As alternatives continue to gain favor with retail investors, it is important to consider the risk that is inherent in these nontraditional investments based on where they fall within the liquidity spectrum.

LIQUIDITY AS A CONTINUUM IN ALTERNATIVE ASSETS

It is easy to think of an investment as either liquid or illiquid, when, in fact, liquidity should be examined in terms of a continuum. At the far left side of the continuum are alternatives geared toward individual investors, such as long-short hedge funds, which are highly liquid (refer to Figure 1).

Moving toward the right of the continuum are hedge funds engaged in strategies that are harder to value or that take longer to liquidate, such as global macro strategies or distressed/credit hedge funds. Farther to the right of the spectrum are direct participation programs (DPPs), such as non-traded real estate investment trusts (REITs) and non-traded business development companies (BDCs). Although DPPs are depicted as the midpoint on the spectrum below, these investments would be the most illiquid investments for a retail investor had the illustration below represented only retail investments.

Next are typical institutional alternatives, including private equity funds, direct lending funds and other structures with long lock-up periods. Finally, toward the institutional, far right side of the spectrum are emerging alternatives, such as timber, life settlements and collectibles.

LIQUIDITY AND ITS IMPACT ON A PORTFOLIO

Understanding the impact of the liquidity spectrum in a portfolio is vital before making an investment decision. The four considerations below are a starting point for investors looking to include alternative investments in their portfolio.

1. CONSIDER LIQUIDITY AS A RISK FACTOR

Liquidity has to be viewed as a risk in its own right. Most of the time, people look at metrics such as volatility as the primary risk indicator of an investment. However, it is important to supplement volatility and other risk metrics with those measuring liquidity. For example, buying a Picasso might seem like a great investment based on the past performance of such works of art. However, unlike stocks, which are traded throughout the day, the market for collectibles, antiques and fine art operates under a much longer time horizon.
Similarly, a more institutional investment, such as a 12-year, locked-up, private equity vehicle has limited liquidity. This is true even with the rapid growth, under certain circumstances, of the secondary funds market where private equity interests can be bought and sold on an exchange.

2 CONSIDER A PORTFOLIO’S ASSET ALLOCATION

It also is essential to understand the illiquid nature of certain products along with other meaningful risks. Prior to the Great Recession, many investors became interested in alternatives because they were fashionable. The problem was that as the Great Recession played out, many investors started selling their more liquid alternative assets. Consequently, these alternatives suffered far more than the models would have suggested they could have due to the “black hole” effect.

A liquidity black hole refers to events in which share redemptions cause more investors to sell their shares. When investing in an alternative, the portfolio needs to be constructed in such a way that it has sufficient liquidity in downside scenarios, without relying on the alternative portion of the portfolio.

3 CONSIDER THE ILLIQUIDITY PREMIUM

As mentioned earlier, many alternative investments are considered illiquid because investors are unable to easily redeem shares in these kinds of products, if at all. Alternative investments can have restricted share redemption plans. For example, non-traded REITs and BDCs limit share redemptions and repurchases, as well as may modify, suspend or terminate the plans at any time. Figure 1 lists examples of more illiquid alternative investments. However, for investors who can withstand high periods of illiquidity, these investments may provide what many have termed an illiquidity premium.

4 CONSIDER THE INVESTMENT’S LIQUIDITY LEVEL

Finally, it is important to investigate and understand the liquidity level of the alternative investment you are considering. Liquidity is restricted by such features as lock-up periods, call/investment periods and annual redemptions.

IN BRIEF

Liquidity needs to be considered when looking at any investment. However, particular consideration needs to be given to the liquidity of the alternative assets you are considering, whether they are traded or non-traded, or geared toward retail or institutional investors.

In addition, part of the way that some alternative assets generate their returns is through their less liquid positions. Thus, the limited liquidity of these investments represents a risk for which investors should get fairly compensated. Being mindful of the liquidity level of alternative investments also can help investors understand the important role alternative assets may play in a well-diversified portfolio.

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