The PODfolio Podcast Episode 18: Asset Class Mini-Series: Illiquids

[MUSIC PLAYING]
DUNCAN HALE: And one of the things I learned when we started looking at these greenhouses is just how much of the cost of growing produce in a greenhouse comes from generating heat. About 30% of the cost of tomatoes comes from actually the generation of heat.
[MUSIC PLAYING]
SPEAKER: Welcome to The PODfolio, Willis Towers Watson's investment podcast series, where we'll give you an update on the latest developments across global markets, and talk to expert guests on hot topics that matter to institutional investors and their portfolios.
[MUSIC PLAYING]

LOK MA: Hello, and thank you for listening to The PODfolio. I'm your host, Lok Ma. Today's episode is the third one in our miniseries looking at different asset classes. So far we've done equities and bonds. And I think a very simplistic way of looking at these two main markets is maybe to say that equities tend to be riskier, more volatile investments.
So you'd think supply and demand and really common sense would suggest that equities would be priced in such a way that you expect a higher return on them, compared to maybe at the other end of the spectrum, things like very safe investment grade bonds. And that all speaks to, I think, the inviolable law of investment that says, more risk, more expect a return. But is that always true, that simple relationship between risk and return?
We're just going to test that a little bit by looking at some illiquid investments as maybe an asset class that's not so easy to put on this risk and return spectrum. And so for that, we welcome Duncan Hale, who is our head of secure income. First of all, how are you, Duncan?
DUNCAN HALE: Very good, Lok. Thank you for inviting me. I'm an avid listener. So I'm very, very keen to be involved. Thank you.
LOK MA: I knew we had one of those, so thank you, Duncan. So we're talking about illiquid assets, and we absolutely want to cover the important features, especially, I think, around sustainability and ESG factors that I know are particularly important in this area.
But I also just want to get a tiny bit philosophical first, if you like, on this topic around how illiquid assets fit into this overall picture of risk and return. And I think-- you know what I'm getting at, Duncan. I'm thinking about the usefulness of the illiquidity premium. So to start with, can you just give us your definition of the illiquidity premium. What makes these assets particularly attractive?
DUNCAN HALE: Yeah. Yeah. Thanks-- thanks a lot. Yep. I think the first thing to say is that we'd actually consider illiquidity or liquidity a risk. And so this is one of the risks that you get paid for. And so in terms of the illiquidity risk premium, essentially what we view that as is the extra return you need essentially to lock your money up over a period of time.
And so because you have an inability to trade in and out of the assets on a quite frequent or quick basis, you demand, as an investor, a additional return for that. I think there's elements of that around supply and

demand, but kind of what's another feature that we see is to some extent you're being compensated, because it's actually quite hard to transact in illiquid assets. Unlike in a-- you talked about equities. You ring up a broker and ask them to buy you certain stocks of Amazon.

In illiquid asset classes, what you need to go out is you need to source an asset that the seller is looking to sell. Often, you need to compete to buy that asset with other investors in this area. And so it's a lot more tricky to go from a situation where you want to invest, to actually executing and holding that asset. And so the illiquidity premium, the return that you require to lock your assets up, to go through that hassle, is what-- is the additional return that we expect to receive from illiquid assets.

LOK MA: So compensation for the difficulty in transacting, executing-- so I mean-- I mean, yeah. I look at it as therefore, you pick up these things for a better price because of those difficulties and therefore, get higher return. Hence, the premium. So what is the rough size of this premium, based on what you can see in the market? I know that's not an easy question.

DUNCAN HALE: Yeah. I mean, it's not an easy question because there are lots of different assets that are illiquid out there. And to that second point around how easy is it to transact, some of them are easier to transact than others. That has got things to do with the nature of the underlying assets and how you might price it, the skills that you might need to be able to manage those particular assets. Think something like venture capital is really hard to manage, and so you require a large illiquidity premium for that.

There's also size. Obviously, if it's going to be a hassle to transacting something, you want to get as bigger piece of that as possible. And so what we find is that there are large illiquidity premiums for smaller assets.

But to put that into context for the low-risk assets that we refer to in the illiquid markets is secure income assets. So these are assets that deliver long-term cash flows. Historically, that illiquidity premium has been between, let's say, 200 to 300 basis points per annum. So you expect to receive 2% to 3 and 1/2% per annum greater return for investing into these illiquid assets than what you might expect to get from similar risk assets that sit on a listed market.

LOK MA: And you said, Duncan, historically, 2% to 3 and 1/2%. Looking ahead, are you expecting to see a similar sort of number?

DUNCAN HALE: In certain areas, yeah. What we've actually seen is a bit of a dichotomy recently in terms of those returns and the illiquidity premiums you can get. For those assets that are very popular, we're thinking about things like infrastructure debt, things like certain long-lease property assets that have got amortizing leases. We're seeing at the lower end of that, in some cases actually below the 200 basis points.

For some other areas that are newer, parts of the marketplace actually seeing greater than 350 basis points. So if you think about some of the new, interesting energy transition type assets-- we might get a chance to talk about them later-- they're actually looking at significantly more than that 350 basis point. So, again, really comes down to some of those factors we talked about earlier-- how comfortable people are with the market, how easy it is to transact, how annuities, skills required, all of these different things focus in. But we are seeing that split.

I think generally, the other kind of element to that is looking at it versus other comparator assets. And so the comparator assets that lots of people look at this against is long sovereign bonds around the world.

And as we've seen-- almost right across the world, we've seen those sovereign bonds really come down as global easing as happened right across the world.

And while we've seen an element of illiquid assets pricing tighten, so slightly lower returns over time, it's nowhere near what we've seen from those comparator assets. And so from that perspective, the illiquidity premiums actually increased over time.

LOK MA: Yeah, yeah, yeah. So 2%, 3%, 3 and 1/2% a year extra, especially given what's available elsewhere, as you say. I mean, that's exactly why we are talking about this asset class. So I just wanted to get that out of the way and kind of set the scene for the why.

And now, let's actually talk about what these assets are. I mean, you mentioned the kind of more traditional stuff, like infrastructure debt and long lease. But I think this is probably kind of favorite examples time, Duncan, especially in the area that you specialize in-- the secure income assets. You kind of teased us about some of the newer things that you're looking at.

DUNCAN HALE: Sure, yeah. So maybe just to step back. When we talk about secure income, what we're looking for is liquid assets. It's generally in the real estate or infrastructure or real asset debt-type space, which deliver long-term cash flows, which are delivered through long-term contracts. Those contracts generally have a linkage to local inflation, generally, with very robust counterparties.

And importantly, they're also assets where you deliver quite a lot of the return through the cash flow rather than selling the building or the infrastructure asset at the end of the period. So those are the characteristics that we're after from an economic perspective importantly. Because they're generally very long-term, so 15 to 25, even longer type periods. And so thinking about sustainability over a very long-term period is also quite key.

So those are the characteristics that we're after. And that has got a very wide range of assets that fit within that right across the globe. And so some of the things that we've looked at are things like student accommodation in the US, social housing in the UK. Clients have invested into unlevered renewables in Australia. And then things like nursing homes in the Netherlands. And all of them have got those similar characteristics where there's a very stable, long-term cash flow stream that delivers a linkage to local inflation.

LOK MA: Yeah. And this is another of the themes we're coming across, these sorts of conversations, that with an ESG, the social, the S bit, is getting more and more attention alongside the E, the environmental climate-related bit, as well, which is good to see.

DUNCAN HALE: So Lok, you asked me what my favourite investment was. And one of the ones that our clients have invested into recently is actually greenhouses in the East of the UK. And one of the things I learned when we started looking at these greenhouses is just how much of the cost of growing produce in a greenhouse comes from generating heat. About 30% of the cost of tomatoes comes from actually the generation of heat.

And so traditionally, that's been done via fossil fuels, as you can imagine. But what's interesting about these new greenhouses that our clients are investing into is actually that heat is generated through recycling heat from a local sewage treatment work. So the sewage treatment works as it treats water, that process generates heat. These greenhouses use ground source heat pumps to take that heat and pump them essentially into the greenhouse.

And because of this renewable way of using heat, it qualifies for a government subsidy, which means that 50% to 60% of the revenues that this asset actually gets comes from a government source. And so it's got all those features that we talked about. I mean, these assets have got 20-year leases, 20-year contracts with that government for the subsidy, so very long-term.

Those contracts are linked to inflation, so a very robust counterparty in terms of the UK government. So it ticks a lot of those boxes, generates a very nice return, while at the same time, generating some real discernible and impactful environmental impacts.

LOK MA: And another thing I just wanted to pick up on is that when you went through the examples, it kind of struck me that these are all very specialist investments, very specific to their own industries, and also really very different from each other. And so, how do you go about getting the kind of right sort of expertise in terms of running a nursing home versus a kind of renewable energy project?

DUNCAN HALE: Yeah. I mean, our approach in this area is very much to find partners and managers in each of these areas that are specialists-- not only have the expertise around running the different elements different, but also that it can be quite different from geography to geography. It's very much a local type of situation. So finding specialists in the local area we think is really critical to success in this area.

LOK MA: And another thing I want to pick up on, and it's something we're seeing more of, especially in the UK, is the use of these types of assets to pay kind of pension instalments to retired pension scheme members. And in the UK, we call it cashflow driven investment.

But you mentioned these long-dated income streams. The overall idea of cashflow driven investment is that the income from these assets, if you think about them as they're long-dated, they're predictable-- you said they're kind of linked to the local measure of inflation, then they sound a lot like pension payments in themselves.

And so the advantage of having income streams like that is you don't have to worry about having to sell off your assets from time to time to pay your pensions. And you don't have to worry about the price that you might get when you have to sell your stuff. So can you just tell us a little bit more about these income streams?

I think you mentioned subsidies. I'm kind of interested in what are the things that have to go right for you to get your money and your income? And how sure are these income streams? And what happens if you don't get what you're promised?

DUNCAN HALE: Yeah. So in most cases, what we're looking for are contracted cash flows. And so what we mean by that is we're not looking for a toll road where it depends on how many cars drive down the toll road to get paid. We're looking for assets that if the assets there and it's ready to be used and ready to be available, that we get paid a very predictable cash flow.

And so from that perspective, on a asset-by-asset basis, there's a very high degree of predictability, particularly if you have a diversified portfolio that addresses any of the issues that you might have in some of these assets. These are operational things, particularly on the infrastructure side. So there are things that go wrong from time to time.

Generally, though, what we're looking at is the assets that are low-operational risk. So if it does happen in an asset, it generally can be fixed within a reasonable time frame. So over a diversified portfolio, you get a very stable cash flow.

The things that can go wrong are the things that happen at a very broad basis across a whole sector of your portfolio. Think about-- a good example that's often pointed to was a number of years ago, 10 years ago, Spain changed its tariff around solar, which would have impacted not only individual solar projects in Spain, but all solar projects in Spain as an example.

And so it's those type of, I guess what we would refer to as left tail risk type of things, that we're really mindful of when we're helping our clients think about building portfolios in this area.

LOK MA: And, of course, don't-- the mother of all left tail events was last year. So I think the asset test for all asset classes, I think, is when COVID brought all this volatility to the market. So did the income streams, and also that the kind of asset prices of these investments, hold up?

DUNCAN HALE: The asset prices very much held up quite well. I mean, right across the spectrum, I think the most impacted part of the market were those commercial buildings let to commercial organizations on 25-year type leases. And they generally had a very small impact in terms of capital prices. If down at all-- they definitely went down over 2020, but over the first half of 2020, if they were down, they were probably down by 1% or so.

In terms of cash flows, we saw a vast majority of the cash flows delivered right across that space. Infrastructure did very well. Most of the sectors in real estate did very well as all.

There were some very specific sectors, as you can imagine, in commercial property. We're talking things like gyms and cinemas, hotels which were very negatively impacted. And they asked not to forgive rent, but for rent holidays, which were given by the managers that we work with in many cases.

Because they looked at these businesses and said, it's not necessarily a business issue that's driving this. It's very much a external issue or external event that it was hard for people to foresee. So actually allowing them to defer that rent to another period made a lot of sense from that perspective.

So it goes back to the management of these assets. The managers that we work with, the partners that we work with understood the businesses, the tenants that they had, worked with them to deliver something that kept the value in the asset, delivered as much of the cash flow as possible, but recognize that it's in no one's interest to essentially demand the rent when it's very hard for the underlying tenants to deliver that.

So what-- I mean, overall, what does that mean? It means in terms of a portfolio that looked at commercial real estate, they were probably looking at somewhere between a 60% to 80% cash flow delivery over 2020. So of what they are expected, they received about 80%-- 60% to 80% of that. And then across a diversified portfolio of all the different types of secure income, that was probably at over 90%.

LOK MA: Wow. OK. And I think that brings me back to this kind of wider discussion around risk and return. Because, of course, we haven't managed to break the laws of investment and found an asset class that gives you a better return without taking any extra risk.

You've talked about operational risks. We've talked about kind of left tail risk. But, of course, as you said, right at the beginning, there is this risk with illiquidity, which is for me, the risk that for whatever reason, you need to sell these assets quickly. And you find that you can't do it, or you can't do it without accepting a drop in the price.

So I just want to kind of test that a little bit more. So what are the bad things that can happen when you come to sell these secure income assets?

DUNCAN HALE: Yeah, so most of the-- because of the nature of them, they're not sold on an exchange. You do have to find a willing buyer, willing seller. And so in the worst case scenario, you come to wanting to sell it. And there just isn't a buyer for the assets that you want to sell.

And so there have been periods over the last 15 to 20 years, we're thinking the deepest, darkest days of the global financial crisis, there was a few months during the COVID crisis where selling of these assets stopped for various reasons. In COVID times, it was largely a physical issue. People want to be able to see the assets before they buy them.

And so with COVID and people being locked down, that meant that they couldn't go out and see these assets, and so transactions stopped within the global financial crisis. That was more of an economic thing. There was a question about buying these assets. So there are periods from time to time when you can't sell your assets.

And so if you have a very specific requirement to be able to exit your assets at a time that you don't have flexibility around, you can be stuck in these assets. That's very much a reality that people need to view and to understand when they look to invest into these types of things.

I think that the counter, I will say, to that is that probably those times that I've just described-- the middle of COVID, the middle of the global financial crisis, is exactly the wrong time to be selling out of these assets, be that strategically, or be that tactically.

Because even during those periods of time, as we've just described during COVID, similar situation during the global financial crisis. They still do deliver largely the cash that they're expected to deliver. And so they're actually quite nice assets to hold during those periods of time.

So if you do have the flexibility, that's a positive. But we do recognize, and going back to your point, there is no such thing as a free lunch in investments. And the thing that you need to really accept when investing into these assets is there is this illiquidity which will limit your ability to trade at certain points.

LOK MA: But I really like the way you put that though, Duncan. I would interpret that as kind of thinking about it in terms of a plan A and a plan B, or a scenario A and scenario B, if you will. So if you need to sell these kind of illiquid assets or secure income assets, it tends to mean that the markets are already doing fine, and you've achieved your goal with your portfolio anyway, in which case in that scenario, you should be able to sell these assets in that kind of market. I mean, obviously worth planning ahead and doing it in an orderly way and so on.

But the other scenario, the plan B, if you like, or scenario B, is where the markets are not doing well, and maybe the liquidity does dry up for a while. But as you say, in that scenario, you're glad that you've got these relatively safe assets giving you that reliable income anyway, and you don't want to be selling your portfolio. So good plan B assets to hold onto is what I'm saying.

And I do get slightly frustrated when I hear an argument along the lines of, oh, you never know. You might need to suddenly sell all your assets at short notice. So let's have no illiquidity at all in the portfolio, because it sounds like you're being prudent and you're playing it safe.

What I think it actually could mean is you're not taking advantage of an asset class that gives you a strong return. And so you're actually taking more risk elsewhere in the portfolio. So just avoiding one type of risk isn't necessarily prudent if you end up taking more of another type of risk elsewhere, right?

DUNCAN HALE: Exactly, Lok. You're singing to the-- you're preaching to the choir there, or whatever the saying is.

LOK MA: I'm singing to the converted.

DUNCAN HALE: Singing-- yeah, yeah, yeah.

LOK MA: Preaching to choir? I don't know.

DUNCAN HALE: Preaching to the choir, singing to the converted. Yeah. There must-- there's some religious reference there somewhere. Yeah, I completely agree really, Lok.

And in terms of what you were describing there as scenario A and being able to sell your assets, the most experience we have with that is in the UK, which is the most mature market for investing in these type of areas. And the experience of investing in what's referred to as the secondary market, which is where you sell parcels of your assets or your units in a fund to another investor is actually very mature.

And so what we've seen in that area is that generally, it takes you between two to six months to be able to get out. And generally, you're selling at a premium. Because as we mentioned earlier, some of the additional return you get here is because it's hard to package up these assets and build a portfolio.

So if you've already built that portfolio or been investing into it for a while, enjoying the cash flows of it, then you're looking to sell that on to another investor. Often, they're willing to pay a premium to get access to those assets.

LOK MA: And just-- I mean, maybe my final question for you, Duncan, in terms of the size of a reasonable allocation, obviously, we're saying that zero allocation to illiquid assets-- you're potentially giving up on a very useful source of returns and taking risk elsewhere that you might not need to.

No one's going to have 100% in these things, because the illiquidity is the thing to watch out for, so somewhere in between. I mean, what is a reasonable size of allocation?

DUNCAN HALE: You're asking the wrong person there, Lok. I--

LOK MA: 99%.

DUNCAN HALE: 99%, from my perspective. Generally, what we've seen from investors on a global basis is somewhere between maybe 10% to 20%. We talked about how these are great for those investors that are looking to kind of generate their cash flow more towards the end of their journey.

So that might be relevant to a DC member in Australia. And they might have, let's say, 10%, because liquidity is more of a concern for an individual, while for a corporate in the UK, as an example, they might have somewhere closer to 20%, so in that type of area.

LOK MA: Anyway. I think it's time to wrap up. So we've talked about illiquid assets, and within that, secure income assets. So a relatively high return, high yield, high level of income, whichever way you prefer to look at it, but exposed to quite a different kind of risk as maybe the rest of your portfolio-- so liquidity risk rather than asset volatility or pricing or default risk.

And if you're in that happy position to be less bothered about the illiquidity risk because you're a long-term investor, then I think, a very strong case for thinking about including these in your portfolio to make it maybe less risky overall. So thank you very much, Duncan, for coming onto the show today.

DUNCAN HALE: Thanks for having me, Lok. Appreciate it.

LOK MA: And next up will be a continuation of our miniseries on asset classes. I think we've got three more to go. So please do keep an eye out for the next episode. Thank you.

[MUSIC PLAYING]

SPEAKER: You've been listening to a Willis Towers Watson podcast. For more information, visit willistowerswatson.com.

[MUSIC PLAYING]