alt thinking

The Liquidity Myth

WHY A LONGER-TERM VIEW MAY BE BENEFICIAL TO YOUR PORTFOLIO

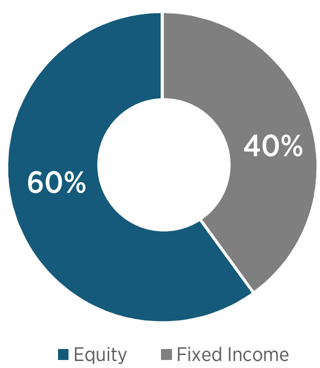
ninepoint PARTNERS

The Liquidity Myth

Most investors are risk-averse. That has led, over the years, to the accepted wisdom that *liquid* investments are less risky, while *illiquid* investments are more so.

But what if that isn't always true? What if retail investors are potentially handicapping their portfolios by overlooking asset classes that are less liquid, yes, but which offer hard-to-find diversification and income benefits that their portfolios sorely need?

Though many retail investors have long been conditioned to fill their portfolios with the most liquid large-cap stocks and government bonds to preserve financial flexibility, in volatile times eschewing non-traditional asset classes with longer investment horizons and higher average returns could potentially reduce the size of their nest-egg, according to Ramesh Kashyap, Managing Director of the Alternative Income Group at Ninepoint Partners. Investments that typically require longer time horizons include real estate, infrastructure, and private equity, as well as newer asset classes like private debt. Speaking with the Alt Thinking Podcast, Kashyap said few investors need a fully-liquid portfolio at any given time.



"The odds that an investor would have to liquidate the entirety of their portfolio all at once is incredibly low," Kashyap said. "But, by ensuring that they are in a position to do so, many retail investors are missing out on the benefits offered by allocating part of their portfolio to less liquid alternative investments which have the potential to enhance a portfolio's construction."

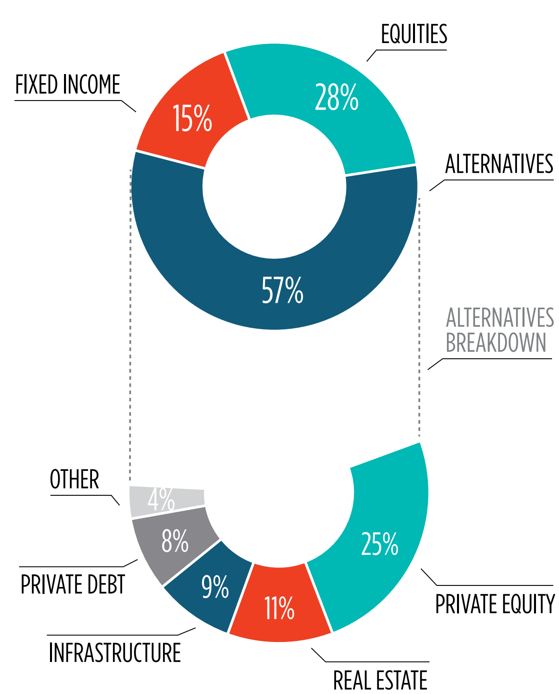
The diversification offered by less-liquid alternative asset classes can help investors reduce their overall risk profile, according to investment strategy consultant and former Managing Director, Global Macro and Quantitative Investments at OMERS Capital Markets, Andrew Spence. Speaking with the Alt Thinking Podcast, Spence said with the right alternative investment strategy, retail investors could replicate the performance they expect of a stock-bond portfolio while simultaneously lowering the volatility of their portfolio and lessening their exposure to drawdowns.

"When you look at the alternatives space, you can obtain less volatility while achieving similar returns. You may not see the double-digit gains in a single year like you may experience with an equity-heavy portfolio, but you can sleep at night with a reasonable rate of return at lower risk," he said. "If I want to avoid the volatility that equities can produce, then today the trade-off needs to be a consideration of at least some less-liquid investments in my portfolio."

Ninepoint's Kashyap said there are a number of factors at play in the reluctance of retail investors to dip into lower-liquidity alternative assets, not least of which is the fear of going against the herd. The herd, it will be remembered, notched double-digit returns over the course of the long bull market in the wake of the Great Financial Crisis of 2008.

While retail investors have been slow to make room in their portfolios for alternative investments, the strategy has been employed to great effect by private equity giants like KKR, Brookfield Asset Management, the Blackstone Group, and pension plan behemoths like the Ontario Teachers' Pension Plan and the Canada Pension Plan Investment Board (CPPIB).

CPPIB 2020 ALLOCATIONS



Source: Canadian Pension Plan Investment Board, Annual Report 2020.

CPPIB, which manages $409.6-billion on behalf of 20 million Canadians, shifted to active management and an increased focus on alternative assets that now includes infrastructure, real estate, private debt, and private equity. CPPIB has posted a 9.9 per cent annualized rate of return over the last decade. Private investments and real assets accounted for 57 percent of the fund's assets at the end of fiscal 2020.[1]

So, how does a retail investor access lower-liquidity alternative investments and what advantages can they expect?

Many investors have already embraced real estate – their principal residence is often one of the biggest investments they make in their lifetimes. While real estate prices can be affected by big equity market swings, the changes are not nearly as pronounced and real estate prices, over longer periods of time, are generally inured from public market volatility.

Is real estate liquid? No, but most would agree it's liquid enough for the anchor role it plays in a portfolio. Investors understand real estate.

Table 1: Retail Access to Alternative Investments

Alternative Investments	Private Investments	Mutual Funds	Exchange Traded
Real Estate	• Direct Investment • Private REITs	• REIT Funds • Real Estate Sector Funds	• Public REITs • Closed-End Funds
Infrastructure	• Direct Investment • Direct Investment Funds	• Infrastructure Sector Funds	• Infrastructure ETFs • Closed-End Funds
Commodities	• CTAs • Managed Futures • Direct Investment Funds	• Resource-Focused Sector Funds • Precious Metals Funds	• Resource ETFs • Precious Metals ETFs
Private Debt	• Direct Investment • Private Debt Funds	• N/A	• BDCs
Private Equity	• Direct Investment • Private Equity Funds	• N/A	• Listed Holding Companies
Marketable Securities	• Traditional Hedge Fund Strategies	• Liquid Alt Funds	• Hedge Fund Indexed ETFs • Closed-End Funds

Investors are less likely to understand newer alternative asset classes. Private debt, for instance, emerged after the 2008 market crash and has been available to Canadian retail investors since 2010.[2] Being a relatively unfamiliar investment, retail investors are cautiously exploring private debt's ability to support and enhance the role that fixed income has historically played in a portfolio.

Private debt involves raising pools of capital from accredited investors, and using that capital to provide senior-secured loans to mid-sized companies who meet strict loan criteria but who, since 2008, have had greater difficulties getting loans from banks, who were motivated to tighten their lending criteria.

For investors, private debt offers a number of benefits. It's low in volatility, the default and loss rates are lower than high-yield bonds, and it's collateralized by assets. Another advantage is that it has a low or negative correlation to traditional asset classes like stocks or bonds, providing greater portfolio diversification. It also provides reliable and attractive income to a portfolio whose fixed income component is now hampered by chronically low interest rates.

Ninepoint's Kashyap said investors should consider taking a page out of the big pension plans' playbook by increasing their exposure to longer-term alternative assets, though emphasized that retail investors' allocations to alternatives could certainly be more modest than those of the large-scale plans.

"It would be unreasonable for an individual investor to allocate a large part of their portfolio to alternative investments. Life will happen – sometimes there's a divorce, or you have to pay for university for your children – and you'll want to have some liquidity available," he said. "I tell clients, between five and ten per cent in alternatives can typically help diversify their holdings while still giving them plenty of flexibility if life does happen and they need cash more quickly. But everyone's situation is different, and a discussion with your financial advisor is always the first step."

Like the big pension plans, individual investors need to approach alternative investments with a view to longer term returns. Kashyap said both investors and even fund managers themselves can compromise their goals if they fall into the "short-termism" trap.

"There are some alternative fund managers who carry as much as 30 per cent cash in their alternative investment portfolios as a buffer for potential redemptions by investors who demand liquidity. It might give nervous investors peace of mind when it comes to swift redemption windows, but it ultimately compromises the goals of the fund," he said. "As a fund manager, the concern you have with funds that hold too much cash is that short-termism can sweep the long-term benefits under the rug because idle cash offers such poor returns." That said, some retail private debt investments are now available with redemption windows as short as 30 days while still offering the potential for attractive returns.

According to Spence, investors need to take a clear-eyed look at their current investment horizon and prepare for the fact that their ability to make-up ground lost during a market sell-off can be highly unpredictable.

Table 2: Declines in the S&P500 from Dec 1945 - Jun 2020

Decline %	Number of Declines	Average Decline %	Average Length of Decline in Months	Average Time to Recover in Months
5-10	80	(7)	1	1
10-20	29	(14)	4	4
20-40	9	(28)	11	15
40+	3	(51)	23	58

https://www.aaii.com/journal/article/stock-market-retreats-and-recoveries; https://www.guggenheiminvestments.com.

"There's going to be a day, one day, when the dip in the market is not going to reverse immediately, and some investors, based on their age, won't have enough time left to grow their assets back to the same level," he said. "That underscores the need to have a diversified portfolio that includes uncorrelated alternatives." Over the 75 year period defined by table 2, there have been an average of 1.6 drawdowns per year, some requiring over 5 years to recover ground lost. No one knows what the next recovery period will look like.

What's missing for Kashyap, is the transparency needed to make retail investors more comfortable with alternative investments to help allay their concerns with the liquidity of some of those assets. By virtue of being private investments, that is, they are not traded on a public market, there is no visible pricing market.

What's a retail investor to do? Kashyap suggests that performance benchmarks are a start – giving retail investors an easy measuring stick to gauge the performance of their alternative investments, while encouraging fund providers to stick to the core goal of increasing risk-adjusted returns through their strategy.

"Getting a clearer framework solves 90 percent of the problem," he said. "Having industry and regulators make things as clear as possible when it comes to how these products work – how they should be evaluated – would help enormously in improving the public's understanding of less liquid alternative investments." That, in turn, would help managers avoid watering down their alternative strategies by holding unnecessary, excess cash to pay out redemptions caused by liquidity fears.

Another thing that investors in less-liquid alternatives should look for is rigorous oversight by the fund manager. A good fund manager will provide a risk management function that can offer a surprising degree of transparency for these kinds of investments.

If investors are averse to risk, in today's investment environment it becomes more important than ever that they assign that risk appropriately. If your portfolio is entirely composed of traditional asset classes like stocks and bonds, you are, as Andrew Spence points out, at risk of running out of runway should the next market recovery take longer than the last few have.

With that in mind, can you risk not exploring the role that lower-liquidity alternative assets can play as a buffer for your portfolio? ■

Listen to the **“The Liquidity Myth with Ramesh Kashyap”** podcast, featuring host Michael Hainsworth.

Part of Ninepoint’s Alt Thinking Podcast Series. Available at Google, Apple, and Spotify Podcasts, or at Ninepoint.com/podcasts.

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FOOTNOTES

[1] Source: www.cppinvestments.com/the-fund/our-performance.

[2] The management team of Ninepoint launched the first private debt fund in Canada as the Sprott Private Credit Fund.

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