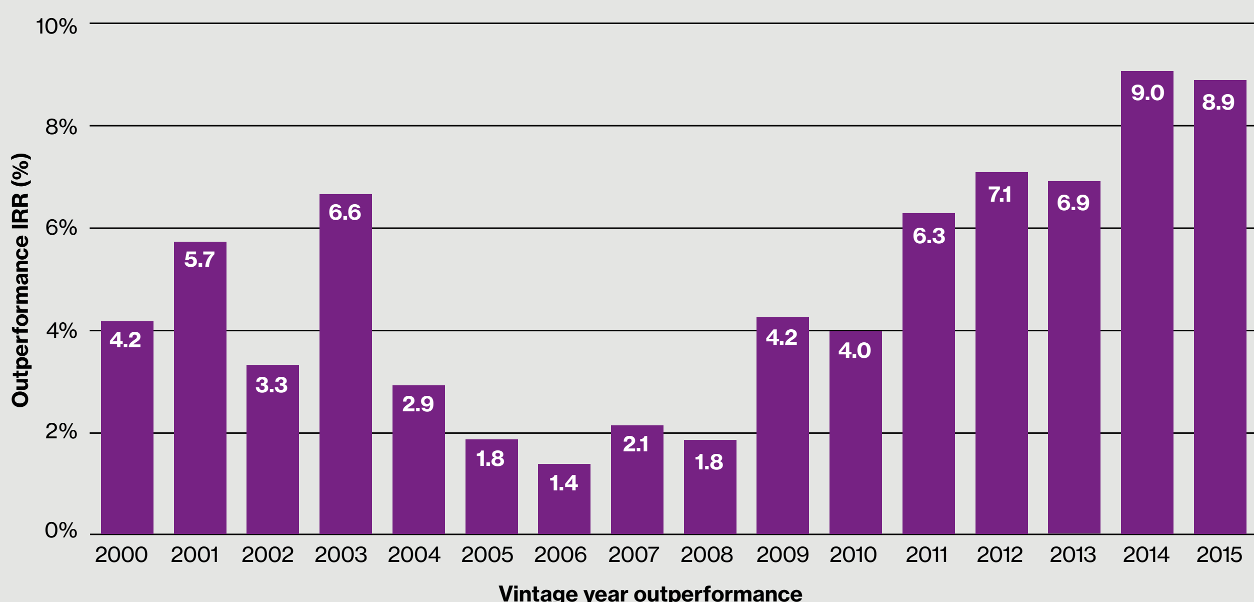
Instead, more institutional investors are turning to private market opportunities, where the rewards associated with illiquidity and complexity can bridge the return gap but where assets also aren't generally as 'illiquid' as the label might suggest. Investing in areas that others cannot enter (for example, due to a short investment timeframe or relative lack of governance) can mean attractive prices, a high return for relatively low risk and a wider array of exit options than perhaps expected.

The return story

Nothing talks louder than returns (see *Figure 1*) and recent evidence points to superior returns from private markets compared to public markets. In recent years private markets have outperformed public markets by 4.8% pa.

The future also appears to be bright. The illiquidity risk premium (IRP) is estimated to be worth 0.5%-2% per annum – and potentially even higher for very long-horizon investors.[1]

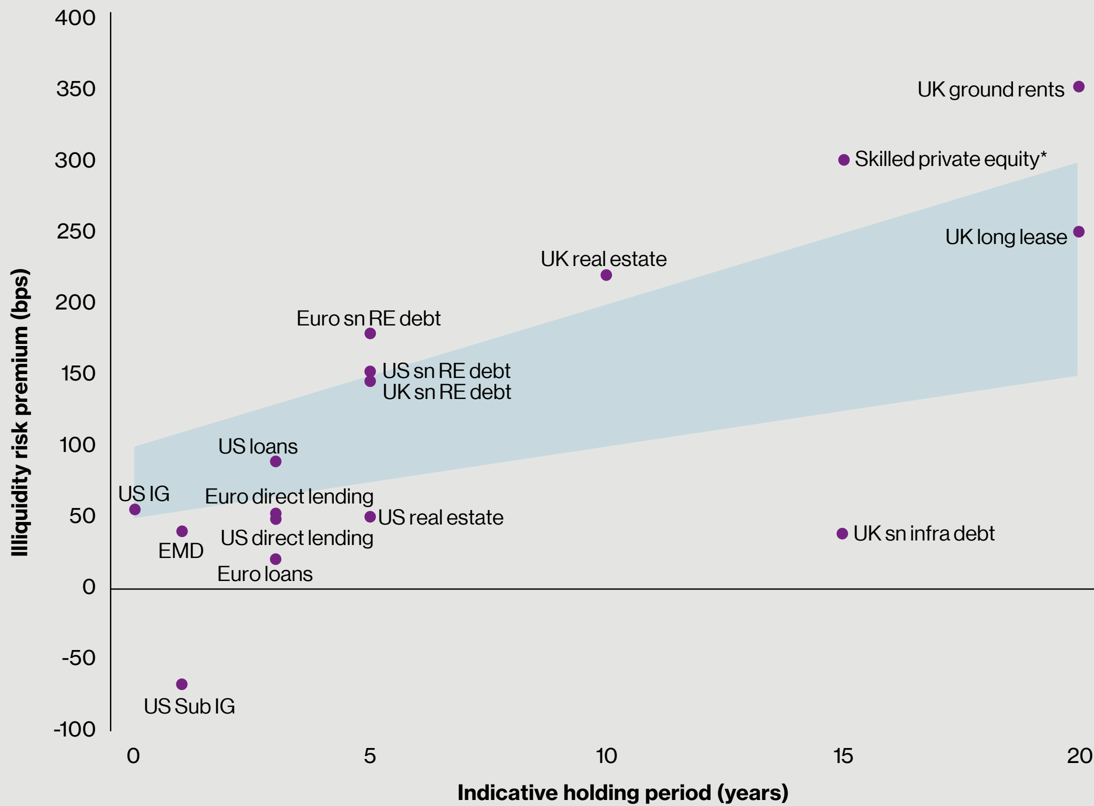
Figure 1. **Performance of private markets relative to public equities**



Source: Preqin data to Q4 2018
Please note that investment returns can fall as well as rise and that past performance is not a guide to future investment returns.

[1] Willis Towers Watson Thinking Ahead Institute, The search for a long-term premium. 2017

Figure 2. **Forward looking illiquidity risk premium**



Source: Willis Towers Watson, October 2019

*This represents the additional expected return of skilled private equity over skilled public equity. This additional return is due to a variety of factors: a control premium, small cap premium and an illiquidity risk premium. The number shown here is conditional on skilled managers being able to recoup high fees and costs, and adding value through sound business management (not just levering a business and hoping to flip it at a higher multiple).

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Such figures don't, however, obviate the need to be selective when allocating capital. In a similar story to public markets, investors are chasing a relatively small number of opportunities, typically those that are easier to access, leading to a reduction in the attractiveness of certain illiquid assets. *Figure 2* shows our current view of the illiquidity premium being offered by various asset classes. The grey area in the diagram represents our view of the fair value of the illiquidity premium. A common theme we see with asset classes sitting below the fair value is excessive demand, for example infrastructure debt is very attractive to insurance companies given their solvency II restrictions and $263 billion of capital has been raised to invest into mid-market direct lending. Nearly half of that capital has yet to be invested, which we observe has led to lower expected returns, relaxation of lending standards and, as a result, higher risk.

We still continue to find value and attractive premiums in many areas of private markets, including private debt, by avoiding the crowds.

That still leaves numerous attractive investment opportunities, such as:

Secure income assets

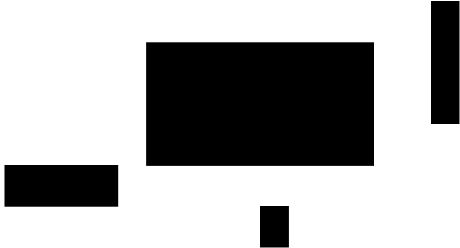
These investments (e.g. ground rents and long lease property) can provide long-dated, inflationary, and predominantly contractual cashflows. As such, they are particularly attractive to pension funds looking for a safe way to meet increasing benefit outgoings. And from that point of view, pension funds have an advantage over insurers in that they aren't so restricted by regulatory and solvency issues. Meaning they have a broader opportunity set away from competition with the insurers.

Private equity

Another opportunity for longer-term investors is investing into private companies. In the U.S. 98% of companies are private, and more businesses are choosing not to list, or to list later. It's no coincidence that the private equity (PE) industry has grown from the beginning of the 21st century to around $3 trillion in value.[2] Some parts of the market are relatively expensive and savvy investors will want to ensure that their capital is invested selectively.

Environmental, social and governance (ESG)

Many investments in the above asset classes can also enhance investors' increasingly scrutinised environmental, social and governance (ESG) credentials. For example, recent investments from Willis Towers Watson's pooled funds have given investors access to the UK's largest waste to energy project, the development of solar farms in Japan and support for social housing development.



[2] Source: Willis Towers Watson, July 2019

Getting in: beware queues

As with any overarching asset class, diversification is key along asset type, manager and time (vintage). Also, investors need to be conscious of time horizons. Typically, private investments last 10-25+ years, and building up a diversified portfolio can take some time. Another issue with investments in this area is that you will need to make many of them to build a diversified portfolio, requiring significant governance.

Investing via a pooled fund helps to avoid these issues, by providing instant access to a diversified range of assets. That said, if a fund has raised a lot of capital and is taking a long time to invest it or has a long queue, that's usually a good indication that they're struggling to invest capital robustly into a competitive market. This in turn could lead to managers accepting lower returns and/or taking more risk.

We believe that value is more likely to be found in selective opportunities where it is harder to invest significant amounts of capital.

That's where access to an already diversified and mature portfolio can make a difference and allow organisations to instantly reap the benefits of private markets.

Getting out: how easy is it to sell?

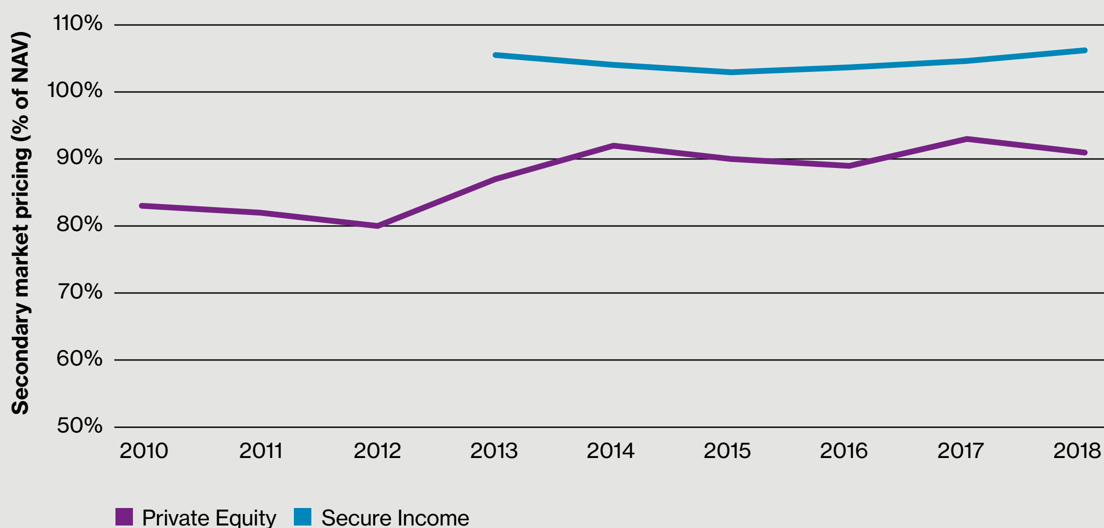
Generally speaking, getting out of illiquid investments is easier than many people think, especially in the context of the typical lead-time for a sale (e.g. a pension scheme negotiating a buyout).

We estimate the secondary market in private equity is now worth $75 billion a year. This market has seen trading volumes and prices trending up over time, whilst *Figure 3* below shows the average price, we see higher quality portfolios trading at a premium to NAV.

The secure income secondary market is less mature, however trading volumes have risen significantly since 2013. According to the trades facilitated by one of the key brokers, CBRE, nearly £1 billion has been transacted over that period. Importantly, it is a seller's market; with significantly more demand for stakes when they do come to market than is generally supplied.

The use of pooled funds can further enhance liquidity. At any time, investment activity will be balanced by capital redemption activity. This gives more potential flexibility to exit an investment at a time of an individual scheme's choice. Whilst some pooled funds have received something of a bad press recently as a result of the suspension of Neil Woodford's UK Equity fund, we believe these issues are less relevant in a defined benefit scheme's context, where the pooled fund liquidity much better reflects that of its underlying investments and trustees have appropriately sized their exposure to less liquid assets.

Figure 3. **Secondary market pricing for Private Equity and Secure Income**



Source: Willis Towers Watson, data as at 31 March 2019

Please note that investment returns can fall as well as rise and that past performance is not a guide to future investment returns.

When do you need the liquidity anyway?

When considering liquidity requirements, it is also important to think about the scenarios in which the investor is realising these assets. Take a pension scheme for example:

Selling secure income assets

This may be at the point of buying out the pension scheme. This is likely to be driven by strong asset performance or improved insurer pricing, both of which are positively correlated with strong secondary market liquidity. Conversely, in a scenario where market liquidity has dried up, pension schemes are unlikely to be in a position to buyout (and so should hold onto the secure income assets to continue to meet benefit payments). Further, insurers are unlikely to be in a position to write new business at a reasonable price at times like this.

Selling private equity

This will typically be as part of a de-risking exercise, following an improvement in the overall funding level. In such a scenario, assets would have generally performed well, and economic conditions would be favourable – in these circumstances secondary liquidity would be naturally available. It is also worth noting that these investments naturally run down over time, which could facilitate de-risking without the need to approach the secondary market.

The case for change is strong

Private market and illiquid investments provide an attractive return premium for investors with a long enough time horizon and enough governance. The main downside (and the reason behind the return premium in the first place) is a relative lack of liquidity, which can be managed with careful forethought through the secondary market and pooled funds.

For interested investors, it is well worth thinking about making a move sooner rather than later.

As well as maximising the benefit of these long-term investments, there is a strong case for getting ahead of the flow of pension and other institutional assets that is beginning to be channelled into these areas.

Further information

For more information on illiquid investments please contact your Willis Towers Watson contact or:

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