BlueBay
Asset Management

Liquidity in alternative investment vehicles: binary to a continuum

Liquidity is the ability to transact (buy and sell) with sufficient size without impacting the current market price of the security. It is measured both by the speed of execution of those transactions and by the costs incurred in the exchange.

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AUTHOR
Nacho Morais
Consultant

Alternatives to core fixed income

It may be easy to identify liquid and illiquid investments in certain environments. The former group would be composed by on-the-run US Treasury bonds, large cap equities and sold-out Beyoncé tickets in the week before the concert. In the latter, we have venture capital, middle market loans and football trading cards when the majority of the classroom has completed their album. For the assets in the middle – small cap equities, medium-size issue corporate credit, to cite a few examples – liquidity can be variable. These assets might be quite liquid in the build-up of a bubble or when credit is cheap, to then give way to a trading drought when conditions reverse. Investor demography – the number of market participants, investor appetite, and market structure, warehousing ability by intermediaries and ease of price discovery – influence the liquidity of an asset class.

For those who invest assets on behalf of others, liquidity has implications in how they conduct their activity. Some facets to be taken into account are:

Liquidity premium: As mentioned, some assets are less liquid than others, either because of lower investor interest, small issue size or the nature of the asset. For instance, liquidity in corporate bonds tends to fall after a company is downgraded to junk status (BB or below), since many holders are restricted to investment grade securities. Small issues will be less liquid as they are not investable by large institutional investors who need minimum ticket sizes. Moreover, unlisted securities will normally be less liquid than publicly traded ones due to the lack of price visibility, lower company transparency and absence of a centralized trading venue. The fact that an investor needs to keep their money committed for a certain period of time should come with a premium.

Flexibility: The liquidity of an asset enables the fund manager to sell the asset on a different range of circumstances, such as responding to client redemptions, changing his or her view about an investment thesis or executing a stop-loss protocol. Therefore, illiquidity does not imply only a premium due to the time value of money – which increases in a normal yield curve, but also giving up flexibility. The manager, therefore, needs a higher degree of conviction when entering a trade in a less liquid asset, since the exit will be more expensive, if at all possible.

Asset-liability matching: The manager funds investments through the issuance of equity – fund investors assets – and through leverage from other sources, such as prime brokers and other leverage providers like banks. In the traditional investment space, attention is primarily focused on matching the liquidity of the assets with the ability to respond to investor redemptions, as they use little to no leverage. In alternatives, though, responding to leverage providers is just as important.

These circumstances highlight the importance of the following aspects when running an alternatives fund:

- The liquidity offered to investors needs to match the liquidity in which the portfolio and its leverage can be unwound. Before the financial crisis, it was not infrequent that some managers – especially in the US – offered open-ended fund structures which contained non-traded assets, priced on accrual or appraisal. This is not right for two reasons:
  1. The assets could not normally be liquidated in the timeframe offered to investors.
  2. Investors were being allowed in and out with valuations based on non-market NAVs, which frequently did not even take into account situations of default. This creates a conflict between incumbent, subscribing and redeeming investors.
- When a manager is running a levered strategy, the funding of the leverage is as important as the liquidity given to investors. The manager must assess the circumstances under which the terms leverage is accessed can be changed and negotiated with the primer broker. It is also prudent to have more than one prime broker. Whereas a crisis can mainly affect one asset class, if the prime broker is very exposed to that asset class, it may pull back funding across the board, affecting other strategies.
- When a fund uses short selling, the manager must have the adequate infrastructure to manage the funding of those shorts and the risk of recall.
- As mentioned earlier, liquidity is not a constant. Single security, asset class and positioning circumstances affect liquidity. For instance, the inclusion or exclusion of a security in an index can increase or decrease the liquidity of the security. Runs on some asset classes can dry up liquidity in a short period of time. Finally, crowdedness in some trades can make the liquidity very asymmetric and prompt sharp movements due to the lack of new marginal buyers or sellers.

A couple of examples of positioning are as follows:

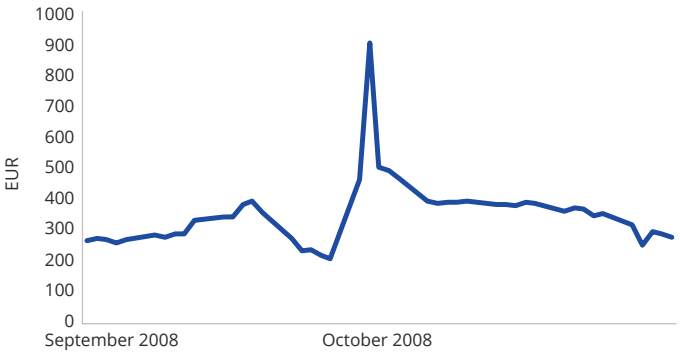
In August 2007[1] , there were sharp losses amongst statistical arbitrage equity market neutral funds. Many funds were using similar quantitative strategies in equities, including some multi-strategy funds, which created commonality of positioning and crowding in some trades. When mortgage losses started to bite some multi-strategy funds had to de-lever and generate cash by selling the most liquid securities they had in the books, namely their equity strategies, creating a vicious circle of price pressure, stop loss triggers and further unwinding, provoking losses for many players with considerable pressure in the cost of liquidation of positions.

HEDGE FUND RESEARCH EQUITY MARKET NEUTRAL INDEX

Source: Bloomberg as at October 2007

In October 2008[2] , Porsche announced that they had increased their holding in Volkswagen from 31% to 43%, plus another 31% in options. Lower Saxony state was the other large Volkswagen shareholder, with 20% of the firm. Meanwhile, outstanding short interest on the company's shares grew to13%, whichwould have to be bought back from a free float of only 6%. A short squeeze ensued, and the price of Volkswagen grew five-fold in a couple of days, making the German carmaker the largest company in the world by market capitalization (for a bried period).

VOLKSWAGEN SHARE PRICE



Source: Bloomberg as at December 2008

Liquidity shocks can lead to situations when prices dislocate, and the ability to have staying power and deploy capital at those dislocated prices is important.

How times have changed

The financial crisis and these coincidental events have brought us a more mature industry. In the aspect we are commenting, we can identify several areas:

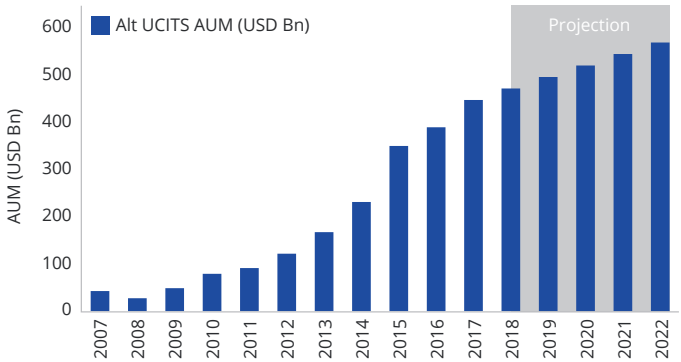
Firstly, there has been **a rationalization of the liquidity of the alternative investment vehicles.** Whereas in the past, there was little differentiation aside from the private asset (closed-end) versus public asset (monthly-quarterly liquidity) vehicles, we find now more diversity of products, which are more aligned with the underlying strategies. In this sense, we can split alternative strategies in the following types:

1 More about this can be found in Amir E. Khandani and Andrew W. Lo's "What happened to the quants in August 2007?: Evidence from factors and transactions data" (NBER Working Paper 14465, 2008) and Bank of England' Quarterly Bulletin 2017 Q4, page 5.

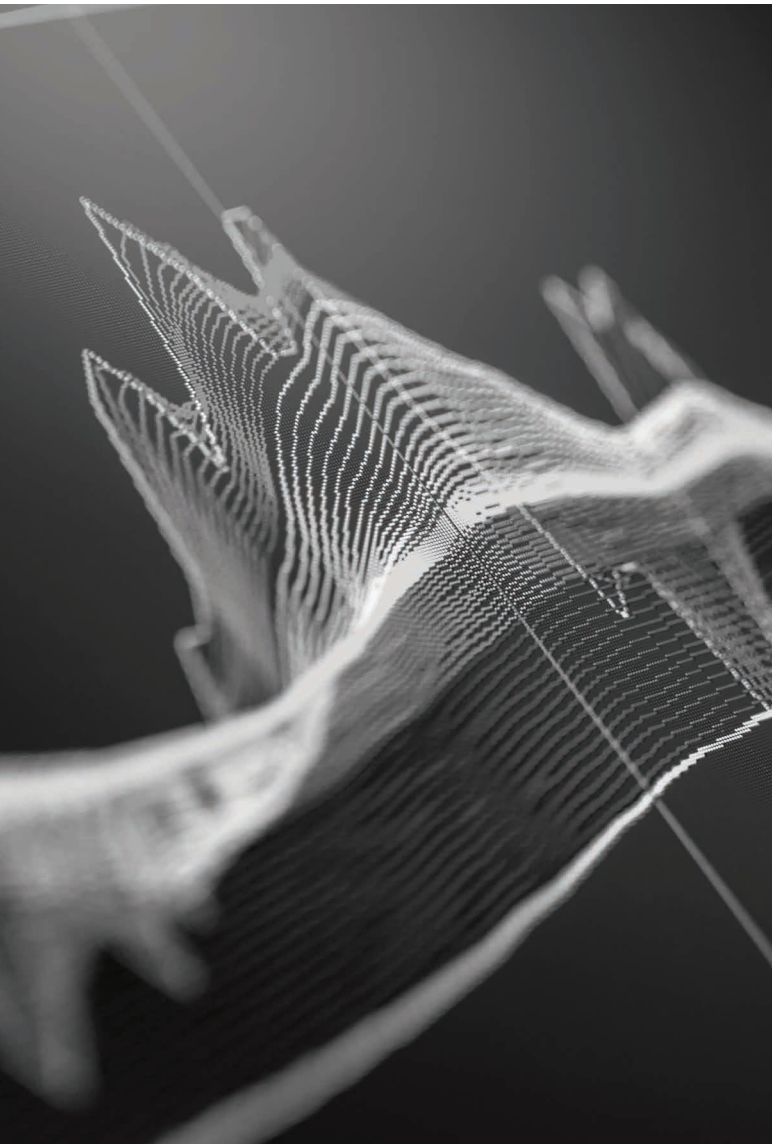
2 FT, 27/Oct/2008

Liquid strategies: Here we can find from managed futures strategies to mid to large cap equity, or credit strategies investing in CDS and/or bond issues with decent issue size. While in many cases these strategies are still in offshore or onshore medium liquidity vehicles – monthly or quarterly redemptions – they have found a large push in regulated, more liquid structures, such as UCITS (EU) or 40 Act (US). The limits to leverage that these structures impose are also consistent with the need to unwind the structure in a limited timeframe.

ALTERNATIVE UCITS GROWTH AND FORECAST



Source: Morningstar, BlueBay calculations, as at end-2017



Medium liquidity strategies: By this definition, we can find structures which offer liquidity terms which span from monthly to quarterly, with limited use of gates and with notice periods which span from 15 to 90 days – which used to be the standard before the rise of liquid alternatives. These strategies have the ability to invest in traded securities in equity and debt with smaller issue size, as well as in bank loans or less liquid markets, while having the option to take more leverage than the more liquid ones. Many long-short equity, long-short credit, event driven, global macro and emerging market funds belong to this category. The higher staying power of these strategies enables them to build more levered structures, invest in securities further down the liquidity ladder, or invest in trades contingent to events which happen over the medium term.

This is also frequently the natural home of asset classes which are outside the typical equity or bonds strategies. This would be the case for some levered quantitative strategies, commodity funds or volatility traders.

Low liquidity strategies: Here we can find strategies that either have stricter gates in a quarterly liquidity context or liquidity that is annual or even more restrictive, while still investing in traded assets. In some instances, such as shareholder activism or distressed securities, the illiquidity is merited as there is a need to be invested for a long period of time. In the case of an activist, their bargaining power could be weaker if its holdings were subject to sudden woes; while in the case of distressed securities, restructuring and liquidation processes can take many months and even years. In both cases, the manager may be restricted to trade if he takes a more active role, such as 'going over the wall' or sitting on the company's board or a shareholders committee. There are cases where these tougher liquidities may be required when a manager wants to 'play offence when other's plays defence' or play the role of a stronger hand, when more liquidity constrained players are fire selling.

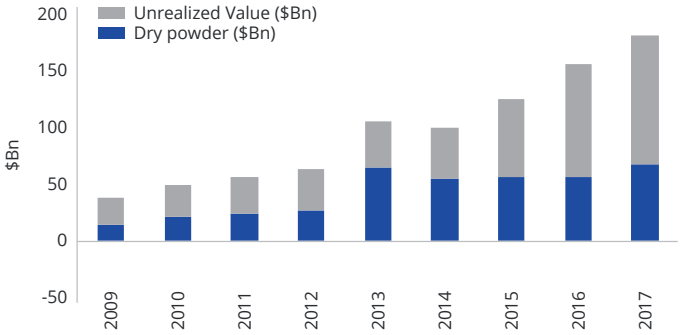
In some cases, though, the manager's main aim is not linked to the requirements of the strategy, but more for self-serving purposes when the manager aims to retain AUM – and therefore income-generating assets – through having his investors locked up for longer. That can delay investor redemptions when investors have lost confidence in the manager or it can make investors opt for other more liquid alternatives – regardless of their opinion on those managers – in case they need to raise cash.

Private structures: This is the natural place of non-traded securities. We can identify several areas of investment here: private equity (non-listed companies), private credit (direct

lending), venture capital (companies which start businesses, often in tech and biotech), physical real estate (offices, residential, commercial or hotels), and infrastructure (privately-owned highways or pipelines, for instance) and natural resources (privately owned mines, forestry and farmland). Some investors place more exotic investments, such as artworks in these structures. The timespan is very varied and can last from a few years (in private credit) to over a decade (infrastructure). Their hit ratio will also span from very high (private credit or infrastructure) to generally low (early stage venture capital).

The key features are a commitment-drawdown-realization capital structure, where investors commit to invest a set amount, and then send money as investments are executed and receive money as they are realized, with back-ended performance fees – only on realized gains. Co-investments are quite frequent in these strategies.

GLOBAL DIRECT LENDING AUM 2009-2017



Source: Prequin

Hybrid vehicles: Which combine liquid and illiquid securities, with the latter working in a drawdown manner, with the capital being contributed by the main fund.

Secondly, there has been a **more solution-driven approach to the industry**. Whereas there are differences between agents in the sector, client-oriented approaches are gaining traction. This focus aims to deliver the strategy in the format that caters best to each client, rather than having a one-size-fits-all approach. The increase in demand for liquid alternative products has prompted the rise of UCITS. More investors of size are now willing to access a strategy through a separate managed account or a fund-of-one because the investor is now more discriminating and not accepting of the terms that are not merited by the strategy. This has driven the push for a wider range of investment options as described above. Together, there has been development of investment alternatives in the following fashion:

Co-investments: When a single trade is especially attractive and/or the size of the trade exceeds the prudent allocation to the fund, the manager may choose to offer direct allocations – through a special purpose vehicle or through direct investments in the trade. In some cases, the model may be tilted towards open architecture, where the investor picks and chooses the trades from a suite offered.

Managed accounts: Either through funds-of-one or through segregated mandates, many investors have opted to have their own segregated portfolios. This gives them more control of the assets and occasionally they can customize the mandate for the manager – for instance, commissioning higher or lower leverage versions, or more concentrated versions of a strategy. The caveats for this are that they involve a larger administrative and operational burden for the investor and require minimum tickets not at the reach of many investors.

Managed accounts can also be the basis for hedge fund platforms, which consolidate smaller tickets of a large number of investors put together by the sponsor of the platform, who also acts as an additional layer of control.

In both cases, it is paramount that the manager maintains the highest standards in terms of compliance, so that clients are treated fairly, and there is no space for a *primus-inter-pares* situation.

Thirdly, **the lines between alternatives and traditional strategies are more blurred** than ever. There has been abundant research and development of factor models, essentially in the equity space, which has led to commoditization of some very simplified strategies and those strategies being subsequently wrapped in 'smart-beta' solutions. In strategies that are only providing exposure to a factor, cost efficiency prevails, pushing alternative managers to add value and not pursue strategies which can be easily replicated.

There are also more products targeted to a traditional audience which use some alternatives tools, such as duration management or macro overlays, added to a traditional core. We are also transitioning from a binary approach to a continuum. Whereas investments in alternatives have been typically looked at in isolation to traditional investing, it is gradually evolving to a situation where investors will look at those portfolio lines in a combined manner and reflect their alpha and beta conviction through shifts towards one or the other.

Obviously, this movement can have implications for the liquidity, as factor packaging can move crowdedness from a single-security concept to a strategy concept, and the use of techniques which may resort to leverage require being aware of those liability items when analysing the liquidity of the book.

Fourthly, **investors demand higher standards of corporate governance**. The financial crisis of 2007-2008 unveiled the fact that certain corporate structures could be subject to abuse. Many investors felt unfairly treated and since then their requirements have been stricter. A higher degree of transparency on expenses and portfolio holdings are some of the most usual demands. The on-shoring trend of which UCITS is part of also has a component of reliance on the higher bar of onshore jurisdictions. In the offshore space, investors have increased their demands to hold voting rights and to clearly delimit what the manager can do before requiring investor consent.

This has also impacted boards' compositions. Whereas it was quite frequent for many funds to have directors who were mere 'yes men' of the manager, the trend is increasingly towards having directors who are truly independent from the manager, who place the manager and the rest of service providers under heightened critical scrutiny and who are accountable to investors as owners of the fund. Therefore, due diligence on fund directors is on the rise. In summary, we are transitioning to structures where the investor occupies the central position as owner of the fund and the manager, despite their discretion within the investment policy, has their mandate and responsibilities clearly defined as one – albeit important – service provider to the fund. Legal structures that look after investor interests more should create a level playing field, increase trust from the investor community and reduce the potential of the managers to take decisions against investors' interest in situations of market stress.

The last change comes in the **regulatory environment**. This is probably the change that has captured most headlines. It seems ironic that in June 2006, Securities and Exchange Commission (SEC) Chairman William Donaldson saw his effort for hedge fund managers to be regulated by the SEC overturned by an appeals court. Back in 2004, the SEC board had taken a split decision that managers running hedge funds with more than 15 investors and over USD30 million in AUM had to register at the SEC. The 2006 ruling stated that the SEC had exceeded their powers when stating that. The rebuke was predicated on the SEC lacking power to decide that the underlying investor, and not the fund, was accountable. In the post-financial crisis world, it makes sense that a blunt exemption like this has no legs, and new regulation has put in place registration requirements for funds managing over USD100 million (or USD150 million in case they qualify for the private fund advisor exemption). EU's AIFM Directive (2011) and MiFID II (2014), and US Dodd-Frank (2010) have been some of the key pieces of legislation that had been put in place in an attempt to mitigate some circumstances that brought about the 2007-08 global financial crisis and its deep consequences. Some of the key objectives for these regulations are as follow:

- Increase investor protection and, more generally, that of consumers of financial products.
- Reduce systemic risk, including creating new institutions for its control and increase transparency from market operators so the current and new supervisors can take more effective action, introduction of resolution mechanisms for orderly winding down of bankrupt firms.
- Coordinate international standards and increase cooperation.

In such an interconnected eco-system as the financial markets, the 2007-08 financial crisis unveiled the transmission mechanisms present for instability to go from one asset class to the next. Commonality of investor base or sources of funding can create stress in the form of selling pressure, illiquidity of constraints to funding that in turn contribute to price declines. As mentioned before, it highlighted the variability of liquidity across time and rekindled the attention in this specific risk as both a source of volatility and of investment opportunities. Losses in one strategy of multi-strategy funds can prompt redemptions that then excise fire selling on other strategies, especially those which invest in more liquid assets. As mentioned, this happened in the quant meltdown in 2007.

Prime brokers which are facing pressure from losses in one of their strategies may place stricter lending limits across the board, putting pressure in managers of unrelated strategies. Managers can mitigate those factors by having adequate liquidity in their vehicles, having in place proper funding structures and diversifying their counterparty complex.

To conclude, we can affirm that we are in a different place in what pertains to liquidity. While measures have been taken to prevent systemic risk, it is also true that the inability of banks to warehouse assets under the current regulatory framework can cause gaps in moments of market shocks. Whereas the market has responded providing more vehicle types which cater to different liquidity profiles, it is ultimately the responsibility of the manager to manage the fund in a manner that is congruent with the liquidity offered to investors and the terms agreed with leverage providers.

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