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INNOVA
ASSET MANAGEMENT

INVESTMENT MANAGEMENT INSIGHTS FOR PROFESSIONAL FINANCIAL ADVISERS

NO FREE LUNCH: WEIGHING THE PRICE OF THE ILLIQUIDITY PREMIUM

Liquidity is like the rabbit in a magician's hat. One minute it's there, the next it's not. But look closer and there's a dangerous slight of hand at play: the extra returns produced by illiquid assets also come with hidden risks.

Unlisted assets such as infrastructure and property are obvious examples but the global financial crisis proved that even liquid investments can be frozen. Liquidity is there for long stretches when you don't need it, but when you do, it can evaporate quickly as markets worsen.

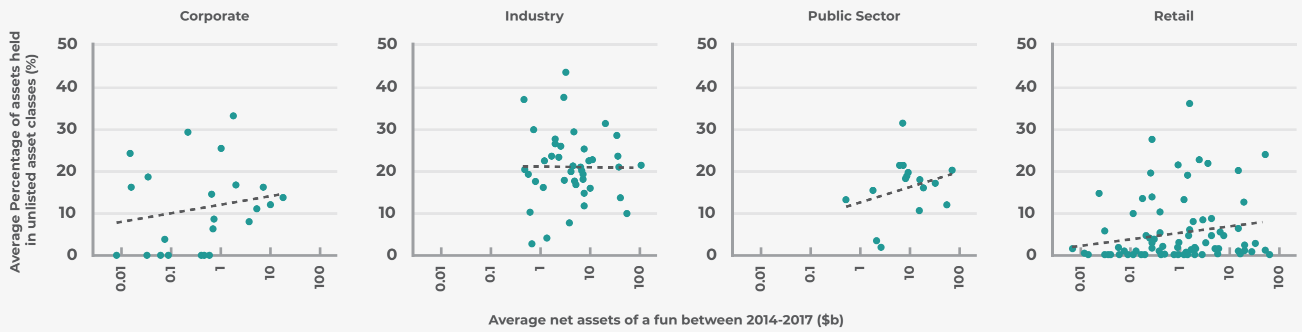
This extra risk is reflected in the illiquidity premium, which should deliver investors about a 2% performance boost over the long-term. This is the compensation for locking up your money.

It should be no surprise that industry funds such as Hostplus, which hold no cash but have significant unlisted assets in their balanced fund, should be topping super industry performance tables in recent years.

(Interestingly, last year's exhaustive study into superannuation competition by the Productivity Commission found "limited evidence" that industry funds' strong net returns were due to greater exposure to unlisted assets[1]. Another possibility is that outperforming funds were simply making better investment decisions within asset classes.)

But while the predicted return boost of unlisted assets may ebb and flow over time, the greater risk of holding unlisted assets does not (something the Productivity Commission gave only a cursory analysis).

AVERAGE PROPORTION OF ASSETS HELD IN UNLISTED ASSET CLASSES 2014–2017



Source	PC analysis of unpublished APRA data (2014-17)
Coverage	178 funds representing 92 per cent of the system in 2013-14
Survivor Bias	Yes. **Selection Bias** No.

[a]Excludes eligible rollover funds and insurance only funds. This figure only includes funds which have been in operation in all years from 2014 to 2017. For each fund, net assets are taken as an average over the time period. Unlisted asset classes refer to unlisted infrastructure, unlisted property, and private equity.

[1] *"Superannuation: Assessing Efficiency and Competitiveness, Inquiry Report no. 91 Technical Supplement 8." The Commission found a strong relationship between unlisted infrastructure exposure and higher net returns in recent years as unlisted infrastructure has performed well but no such relationship for private equity exposure.*

The ten largest MySuper funds hold between 10 and 36% of their portfolios in unlisted assets, according to **Chant West**[2]. While these assets can suit the decades-long time horizon required for retirement savings, portfolios are priced daily to enable rollovers and withdrawals. This mismatch can create a liquidity crunch.

Some large industry funds point to their young membership and strong inflows as cover for any potential liquidity issues that would require the forced sale of unlisted assets. However, liquidity stress-testing to back up these type of assertions was still sorely lacking in the years after the global financial crisis – the greatest illiquidity event of our generation.

A 2010 APRA survey found that only 6% of trustees undertook formal liquidity stress testing and only 14% of trustees actively monitored liquidity for the investment choices offered to members[3]. We hope the situation has improved but there's no practical way for an investor to know.

EQUITY AND BUY-SELL SPREADS

Member equity also remains an issue with buy-sell spreads a case in point.

Buy-sell spreads apportion the extra cost of a member entering the fund (which requires buying assets) or leaving the fund (which requires selling assets) to those specific members. That's because the costs of buying and selling these assets shouldn't be borne by the current unit holders.

A typical buy-sell spread is just 0.25% whereas the cost of buying or selling truly illiquid assets, such as commercial property or infrastructure, might be 5% or more.

A fund with significant levels of illiquid assets (30% or more) should charge higher buy-sell spreads if it has to liquidate one of those assets or the true cost of unit holders leaving will be borne by the remaining unit holders.

This would be a breach of the trustee's fiduciary responsibility to treat all unit holders equally because outgoing investors are effectively receiving preferential treatment at the expense of remaining unit holders.

The funds' answer is, once again, that inflows from new members outweigh those who are leaving or retiring, so the fund does not have to sell illiquid assets. One might say there's a Ponzi flavour to any scheme reliant on people constantly joining and contributing money, but falls apart when the inflow stops.

For those who think this risk is far-fetched, look no further than the outflows AMP is suffering after its disastrous showing at the Royal Commission. Its share price rout shows the market miscalculated that risk.

Now imagine other scenarios that could hurt industry funds. Awards that currently name particular industry funds as defaults could be reformed, cutting off guaranteed inflows. A sustained market downturn could present its own unique risk that catches many unaware (remember MTAA Super, which was heavily exposed to unlisted assets was caught in just this scenario by the GFC and nearly collapsed). No doubt there are other risks and Black Swan events that could crystallise illiquidity risk.

Investors need to be aware of this risk and place a value on illiquidity.

They need to understand their goals and what portion of their portfolio can be locked up to benefit from the illiquidity premium. A bucketing strategy can keep the right amount of cash ready, also providing useful optionality to take advantage of investment opportunities.

Illiquid assets can deliver great returns in the right circumstances but investors need to understand the associated risks. Most importantly, they need to be comfortable that their investment providers also understand those risks. If they don't, illiquidity may rear its head at the worst possible time leaving investors painfully exposed.

[2] *"Superannuation: Assessing Efficiency and Competitiveness - Productivity Commission Inquiry Report", page 186.* **www.pc.gov.au/inquiries/completed/superannuation/assessment/report.**
[3] *"Institute of Actuaries of Australia: Managing Liquidity in Superannuation", presented to the Institute of Actuaries of Australia Biennial Convention 10-13 April 2011.*

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Dan Miles is the Managing Director & Co-Chief Investment Officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios for 8 years. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.

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