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In Pursuit of Value

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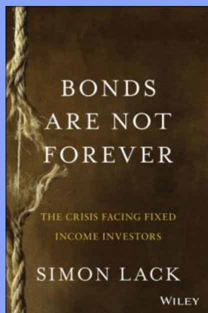

Liquidity

Liquidity is a quality about one's holdings that investors crave at certain times and happily cede at others. During the 2008 financial crisis liquidity all but disappeared for many assets just as investors sought it most keenly. Only a year or two earlier, liquidity had been both readily assumed to be available as needed and not particularly valued as investors traded away investment flexibility in exchange for perceived higher returns.

A March 1 article in Barrons titled "Treasure Hunt" describes how the prevailing wisdom among "leading wealth managers" is to invest in a "triple-play of alternatives: hedge funds, private equity and private debt". Put aside for a moment the far more colorful prose of professional journalist Karen Hube, compared with your portfolio manager, whose compensation for writing remains substantially non-financial, and consider the beneficiaries of such advice. Hopefully, the guidance by so many wealth managers of their clients into less liquid investments is driven primarily by what is in their clients' interests. Conveniently though, having one's clients commit to holding an investment for multiple years is invariably in the manager's best interest. A business that's funded with permanent, equity capital is more secure than one that needs to periodically roll over maturing debt, and an asset manager whose clients cannot readily leave has a more secure stream of fee revenue than one whose clients are highly liquid.

Just as equity investors typically demand higher returns than bond investors (and such is abundantly true today), holders of illiquid alternatives ought to be entitled to an "illiquidity premium", or additional compensation over their more liquid choices. The price for illiquidity varies widely over time, and there are many instances where investments that required the holder to sacrifice liquidity have paid handsomely. Calculating what additional return should accrue to illiquid investments is a mix of art and science. There's more than one right answer, since it is in part a question of taste. For my part, I value liquidity so excessively that I in effect price myself out of the market for things that can't easily be sold. When inviting people to visit us at SL Advisors, I warn that it will not appear to be visually very exciting. Watching others study SEC filings, company presentations or spreadsheets may even compare poorly with Olympic curling with its mercifully long four year intervals. In short, we don't trade actively. But we do make mistakes and while they're designed to be individually small and not that harmful, a speedy diagnosis and response can prevent a small problem from becoming a big one.

For example, expressed as a return premium over public equities, my illiquidity premium is above 10%, far more than for many other investors. Consequently, I don't invest in private equity because the marketplace generally offers far less. Calculating what reward illiquidity has provided to those who accept it is tricky. Private equity funds invest their capital over time, and a true comparison with public markets needs to align the timing of the cashflows of any private fund with the public market prices each investment would have faced. Whether investors in private debt and equity get fairly compensated is open to debate. What does seem to be clear is that the compensation has often been insufficient.

For example, Cambridge Associates last year published an apples-to-apples comparison of public versus private equity returns (see table below).

Index	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years	25 Years
Cambridge Associates LLC U.S. Private Equity Index	17.19	15.66	10.95	14.21	12.02	13.49	13.39
Russell 2000 Index	29.75	18.2	12.07	10.00	9.15	9.06	9.43
PE Advantage	-12.56	-2.54	-1.12	+4.21	+2.87	+4.43	+3.96

In recent years the return to illiquidity has actually been negative, although such short term data is unreliable because most private equity funds take 5-10 years or longer to complete their investing cycle. But even over ten years the additional return is only around 4%. Now, 4% of additional return can turn out to be substantial, if it can be reliably harvested. This is where the manager selection question becomes vital. Deciding you've picked the wrong private equity manager, as with making the wrong private equity investment, is likely to be followed by years of remorse and, as with a hangover, solemn promises to self to not touch the stuff again. Although 100% of private equity managers somehow show themselves to be top quartile performers, choosing those who will not disappoint after you switch from prospect to client turns out to be surprisingly difficult.

The drive into the "triple-play of alternatives" perhaps reflects a modest loss of respect for liquidity. Cash of course earns you 0%; its value comes in the flexibility it affords you to use it tomorrow on something you weren't contemplating today. Other liquid investments such as U.S. treasuries charge similarly (through a low yield) for the option to sell, and quite possibly add the additional insult of a modest capital loss while you hold them. Correctly selected public equities, in spite of their ever-present risk of a sharp drop, do at least offer the prospect of a reasonable return combined with the freedom to change your mind.

While investors presented with opportunities to commit their funds with no near term exit must ponder whether the return they will earn includes compensation for giving up the ability to change their minds, investment managers and brokers promoting such vehicles have no equivalent downside. Indeed, while illiquidity may or may not deliver commensurate compensation to the client, it ALWAYS benefits the manager. The multi-year stream of management fees, guaranteeing as it does a captive if not always willing client for a considerable period, is a highly attractive business model. It's another example of the principal-agent problem that exists throughout Finance. Brokers and clients don't always have an alignment of interests. Hence the following advice: next time your broker recommends a private equity or debt investment, or an unlisted registered REIT (a type of security that truly should not exist; why register if you won't list, other than to draw in unsuspecting retail clients to something they can't sell?), ask if he's putting his own money into it. Of course not every recommendation is appropriate for every broker, but I have more than just a strong feeling that if clients followed this rule and rejected every proposal from their broker unless he/she was investing *his/her* money, they would get a better return on *their* money.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

I recently saw a presentation at a conference by a peddler of unlisted registered REITS who noted among their many advantages fewer extreme, stress inducing valuations. This is because there are no public valuations at all for such securities, and sounds like a marketing pitch aimed at ostriches. In fact, I don't know why registering a security (which after all qualifies it to be offered to the general public) doesn't carry with it a requirement that the security be listed so as to allow the retail investors to whom they're offered an opportunity to exit. But for some reason there isn't such a requirement, and the absence of public quotes or critical sell-side research (pointless if there's no trading in the security) are items that wholly benefit the underwriter at the expense of the client.

"Liquid alternatives" is an area of substantial interest of late. Many hedge funds operate strategies that are in fact far more liquid than is reflected in the investment terms offered to their clients. I fondly remember one of the pre-2008 justifications for a long-short equity fund requiring a one-year lock up (and in some cases longer); it was, so went the explanation, in part to protect investors from themselves. The lock-up was designed to spare the investor the inevitable regret that would accompany a hasty decision to redeem their investment during a market swoon. Since the financial crisis with its attendant restrictions on redemptions, sidepockets and so on, such "client-friendly" justifications are no longer heard. And the development of registered vehicles offering liquid ways to access alternatives seems like a totally reasonable commercial response from hedge fund managers. Although at SL Advisors we don't run any hedge funds, we do run liquid hedged strategies. In at least one respect the gap between us and the hedge fund industry is narrowing.