The Hidden Cost of Liquidity

How Alternatives Can Reward Long-Term Investors

Alternative Thinking Series

The term liquidity refers to the ease with which an asset can be converted into cash. Assets or securities that can be easily bought and sold, such as bonds, public stocks and U.S. Treasuries, are considered liquid. Those that are more difficult to buy and sell, such as real estate, private debt and private equity, are said to be illiquid. Given investors' natural bias for cash, most investors gravitate toward owning liquid assets. **But at what cost?**

Less Liquidity, More Potential Return

The financial crisis and persistent market volatility have intensified investor bias toward liquid securities. Unfortunately for investors, this increased demand has coincided with deteriorating yields for highly liquid assets in the public markets. Generally speaking, yields in more liquid assets have been decreasing due to a shortage of supply, while yields in less liquid parts of the market have been increasing due to a lack of demand. The result has been an increase in the **illiquidity premium** — that is, the difference in yield between liquid and less liquid securities. The mismatch between the demand for and supply of liquid securities creates an opportunity for those willing to employ a long-term alternative investment strategy.

As investors' demand for liquidity has increased, so too has the relative cost of owning a fully liquid portfolio. The result is that the illiquidity premium is well above its historical average. The chart in **Figure 1** illustrates the illiquidity premium in the high yield bond market from 1997–2012.[1]

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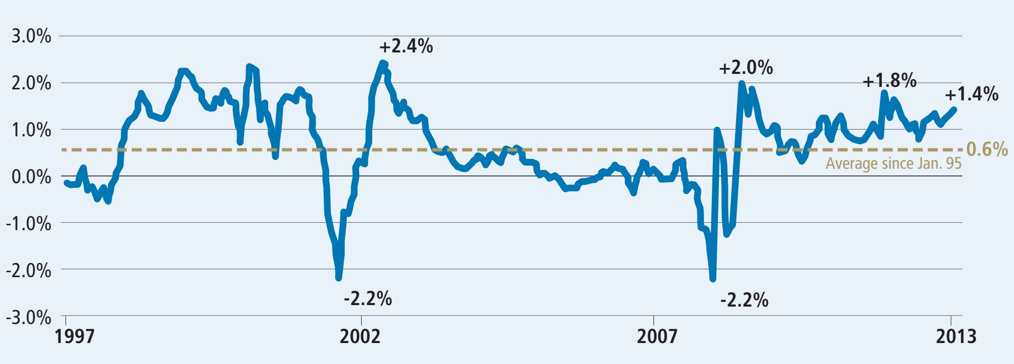
Figure 1

Spread Differential Between Liquid and Illiquid High Yield Bonds (1997–2012)



What the data tells us: The yield premium for less liquid high yield bonds in December 2012 was 1.4%, considerably higher than the long-term average of 0.6%. Moreover, since the overall yield in high yield bonds has decreased so dramatically, with the Barclays High Yield Index ending 2012 at 6.1%, the spread differential due to liquidity represents a substantial component of an investor's total return.

[1] Barclays Research, January 2, 2013. Liquid Index (GO-GO Index) contains bonds with more than $500 million in par that were issued less than 18 months prior to January 2, 2013. Illiquid Index (SLO-GO Index) contains bonds with less than $250 million in par that were issued more than 18 months prior to January 2, 2013. The difference in yield is calculated using the option adjusted spread (OAS) differential.

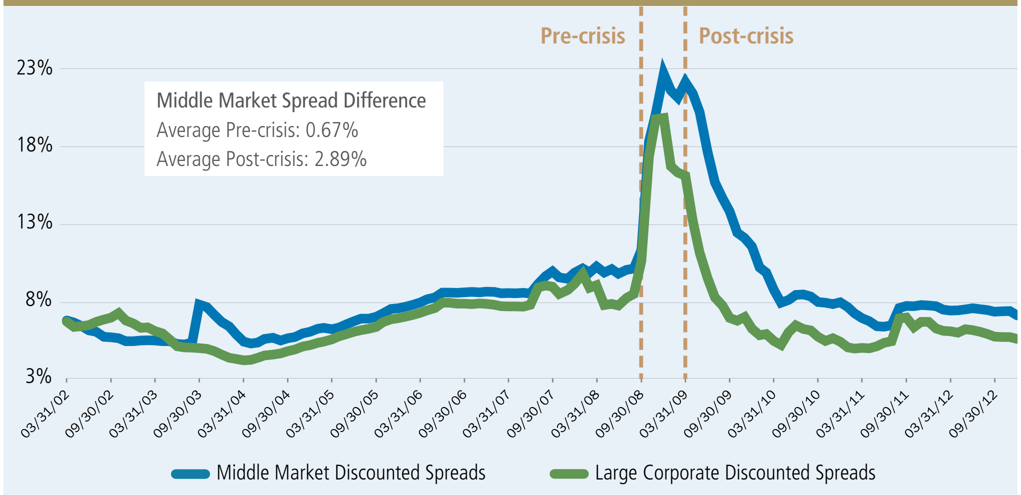
Illiquidity Premiums in the Senior Secured Loan Market

The illiquidity premium phenomenon extends beyond the high yield bond market. Senior secured loans, also known as bank loans, are a $1.2 trillion asset class that provides a form of debt financing to corporate borrowers. Although senior secured loans are used as a financing option by many public companies, they are more commonly found in the capital structures of private companies that lack access to public markets.

Figure 2 examines the spread differential between syndicated middle market senior secured loans (defined as loans to issuers with less than $50 million in EBITDA[2]) and syndicated loans to large corporate borrowers (issuers with more than $50 million in EBITDA[3]).

Figure 2

Middle Market Loan Premium (March 2002–December 2012)



What the data tells us: Prior to the financial crisis in 2008, syndicated loans to middle market borrowers offered higher yields than syndicated loans to large corporate borrowers by an average of 0.67%, and since the financial crisis the spread differential has grown to an average of 2.89%.

The primary driver behind the middle market yield premium is liquidity. In response to regulatory changes, such as those required under Basel III and Dodd-Frank, large banks have generally re-focused their strategies to dedicate capital to only their largest and most profitable clients. Left behind are the private, middle market companies that historically relied on bank loan financing as their primary source of funding. To entice new lenders to fill this funding void, middle market borrowers have been forced to pay higher interest rates than larger corporate borrowers of similar credit quality. The higher yields available in the less liquid parts of the senior secured loan market create an opportunity for those willing to accept less liquidity in return for better risk-adjusted returns.

[2] EBITDA is earnings before interest, taxes, depreciation and amortization, a cash flow proxy commonly used in corporate finance.
[3] S&P/LCD, monthly data as of December 31, 2012.

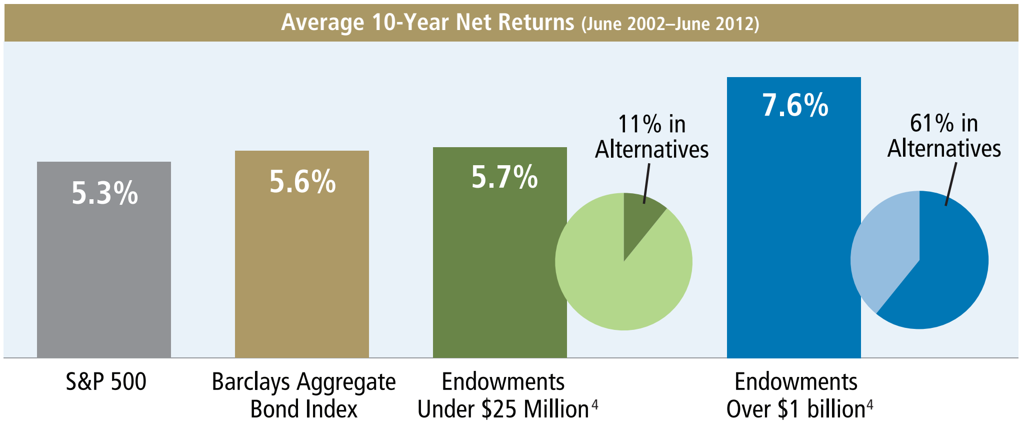
Why Endowments Invest in Alternatives

Alternative investments are often defined by what they are not — a traditional investment in publicly traded stocks or bonds. Alternatives can include both non-traditional assets, such as real estate, private equity or art, as well as non-traditional strategies, such as investing in illiquid securities. While individual investors have only recently begun to allocate a portion of their portfolios to alternative investments, institutional investors and endowments have been using alternatives for years. As of June 30, 2012, the average endowment allocated 54% of its total portfolio to alternative strategies.[4] Yale's endowment, widely considered the pioneer in alternative investing, allocates nearly 65% of its portfolio to less liquid investments.[5]

The basic premise behind endowments' relatively high and growing allocation to alternatives is their pursuit of enhanced risk-adjusted returns and their belief that illiquid securities can provide higher yields and less correlation to traditional markets. **Figure 3** compares 10-year investment returns for endowments against the S&P 500 and an investment grade bond index.

> "…serious investors benefit by avoiding overpriced liquid securities and by embracing less liquid alternatives."
>
> — David Swenson
> *Chief Investment Officer, the Yale University Endowment*[6]

Figure 3



What the data tells us: Large endowments, which have over a 60% allocation to alternative investments, significantly outperformed both public equities and investment grade bonds over the past 10 years.

Two factors may explain the performance gap between endowments and traditional investments:

- **The alternatives effect.** It is clear from the data that alternatives play some role in long-term investment returns. By harvesting the yield premium on illiquid assets, endowments are typically able to construct a higher yielding portfolio with less correlation to the broader markets.
- **The quality of the manager.** Illiquid securities, by their nature, are more difficult to evaluate than publicly traded securities. Skilled managers that are adept at taking advantage of pricing inefficiencies in illiquid securities will have a greater impact on returns than skilled managers operating in the public markets, where price inefficiencies are fewer in number and generally offer less return potential.[7]

[4] 2012 NACUBO-Commonfund Study of Endowments.
[5] As of June 30, 2012. Investments include allocations to Natural Resources, Private Equity and Real Estate.
[6] Swenson, Pioneering Portfolio Management.
[7] The Yale University Investments Office 2012 Endowment Update.

Individual investors may benefit from an **allocation to long-term investments.**

Where Alternatives Fit for Individuals

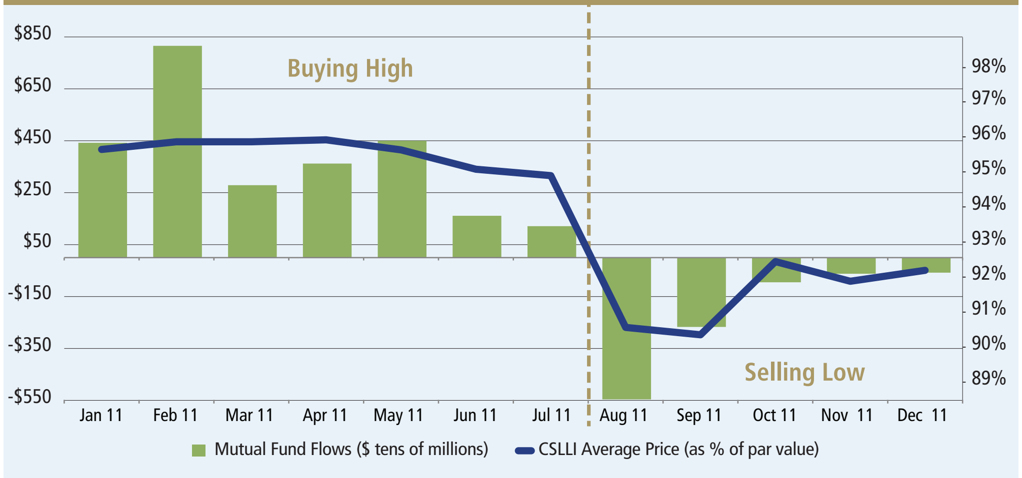
Alternative investments are a clear driver of endowment performance. And while the investment horizon of the average individual is generally shorter than the average endowment, individual investors may still benefit from an allocation to long-term investments.

Today individuals have access to alternatives through mutual funds, closed-end funds and business development companies (BDCs), among others. Each investment structure comes with its own benefits, risks, costs and liquidity.

Among the most common investment vehicles for individual investors are traditional open-end mutual funds, which are typically low in cost and allow investors to redeem capital on a daily basis. One result of daily liquidity, however, is that mutual fund managers are forced to manage without a permanent capital base: when investors withdraw capital, a manager may be forced to sell assets, and when investors purchase fund units, the manager may be forced to buy assets, regardless of his or her opinion on relative value. If investors withdrew funds only when securities prices were high and invested only when securities prices were low, the job of a mutual fund portfolio manager would be relatively easy. In general, the opposite is true. On average, investors tend to sell losing positions and add to positions that have already appreciated in value. **Figure 4** demonstrates this behavior by comparing the senior secured loan mutual fund flows to the price of the Credit Suisse Leveraged Loan Index in 2011.[8]

Figure 4

Loan Mutual Fund Flows vs. Credit Suisse Leveraged Loan Index in 2011



What the data tells us: During the market volatility of 2011, loan mutual fund investors consistently withdrew funds during periods of market stress and invested additional capital during periods of market strength, negatively impacting investor returns.

[8] Mutual fund flows from S&P/LCD, loan index is Credit Suisse Leveraged Loan Index. Data from January 2011–December 2011.

The difference between investors' realized and potential returns illustrates the performance gap between short-term and long-term investment strategies. Portfolio managers are keenly aware of the risks posed to long-term investment strategies from clients managing to short-term trends, and portfolio managers are often deterred from making long-term investment decisions out of fear of experiencing short-term underperformance and capital withdrawals.[9] The more liquidity investors have in their investment portfolio, the more likely they are to be focused on short-term performance, and the greater the challenge of portfolio managers to maintain a long-term investment strategy.

Options for the Long-Term Investor

Closed-end funds have access to **permanent capital,** thereby allowing their managers to pursue less liquid opportunities. Matching long-term investor capital with a long-term investment vehicle is critical to the success of an alternative investment strategy. The historical challenge with closed-end funds for the individual investor has been the volatility associated with their listed shares – closed-end fund shares often exhibit a high correlation to public market indices. Given that one of the objectives of an illiquid alternative investment strategy is to exhibit a low correlation to public markets, the volatility in listed closed-end fund returns can nullify the benefit of an illiquid alternative investment strategy.

Unlisted closed-end funds and **BDCs** are increasing in popularity due in part to their ability to preserve the attributes of a fund's underlying assets and still provide a permanent capital base. In an unlisted closed-end fund, or non-traded fund, there is typically no secondary trading market for the fund's shares — individuals wishing to exit their investment can generally only do so through a limited tender offer process. By matching long-term capital with long-term strategies, portfolio managers of unlisted investment vehicles may have the flexibility to seek the higher returns available in the illiquid parts of the market and potentially improve risk-adjusted returns. As with any investment, unlisted funds and BDCs have risks, including limited liquidity, potential loss of principal and portfolio volatility (see final page for an explanation of other related risks). Investors should consult their financial advisors to understand these risks and how such investments might fit into their investment strategies.

Portfolio managers of unlisted investment vehicles may have the flexibility to seek the **higher returns available in the illiquid parts of the market.**

[9] Stein, *Why are Most Funds Open-End? Competition and the Limits of Arbitrage (The Quarterly Journal of Economics (2005) 120(1)), 247-272.*

Summary

The illiquidity premium has grown. Since the financial crisis, macroeconomic uncertainty and public market volatility have increased investors' demand for liquid securities. At the same time, secondary market liquidity has deteriorated as many banks and broker dealers have deleveraged their balance sheets and reduced risk. The result has been the widening of the yield premium available to investors in less liquid securities.

Endowments favor alternatives for better risk-adjusted returns. Alternative investments are designed to provide access to non-traditional assets and strategies, one of which is investing in less liquid securities. Endowments and institutional investors have been using alternative investment strategies for years as a way to diversify their investment portfolios and capture the yield premium available in illiquid securities. A key to success for these managers has been to match their long-term investment strategy with long-term investor capital.

Unlisted closed-end funds and BDCs make illiquid alternatives accessible. With the unlisted closed-end fund structure, the interests of managers and investors are aligned: managers can invest in less liquid alternatives to drive returns, and investors can execute a long-term investment strategy without being subject to the daily share price volatility associated with the public markets. Investors should consult a financial advisor if they are interested in learning more about unlisted alternative investments.

Risk Factors

An investment in the shares of a fund that invests in illiquid securities (a "Fund") may involve a high degree of risk and may be considered speculative. The following are some of the risks an investment in the shares of a Fund may involve; however, investors should carefully consider all of the information found in the section of the prospectus of the applicable Fund entitled "Risk Factors" before deciding to invest.

- Because there may not be a public trading market for the shares of a Fund and the Fund may not be obligated to effectuate a liquidity event by a specified date, it is unlikely that investors will be able to sell their shares. If an investor is able to sell shares, such investor will likely receive less than the purchase price paid for such shares. While a Fund may conduct quarterly tender offers for its shares, in many cases, only a limited number of shares may be eligible for repurchase, and a Fund may have the ability to suspend or terminate its share repurchase program at any time.
- Investors should consider that they may not have access to the money they invest for an indefinite period of time.
- Investors may not receive distributions, or a Fund's distributions may not grow over time. A Fund may pay distributions from offering proceeds, borrowings or the sale of assets, and each Fund may not establish limits on the amount of funds that such Fund may use from net offering proceeds or borrowings to make distributions. A Fund's distribution proceeds may exceed its net investment income. Therefore, portions of the distributions that a Fund makes may represent a return of capital to investors for tax purposes.
- The Funds may have an investment strategy focused primarily on privately held companies. An investment strategy focused primarily on privately held companies presents certain challenges, including the lack of available information about these companies.
- The Funds may invest in middle market companies, which involves a number of significant risks, any one of which could have a material adverse effect on a Fund's operating results.
- A lack of liquidity in certain of a Fund's investments may adversely affect its business.
- The Funds are often subject to financial market risks, including changes in interest rates, which may have a substantial negative impact on a Fund's investments.
- The Funds may borrow funds to make investments, which increases the volatility of the Fund's investments and may increase the risks of investing in the Fund's shares.
- The Funds may have limited operating histories and therefore may be subject to the business risks and uncertainties associated with any new business.

The Funds may pay substantial fees to investment advisers in return for their services, and may reimburse such investment advisers for certain expenses incurred by them. Among other matters, these compensation and reimbursement arrangements could affect decisions by the Funds with respect to public offerings of equity by the Funds and their use of leverage. Such fees and expenses have the effect of reducing returns earned by investors in the Funds.

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