

The cost of being too liquid

January 2023

Key points

- Private markets (private equity, private credit, & real estate) have historically delivered an “illiquidity premium”
- Institutions and family offices have recognized this illiquidity premium, and have historically allocated significant capital to capture it
- Advisors should consider developing an “illiquidity bucket”
- Allocating a portion of a client’s portfolio to illiquid investments helps in maintaining a long-term approach

Legendary investor David Swensen famously stated that the “**intelligent acceptance of illiquidity**, and a value orientation, constitutes a sensible, conservative approach to portfolio management.”¹ What Swensen, and so many other sophisticated investors recognized, is the *illiquidity premium* available by allocating capital to illiquid investments like private equity, private credit, and private real estate.

In fact, throughout Swensen’s tenure as the chief investment officer of the Yale endowment, he often allocated between 70%-80% of his portfolio to alternative investments broadly, with illiquidity budgets of up to 50% of their total allocation. The illiquidity bucket is a technique used by institutions to identify the amount of capital that they are willing to tie up for an extended period of time (7-10 years). As of the end of fiscal

year 2021, Yale had a 78.5% target allocation to alternatives, with a 50% illiquidity bucket.

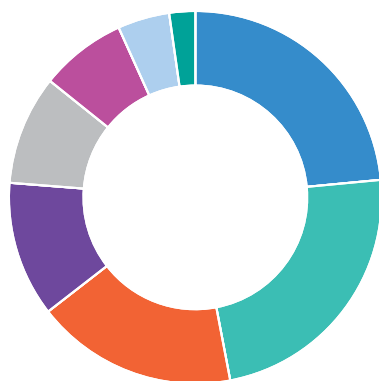
Of course, endowments are very different than individual investors, and Yale has certain built-in advantages, including unique access to private markets, dedicated resources to evaluate opportunities and long-time horizon. If Yale needs capital, it has the ability to reach out to their well-heeled alumni and donors for additional capital.

Most high-net-worth investors would be uncomfortable locking—up so much capital – but the concept of an illiquidity bucket would certainly apply. While high net-worth-investors may not have donors to call upon, they often do share something with Yale—a long time horizon for some of their goals.

Yale endowment

Target Asset Allocation

Fiscal Year 2021



■ Absolute Return	23.50%	■ Real Estate	9.50%
■ Venture Capital	23.50%	■ Bonds & Cash	7.50%
■ Leveraged Buyouts.....	17.50%	■ Natural Resources.....	4.50%
■ Foreign Equity	11.75%	■ Domestic Equity.....	2.25%

The Yale endowment has consistently allocated between 70%-80% of its portfolio to alternative investments, which consequently has led to their strong historical returns.

Source: How The Rich Invest: A Look Inside Yale Endowment’s Asset Allocation (financialsamurai.com).

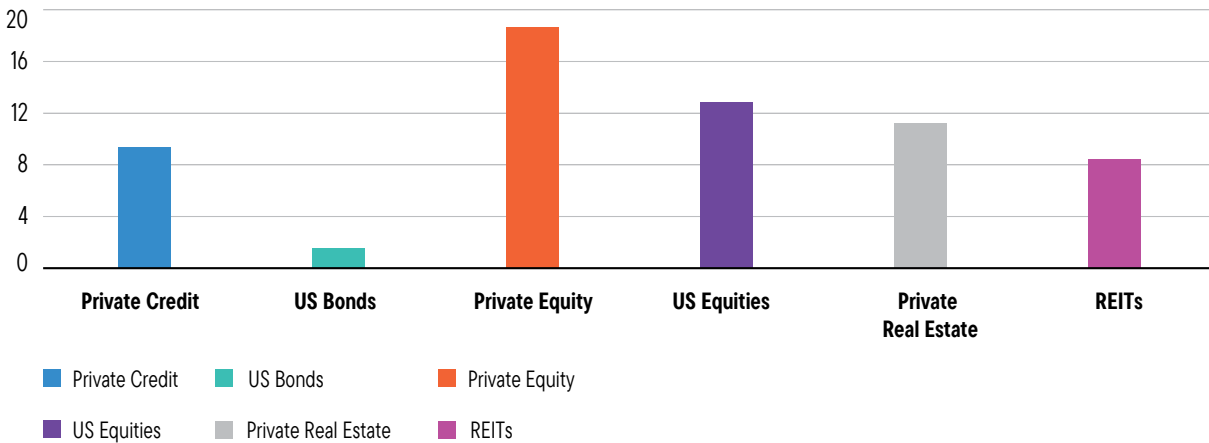
1. David F. Swensen, “Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment”, Fully Revised and Updated.

What does the data show?

Academic research has shown the historic persistence of an illiquidity premium²—the excess return received for tying up capital for an extended period of time. This makes intuitive sense because the private fund manager has ample time to source opportunities and unlock value. The fund manager isn't beholden to investors and shareholders, like their public market equivalents, who are viewing results over shorter intervals.

While the magnitude of the illiquidity premium will vary over time, depending upon the market environment and the fund, the data show that private equity, private credit and private real estate has historically delivered a substantial illiquidity premium relative to their public market equivalents.

10-Year Annual Returns of Private vs. Public Markets (Through June 2022)

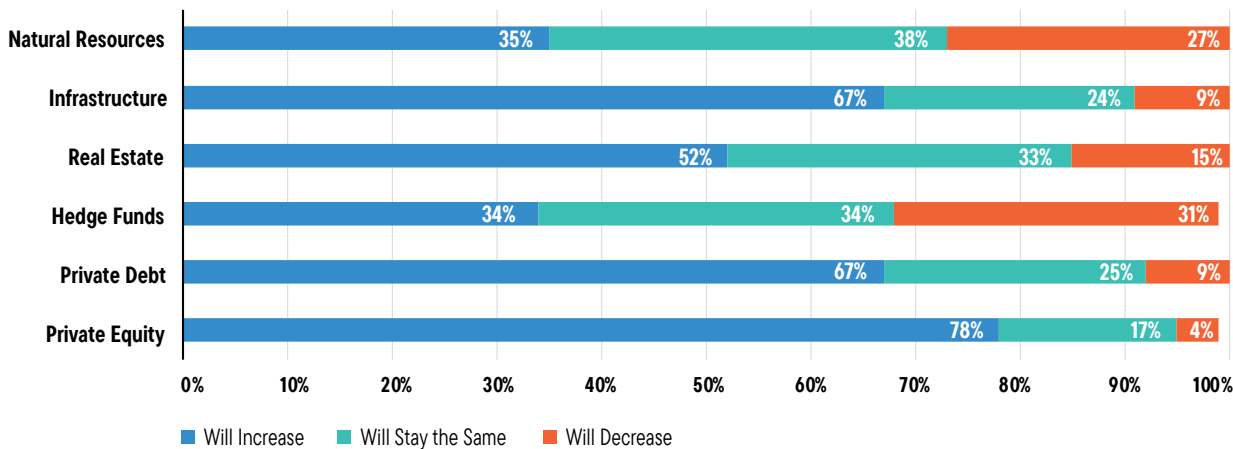


Source: Franklin Templeton Capital Markets Insights Group; Private Credit = Cliffwater Direct Lending Index, US Bonds = Bloomberg US Agg Bond TR USD, Private Equity = US Burgiss Private Equity, US Equities = S&P 500 TR USD, Private Real Estate = NCREIF Fund ODCE Index, REITs = FTSE Nareit All Equity REITs TR USD. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future results.

Institutions and family offices have long recognized this illiquidity premium, and consequently, have historically allocated significant capital to private markets. In fact, given the lower expected returns of public markets over the next 10-15 years,³ many institutions are looking to increase their private

market allocations. Based on the Preqin data below, most public pension plans are looking to increase their exposure to private markets (private equity 78%, private debt 67%, infrastructure 67%, real estate 52%, and natural resources 35%).

Pension Plans to Increase Their Allocations to Alternatives



2. Source: The Illiquidity Premium and the Market for Private Assets | Portfolio for the Future | CAIA

3. Source: Preqin Investor Survey, August 2020. There is no assurance any projection or forecast will be realized. Numbers might not add up due to rounding.

High-net-worth demand

Up until recently, high-net-worth (HNW) investors had limited access to these elusive investments due to HNW investor eligibility and high minimums. However, due to product innovation, and a willingness of institutional-quality managers to bring products to the wealth management marketplace, HNW investors now have a broad array of options to select from.

As the table below illustrates, the first generation of private market funds were only available to qualified purchasers (individuals with \$5 million or more of investable assets), at high minimums, and limited liquidity. This structure was fine for institutions and family offices who could comfortably commit capital for the long run, but not an ideal structure for most investors who wouldn't event meet the minimum or accreditation requirements.

Interval funds and tender-offer funds are available to a broader group of investors, at lower minimums, and more flexible features. Like traditional mutual funds, they are continuously offered, provide daily valuations, and 1099 tax reporting. Unlike traditional mutual funds, they can hold illiquid investments, and their liquidity provisions are quarterly, not daily.

With the proliferation of registered funds, geared toward HNW investors, they can now access the private markets at lower minimums and more flexible features. While interval funds and tender-offer funds offer more flexible liquidity provisions than the first-generation of fund structures, they should be viewed as long-term investments to potentially capture the illiquidity premium noted above. There may be a cost for offering greater liquidity—a “cash drag”—the give up for holding more liquid assets to meet periodic redemptions.

Structural Considerations

	REGISTERED FUNDS		
	Liquid Alternatives	Interval & Tender-Offer Funds	Traditional Private Market Funds
Eligibility	All	All/may be restricted*	Qualified purchasers
Investments	Public and private investments	Public and private investments	Private investments
Continuous Offering	Yes	Yes	No
Daily Valuations	Yes	Yes	No
Min. Investment	\$1,000–\$5,000	\$2,500–\$25,000	\$1M–\$10M
1099 Tax Treatment	Yes	Yes	K-1
Capital Calls	No	No	Yes
Cash Drag	Yes	Yes, but to a lesser extent	No
Liquidity Provisions	Daily	Quarterly**	10+ year lockup

*Eligibility restrictions may vary per broker-dealer and may require investors to be accredited investors.

**Tender-offer funds provide quarterly liquidity, at the board's discretion, while quarterly liquidity provisions are mandatory for interval funds.

How much should advisors allocate to illiquid investments?

The amount of capital to allocate to illiquid investments varies by investors and their underlying liquidity profile. Many investors believe that they should be 100% liquid, but there is an opportunity cost, especially in today's market environment. Traditional liquid market investments may continue to deliver returns below their historical averages, and advisors may need to consider private markets to help investors achieve their goals.

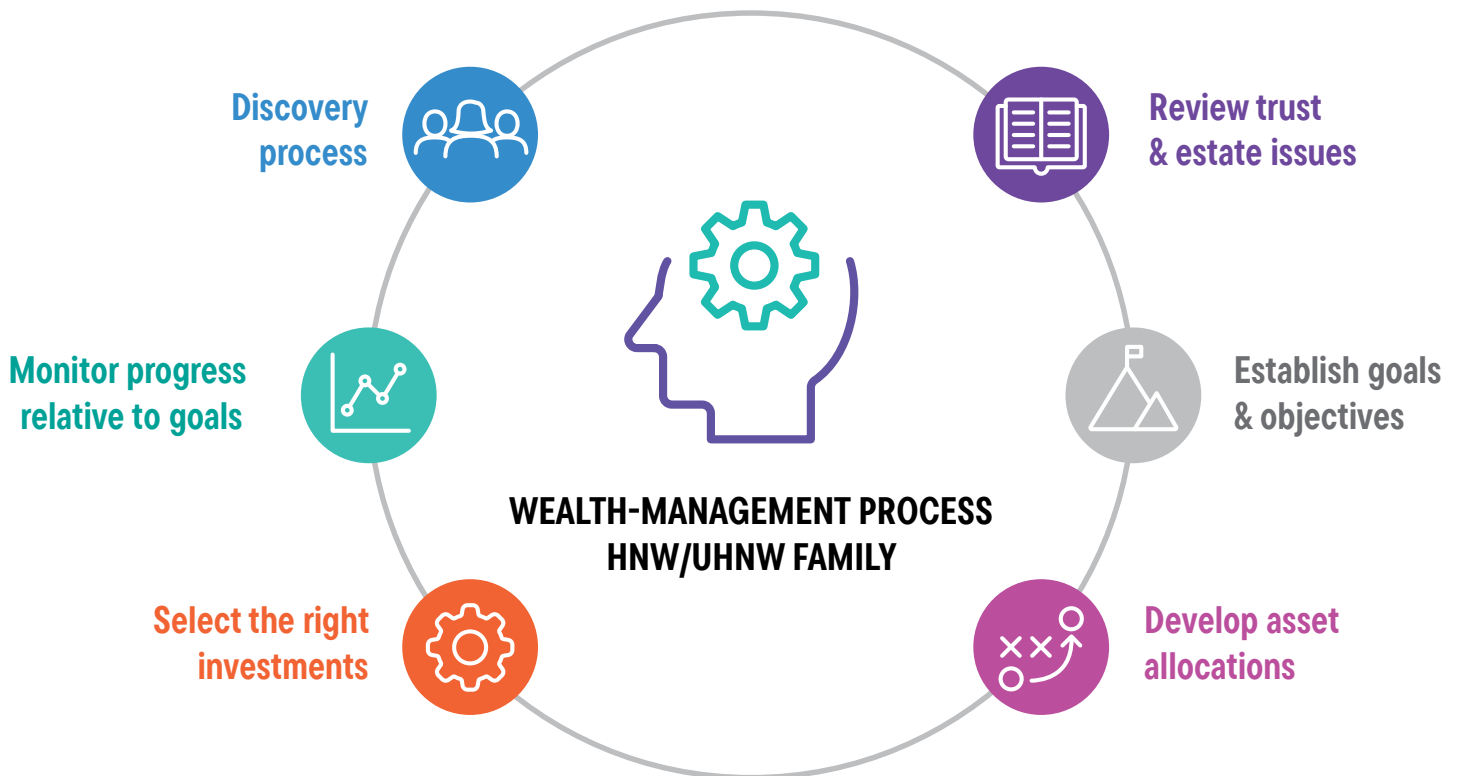
One way of determining the appropriate percentage to allocate to private markets is to develop an illiquidity bucket. Similar to the Yale example covered earlier, the *illiquidity bucket* should represent the amount of capital that an investor is willing and able to tie up for 7-10 years. It can be determined via the discovery process and advisors should designate these investments as long-term in nature.

As the advisor is determining the family's needs and requirements, they should inquire about their short and long-term liquidity needs. Do they have significant capital expenditures in the next couple of years (college funding, purchasing a second home, boats, etc.)? How much of their portfolio needs to be short-term in nature to meet these needs? What portion are they comfortable putting aside for the next 7-10 years?

For many HNW investors, a 10%-20% illiquidity bucket may be appropriate given their wealth, income and cash flow needs. Once the advisor has determined the illiquidity bucket, they can then define which asset classes are appropriate to achieve their client's goals.

Wealth-Management Process

Revisit The Plan



Allocating to private markets

Once the illiquidity bucket for long-held assets has been established for a particular client, an advisor can then determine the appropriate allocation to private markets. There are several factors to consider before allocating.



What are the family's goals and objectives?



What is the optimal combination of asset classes (traditional & alternatives)?



What are the types of investments that provide the highest likelihood of achieving goals?



What is the appropriate amount of capital to allocate per strategy?



What is the most appropriate type of fund given the investor's wealth and liquidity profile?

Note, with the lower minimums of registered funds, advisors may be able to allocate across private markets (private equity, private credit and private real estate). For larger families, with large liquidity buckets, you can diversify your private market exposures.

As with any investment, an advisor must understand and evaluate the many dimensions of a fund before recommending (structure and strategy). Because of the specialized nature of conducting due diligence on private markets, advisors may rely on due diligence conducted by their firm or a third-party provider.

The behavioral benefits of illiquidity

While many consider the Altair 8800 the first personal computer (1974), the original personal computer was the human brain. The brain is capable of complex computations, processing information rapidly, and has extended storage capacity. The human brain processes information in seconds and is capable of learning **history**, **math**, **science**, **literature**, **philosophy** and the **arts**.



However, unlike the personal computers that we use today, the human brain also responds to all sorts of emotional stimuli, including fear, greed, euphoria, grief, pain and pleasure. While the modern-day PC processes information in nanoseconds, in a logical and rational fashion, the human brain often responds to emotional stimuli in an irrational manner.

Daniel Kahneman was awarded the Nobel Prize for his research of behavioral finance, how the brain responds to certain stimuli, and the biases that we all exhibit. One of the behavioral biases that Kahneman studied was “loss aversion”. In his book, *Thinking, Fast and Slow*, Kahneman suggested that investors will go to great lengths to avoid losses.

In fact, his research concluded that for the average investor, the ratio of avoiding losses to seeking gains is roughly 2:1. Consequently, investors may fall short of their goals by being too conservative or leaving the market in times of volatility. While loss aversion is well known, and advisors often coach investors to refrain from these irrational responses, it is still very challenging to act rationally in volatile times.

Of course, there is a built-in benefit of allocating a portion of a client’s portfolio to illiquid investments—it removes the emotional impulse to sell at the wrong time or switch strategies midstream. By utilizing an illiquidity bucket for a portion of a client’s portfolio, an advisor can instill discipline to their investment approach.

For this portion of their portfolio, investors can’t sell at the first signs of volatility or the temptation to chase returns elsewhere. These assets are truly long-term in nature and will require patience to reap the full potential benefit. With that said, registered funds (interval and tender offer funds) do offer more flexible liquidity features, which may provide some level of comfort that investors can redeem if necessary.

Conclusion

The bottom line is there is a potential illiquidity premium for allocating capital to private markets. The illiquidity premium is the reward for giving the fund manager ample time to execute their strategy and unlock value. There is an opportunity cost for being too liquid, especially in today’s market environment.

Advisors should help investors in determining their illiquidity bucket. The illiquidity bucket should be determined based on each investor’s ability to allocate capital for an extended period of time (7-10 years). An illiquidity bucket can help instill a long-term disciplined approach that can remove the impulses to respond to emotional stimuli.

Definitions

Accredited investors are individuals with gross income of \$200,000, or with joint income with a spouse or partner of \$300,000 or more, in each of the two most recent years.

Bloomberg US Aggregate Bond Index is an unmanaged index that reflects the performance of the investment-grade universe of bonds issued in the United States, including U.S. Treasury, government sponsored, mortgage and corporate securities.

Capital calls are mandatory demands made on an ad hoc basis by private investment vehicles for additional capital from investors to support the original investment.

Closed end funds are a type of investment company created by the Investment Act of 1940 in which money is pooled for deployment in a specific set of assets. Many closed end funds raise capital at their inception and issue shares to investors which can be traded on public exchanges.

CPI (Consumer Price Inflation) is a measure of inflation calculated by the US Bureau of Labor Statistics based on price changes for a hypothetical basket of goods and services.

Distribution rate expresses the income and capital distributed to investors as a percentage of the total investment capitalization.

Family offices are private financial advisors employed by very wealthy families or individuals to provide customized planning and investment management services tailored to their specific needs.

40-Act funds are investment vehicles authorized by the Investment Company Act of 1940, including open-end mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts.

FTSE NAREIT All Equity REITs Index is an unmanaged index of public U.S. equity REITs that reflects the performance of the public REIT market overall.

K-1 is a U.S. tax return schedule used to report an investor's share of the profits and losses from a business partnership.

NCREIF property index (NPI) is an unmanaged index of institutional property investments that reflects the performance of the real estate market in general.

NFI-ODCE (NCREIF Fund Index—Open End Diversified Core Equity) is an unmanaged index of open-end commercial real estate funds that reflects the performance of investment real estate in general.

Private real estate is an asset class composed of pooled private and public investments in the property markets which are not traded publicly.

Qualified purchasers are individuals or family-owned businesses with \$5 million or more in investments, or which invest \$25 million or more for others, such as a professional investment manager.

A **REIT (Real Estate Investment Trust)** is a specialized type of company designed to own and/or invest in real estate properties which required by law to distribute at least 90% of its taxable income to shareholders.

Shares in **public REITs** are tradable on public exchanges; **non-traded REITs** are privately held and may be very illiquid.

S&P 500 is an unmanaged index of 500 U.S. stocks that reflects the performance of large-cap U.S. stocks in general.

Standard deviation is a statistical measure of the variation from the average (mean) in a set of data commonly used to assess the volatility of investment returns over a given time period.

Yield to worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. This material may not be reproduced, distributed or published without prior written permission from Franklin Templeton.

The views expressed are those of the investment manager and the comments, opinions and analyses are rendered as at publication date and may change without notice. The underlying assumptions and these views are subject to change based on market and other conditions and may differ from other portfolio managers or of the firm as a whole. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market. There is no assurance that any prediction, projection or forecast on the economy, stock market, bond market or the economic trends of the markets will be realized. The value of investments and the income from them can go down as well as up and you may not get back the full amount that you invested. Past performance is not necessarily indicative nor a guarantee of future performance.

All investments involve risk, including possible loss of principal. Investments in alternative investment strategies are complex and speculative investments, entail significant risk and should not be considered a complete investment program. Depending on the product invested in, an investment in alternative investments may provide for only limited liquidity and is suitable only for persons who can afford to lose the entire amount of their investment. An investment strategy focused primarily on privately held companies presents certain challenges and involves incremental risks as opposed to investments in public companies, such as dealing with the lack of available information about these companies as well as their general lack of liquidity.

Private equity investments involve a high degree of risk and is suitable only for investors who can afford to risk the loss of all or substantially all of such investment. Private equity investments may hold illiquid investments and its performance may be volatile. The risks associated with a real estate strategy include, but are not limited to various risks inherent in the ownership of real estate property, such as fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by general and local economic conditions, the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, environmental laws, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars). The value of most bond funds and credit instruments are impacted by changes in interest rates; bond prices generally move in the opposite direction of interest rates. Investing in lower-rated or high yield debt securities (“junk bonds”) involve greater credit risk, including the possibility of default, which could result in loss of principal – a risk that may be heightened in a slowing economy. Investments in derivatives involve costs and create economic leverage, which may result in significant volatility and cause the fund to participate in losses (as well as gains) that significantly exceed the fund’s initial investment in such derivative. An investment in alternative securities or vehicles which invest in them, should be viewed as illiquid and may require a long-term commitment with no certainty of return. The value of and return on such investments will vary due to, among other things, changes in market rates of interest, general economic conditions, economic conditions in particular industries, the condition of financial markets and the financial condition of the issuers of the investments. There also can be no assurance that companies will list their securities on a securities exchange, as such, the lack of an established, liquid secondary market for some investments may have an adverse effect on the market value of those investments and on an investor’s ability to dispose of them at a favorable time or price.

Any research and analysis contained in this material has been procured by Franklin Templeton for its own purposes and may be acted upon in that connection and, as such, is provided to you incidentally. Data from third party sources may have been used in the preparation of this material and Franklin Templeton (“FT”) has not independently verified, validated or audited such data. Although information has been obtained from sources that Franklin Templeton believes to be reliable, no guarantee can be given as to its accuracy and such information may be incomplete or condensed and may be subject to change at any time without notice. The mention of any individual securities should neither constitute nor be construed as a recommendation to purchase, hold or sell any securities, and the information provided regarding such individual securities (if any) is not a sufficient basis upon which to make an investment decision. FT accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Products, services and information may not be available in all jurisdictions and are offered outside the U.S. by other FT affiliates and/or their distributors as local laws and regulation permits. Please consult your own financial professional or Franklin Templeton institutional contact for further information on availability of products and services in your jurisdiction.

Alternatives by Franklin Templeton

Real Estate | Private Equity | Private Credit | Hedged Strategies | Venture Capital | Digital Assets