ACCESSING INSTITUTIONAL ALTERNATIVES:

Overcoming the "Liquidity Mismatch" in Individual Investor Portfolios

Financial advisors can help clients harness the premiums generated by less liquid asset classes—and avoid paying for excess liquidity

For most individual investors, the vast majority of their investment portfolio is dedicated to funding goals with long time horizons: retirement, paying for children's college expenses and generational wealth transfer. Even though investors do not need immediate access to these funds, their portfolios typically comprise mostly public equities, bonds and other highly liquid assets.

As astute investors know, liquidity is not free. Conversely, investors can generate a premium by investing in less liquid asset classes, such as private equity, private debt, hedge funds and structured credit. The net result is that many individual investors are paying for more liquidity than they need. This is the essence of what we call the "liquidity mismatch." Resolving this mismatch presents a compelling opportunity for financial advisors to add more value to their relationships with individual investors.

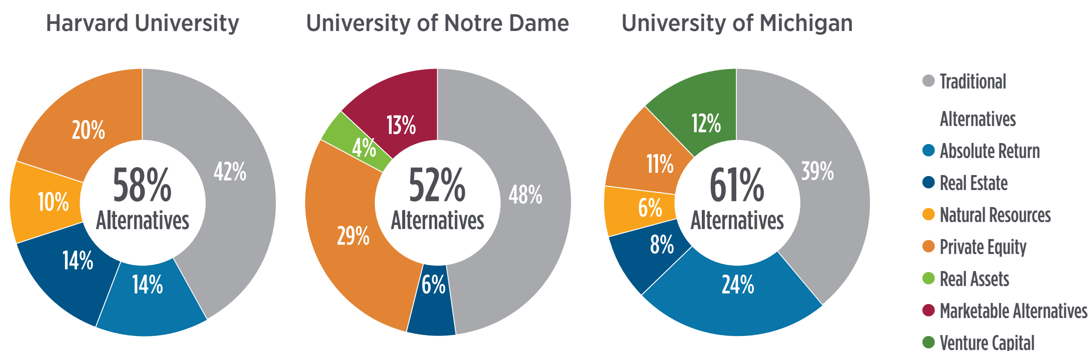
Quantifying the Illiquidity Premium

Numerous empirical studies and theoretical models have supported the conclusion that less liquid assets offer higher expected returns.[1] Institutional investors clearly understand the importance of using liquidity risk as a source of potential returns. The potential advantage of illiquidity is why alternative investments represent the majority of the portfolio allocations for many of the largest U.S. university endowments.

"We should be getting an incremental return for that illiquidity—and we call that the illiquidity premium—of at least 300 basis points annually on average over what we are expecting in publicly traded markets."

Jane Mendillo
then-CEO, Harvard Management Company, 2014

Alternative investments dominate portfolio allocations of top U.S. university endowments



Source: University filings for FY2016. Allocations reflect available data and in some cases include non-endowment assets.

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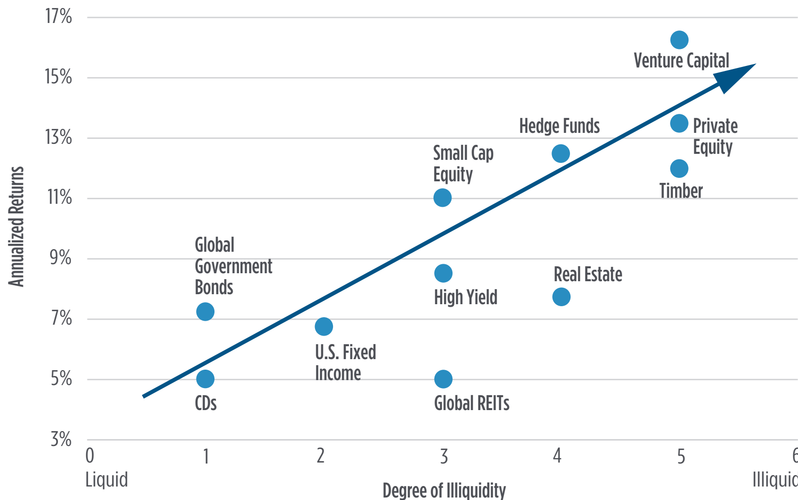
Quantifying the illiquidity premium across asset classes



Source: A. Ilmanen, "Expected Returns," 2011. Average asset returns 1990–2009 on subjective illiquidity estimates. Bloomberg, MSCI, Barra, Ken French's website, Citigroup, Barclays Capital, JP Morgan, Bank of America Merrill Lynch, S&P GSCI, MIT-CRE, FTSE, Global Property Research, UBS, NCREIF, Hedge Fund Research, Cambridge Associates. **Past performance is not indicative of future results.**

Applying an Institutional Approach to Managing Individual Investor Portfolios

Given their size and time horizons, endowments, pensions, and other institutional investors have a much greater capacity to take on higher levels of illiquidity than individual investors. Allocating 100% of a portfolio to less liquid or illiquid assets certainly would be inappropriate for most individuals. But this does not mean that individuals should eschew illiquid assets altogether.

Resolving the liquidity mismatch centers around determining how much liquidity investors need for their short-term spending needs and goals. Then investors can assess how much illiquidity investors should incorporate into the portions of their portfolios dedicated to funding long-term goals. Success at this stage requires a thorough understanding of each client's cash flow requirements and time horizons, as well as a careful consideration of the potential benefits and risks of less liquid asset classes.

Analyzing New Opportunities to Harvest the Illiquidity Premium

Historically, lack of access was among the biggest barriers to individuals investing in illiquid assets. High investment minimums forced individuals to settle for accessing alternative assets through "liquid alts."

Fortunately, recent advances in product design have expanded individual investors' access to alternatives. Closed-end funds (CEFs) may provide improved access to alternatives and have attractive features such as low investment minimums, no performance fees, and the ease of 1099 tax forms. In addition, CEFs are designed to offer purity of strategy and provide individuals the same investment opportunity as their institutional counterparts.

To help their clients capitalize on new opportunities to harvest the illiquidity premium, at XA Investments LLC, we recommend that financial advisors take the following five steps:

1. Help clients understand risks related to alternative, less liquid asset classes—as well as potential benefits of higher yields, improved diversification, reduced volatility, and higher expected returns
2. Develop a deeper understanding of each client's cash flow and liquidity needs relative to the time horizons for their investment goals
3. Evaluate the long-term portions of investors' portfolios to see if reallocating a portion to illiquid assets is appropriate for their situation
4. Learn about the different vehicles available for accessing alternative asset classes and understand the relative pros and cons of liquid alts, limited partnerships, and the new generation of CEFs
5. Recommend pioneering firms that are creating better ways to access alternatives to your clients

For more information about institutional-caliber alternatives and new ways to access them, please visit xainvestments.com or call 1.888.903.3358.

Risks

The information in this paper is provided as a summary of complicated topics and does not constitute legal, tax, investment or other professional advice on any subject matter. Further, the information is not all-inclusive and should not be relied upon as such. Illiquid investments are designed for long-term investors who can accept the special risks associated with such investments. An investment in illiquid investments involves risks, including loss of principal. **Past performance is not necessarily indicative of future results.** Diversification does not eliminate the risk of experiencing investment losses. You should not use this paper as a substitute for your own judgment, and you should consult professional advisors before making any investment decisions. This information does not constitute a solicitation of an offer to sell and buy any specific security offering. Such an offering is made by the applicable prospectus only. A prospectus should be read carefully by an investor before investing. Investors are advised to consider investment objectives, risks, charges and expenses carefully before investing. Financial advisors should determine if the risks associated with an investment are consistent with their client's investment objectives.

Sources: Selection of Empirical Studies on Liquidity Premiums

1 Amihud, Yakov, Haim Mendelson and Lasse H. Pedersen (2013). "Market Liquidity Asset Pricing, Risk and Crises." New York: Cambridge University Press; Bongaerts, Dion, Frank de Jong and Joost Driessen (2011). "An Asset Pricing Approach to Liquidity Effects in Corporate Bond Markets." Working paper, Fisher College of Business (May); Lou, Xiaoxia, and Ronnie Sadka (2011). "Liquidity Level or Liquidity Risk? Evidence from the Financial Crisis." *Financial Analysts Journal*, Vol. 67, No. 3 (May/June): 51–62; Pedersen, Lasse. "Efficiently Inefficient. How Smart Money Invests and Market Prices Are Determined." Princeton University Press, 2015; Sadka, Ronnie (2012). "Hedge-Fund Performance." *Journal of Investment Management*, Vol. 10, No. 2, special hedge fund issue (Second quarter): 60–72.

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