INVESTMENTS®

Liquidity paradox

How asset and fund liquidity impact portfolio returns

Contents

Traditional stock and bond portfolios have served many investors well for decades. But the long-term market dynamics that propelled solid returns for the traditional 60/40 portfolio have begun to slow or, in many cases, reverse course.[1] Building a portfolio that can meet investor goals going forward may require accessing alternative sources of return and diversification by investing in less-liquid or illiquid assets.

1 McKinsey & Company, "Diminishing Returns: Why Investors May Need to Lower Their Expectations," May 2016.

The 60/40 portfolio isn't adding up like it used to

Traditional stock and bond portfolios have had a great run. Over the last 35 years, equity markets generated annualized returns of approximately 13%[2] while bonds returned 7%[3] per year. Given this past, it's no wonder that an FS Investments survey found investors expect their portfolios to generate an average annualized return of 7% over the next five years.[4] But are such expectations well grounded?

How much return is left in "the 60%" tank?

There's a strong relationship between equity valuations and forward returns. Periods of high equity valuations have historically been followed by relatively low future returns. The inverse is true for periods of low equity valuations. When valuations reached their highest level (fifth quintile) as measured by the CAPE ratio, the average annualized return over the next 10 years was just above 5%, with nearly 20% of such periods generating a negative return.[5]

10-YEAR FORWARD ANNUALIZED RETURNS BASED ON STOCK MARKET VALUATION (CAPE)[5]

	P/E range	Quintile	Average 10-year forward return (annualized)
Low valuation	6.6–12.0	1	15.7%
	12.0–17.2	2	13.7%
	17.2–20.7	3	9.9%
	20.7–25.5	4	6.7%
High valuation	**25.5–44.2**	**5**	**5.1%**

Periods of high equity valuations have historically been followed by relatively low future returns.

2 S&P 500 Index, as of December 31, 2018.

3 Bloomberg Barclays U.S. Aggregate Bond Index, as of December 31, 2018.

4 FS Investments survey administered through Google Surveys to a sampling of 515 investors between March 25, 2019 and March 27, 2019. Respondents indicated they had $100,000 or more of invested assets.

5 Macrobond and FS Investments. S&P 500 Index from January 1950 to December 2018. The CAPE (cyclically adjusted price to earnings) ratio is a valuation measure developed by Yale University professor Robert Shiller that uses real earnings per share over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle. The ratio is generally applied to broad equity indices to assess whether the market is undervalued or overvalued. While the CAPE ratio is a popular and widely followed measure, several leading industry practitioners have called into question its utility as a predictor of future stock market returns.

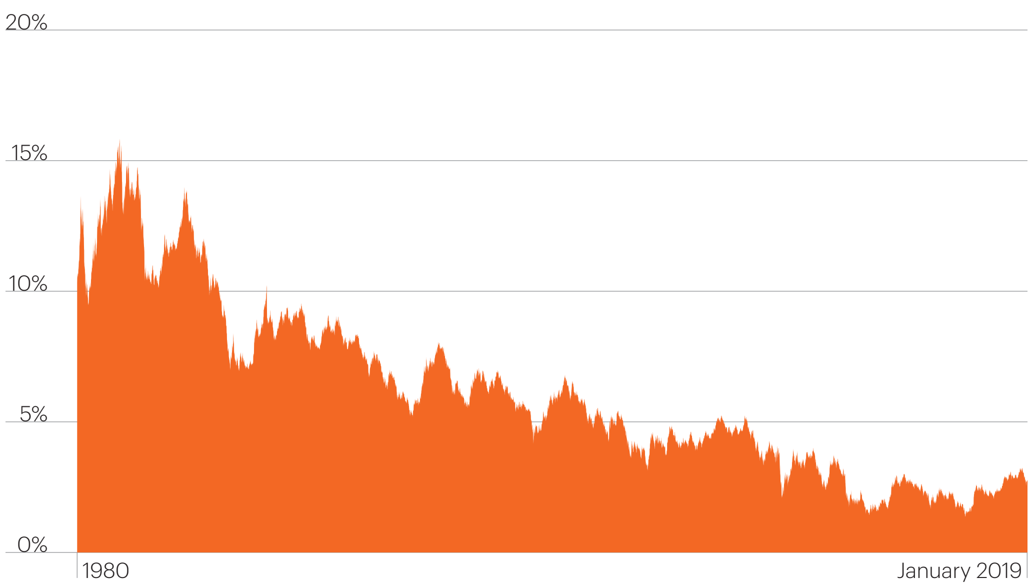
Since 2013, U.S. equity markets have remained firmly within the highest valuation level, sustained largely by unprecedented monetary stimulus. If the historical pattern holds, current equity valuations suggest investors might need to lower their long-term return expectations for the coming years.

How much income is "the 40%" generating?

The prolonged low interest rate environment presents significant challenges for income-seeking investors. The yield of a traditional core fixed income portfolio averaged 2.6% over the past five years, compared to 5.6% over the prior 30 years.[6] Furthermore, as yields have fallen, the duration of a traditional fixed income portfolio has risen from 4.57 years in 2009 to approximately 5.81 years as of March 2019, making a traditional fixed income portfolio more sensitive to changes in interest rates.[6] The low yield environment may limit the upside return potential in many fixed income sectors, while the downside risks could be substantial should interest rates rise or if the pace of the Fed's tightening accelerates.

The yield of a traditional core fixed income portfolio averaged 2.6% over the past five years, compared to 5.6% over the prior 30 years.[6]

10-YEAR TREASURY YIELD



Source: Bloomberg, as of January 24, 2019.

6 A traditional fixed income portfolio is represented by the Bloomberg Barclays U.S. Aggregate Bond Index. The last five-year period is from March 31, 2014 to March 31, 2019. Period shown for prior 30 years is from March 31, 1984 to March 31, 2014. A traditional fixed income portfolio is represented by the Bloomberg Barclays U.S. Aggregate Bond Index. The index shown is for illustrative purposes only. An investment cannot be made directly in an index.

Two challenges with the 60/40

What does all this mean going forward for investors who have relied on a traditional stock and bond portfolio? Today's investing environment may present two unique sets of challenges.

1. THE MATH DOESN'T ADD UP

Let's assume yields remain low and the relationship between equity valuations and forward returns holds true. A traditional fixed income portfolio would generate annual returns of about 3% while equities might average 5% over the next 10 years. A 60/40 portfolio under these conditions would fall well short of investor expectations.

Return of fixed income portfolio (the 40%)			Return of equity portfolio (the 60%)
1.0%			11.0%
2.0%			10.3%
3.0%	Hypothetical fixed income return	Required equity return	**9.7%**
4.0%			**9.0%**
5.0%			8.3%
6.0%			7.7%
7.0%			7.0%
8.0%			6.3%
9.0%	Required fixed income return	Hypothetical equity return	**5.7%**
10.0%			**5.0%**
11.0%			4.3%

Hypothetical 60/40 portfolio performance required to generate a 7.0% annual total return

2. LIQUIDITY COMES AT A COST

The assets that compose a traditional 60/40 portfolio tend to be some of the most liquid. So while a 60/40 allocation has historically met investors' return needs and preference for liquidity, the prospect of lower future returns may provide investors the incentive to look to less-liquid and illiquid investments to achieve their financial goals going forward. Such investments may offer a return premium and/or diversification benefit to help smooth portfolio returns.

SUMMARY

It is important to develop a clear understanding of the role of less-liquid and illiquid investments and how they can be incorporated to manage liquidity across the entire portfolio.

Understanding the liquidity spectrum

There are two ways liquidity applies to investing—the liquidity of individual securities and the liquidity of the fund or investment vehicle used to invest in those securities.

It is important investors understand the distinction. While many recognize how security selection impacts their investment returns, few likely appreciate how an investment structure can impact their experiences as well as limit or expand the potential investment universe.

Defining the liquidity spectrum

Liquidity is defined as the ease with which an investment can be bought or sold without significantly impacting the price of the security. Investments that can be easily bought or sold are said to be liquid while the inverse is true for illiquid investments.

From a fund perspective, those that allow investors to purchase or redeem their investment on an intraday or daily basis are liquid while the frequency for less-liquid and illiquid funds tends to be over longer intervals. Some less-liquid funds offer liquidity on a monthly, quarterly or annual basis while illiquid funds may require hold periods of up to 10 years. Thinking about liquidity as a spectrum can help investors understand how liquidity relates to different assets.

Liquidity is the ease with which an investment can be bought or sold without significantly impacting the price of the security.

THE LIQUIDITY SPECTRUM WITHIN ASSET CLASSES

	LIQUID					ILLIQUID
Equity	Large-cap stocks	Mid-cap stocks	Small-cap/ emerging market stocks	Preferred stock	Private equity real estate	Private equity venture capital
Fixed income	U.S. Treasuries	Investment grade corporate debt	High yield Emerging market debt	Structured products Distressed debt	Private real estate debt	Private corporate debt

How easily assets may be converted to cash can vary considerably. Traditional investments, including many stocks and U.S. Treasury bonds, can be easily bought and sold, so they are considered highly liquid. On the opposite end of the spectrum are illiquid investments, such as private debt and private equity. Illiquid asset classes typically have fewer buyers and sellers than more-liquid investments and tend to lack standardized terms, making it harder for investors to quickly analyze, value and, in turn, buy or sell them.

Sitting in between these extremes are assets that may exhibit attributes of both liquid and illiquid investments. For example, stocks of small-cap companies typically trade on a centralized exchange much like their liquid, large-cap peers. However, because small-cap companies have fewer shares outstanding or the value of their shares is lower, many small-cap stocks tend to be thinly traded and, in turn, less liquid.

Other less-liquid investments have an active secondary market but trade over the counter (OTC) through banks or a dealer network as opposed to a centralized exchange. For example, high yield bonds trade OTC through hundreds of financial institutions and brokerages. The lack of centralized pricing and the otherwise fragmented nature of the market makes it more difficult to buy and sell compared to more-liquid fixed income investments.

Incorporating less-liquid and illiquid investments into a portfolio

Investing in less-liquid and illiquid investments may be uncharted territory for many investors. But the key considerations for investing in them should feel familiar as it begins with selecting assets that align to their financial goals and risk tolerance. From there, it's an exercise in matching the asset class with the management style and investment structure best suited to help deliver the return or diversification benefits of investing in that asset class.[7]

STEPS TO CONSTRUCTING A PORTFOLIO WITH LESS-LIQUID & ILLIQUID ASSETS

1

Asset selection
Identify asset classes and investment strategies that may best meet specific investment objectives.

2

Management type
Assess the size, liquidity and efficiency of the market to determine whether an active or passive management approach is appropriate.

3

Investment structure
Find the investment structure best suited to maximize the benefits of investing in the asset class or strategy and appropriately manage the associated risks.

7 Less-liquid assets are suitable only for investors who can bear the risks associated with limited liquidity and should be viewed as a long-term investment.

1 Select an asset class that aligns with the investment objective

Investors have long turned to public stocks for growth and to high-quality corporate and government bonds for income. The same approach can be applied when evaluating less-liquid and illiquid assets. For example, investors seeking growth might complement or replace their allocation to large-cap stocks with less-liquid investments, such as small-cap or thinly traded stocks, or illiquid investments, such as private equity. Likewise, investors seeking income may look to less-liquid investments like high yield bonds or leveraged loans, or illiquid investments such as private debt, to complement or replace their allocation to traditional investments.

Aside from liquidity risks, less-liquid and illiquid investments may carry other risks specific to the market or asset class. As discussed in step 3, aligning the asset class and investment strategy with the appropriate investment structure may help manage some of these risks.

Investors seeking income may look to less-liquid investments or illiquid investments to complement or replace their allocation to traditional investments.

MATCHING ASSET CLASS WITH INVESTMENT OBJECTIVE

	Less-liquid & illiquid investments	Income	Capital appreciation	Low-moderate correlation to traditional portfolio
Equities	Preferred stock	●	●	
	Equity-linked notes	●	●	●
	Venture capital		●	●
	Private equity		●	●
Fixed income	High yield bonds	●		●
	Leveraged loans	●		●
	Emerging market debt	●		●
	Structured products	●	●	●
	Private corporate debt	●		●
Real assets	Private equity real estate	●	●	
	Private real estate debt	●		

Although individuals and institutions have different goals and liquidity needs, individuals may look to institutions as a guide when considering the potential benefits and pitfalls of investing in less-liquid and illiquid assets. Pension funds, endowments and other institutions have historically allocated a meaningful portion of their portfolios to less-liquid and illiquid assets, including private debt, private equity and absolute return or hedge fund strategies. Yale University's endowment is an often-cited example of an institution that invests heavily in illiquid and alternative strategies, which represent approximately 75% of its portfolio.[8]

8 Yale Endowment Update 2017, as of June 30, 2018. Illiquid and alternative strategies are composed of allocations to absolute return strategies, leveraged buyouts, natural resources, real estate and venture capital.

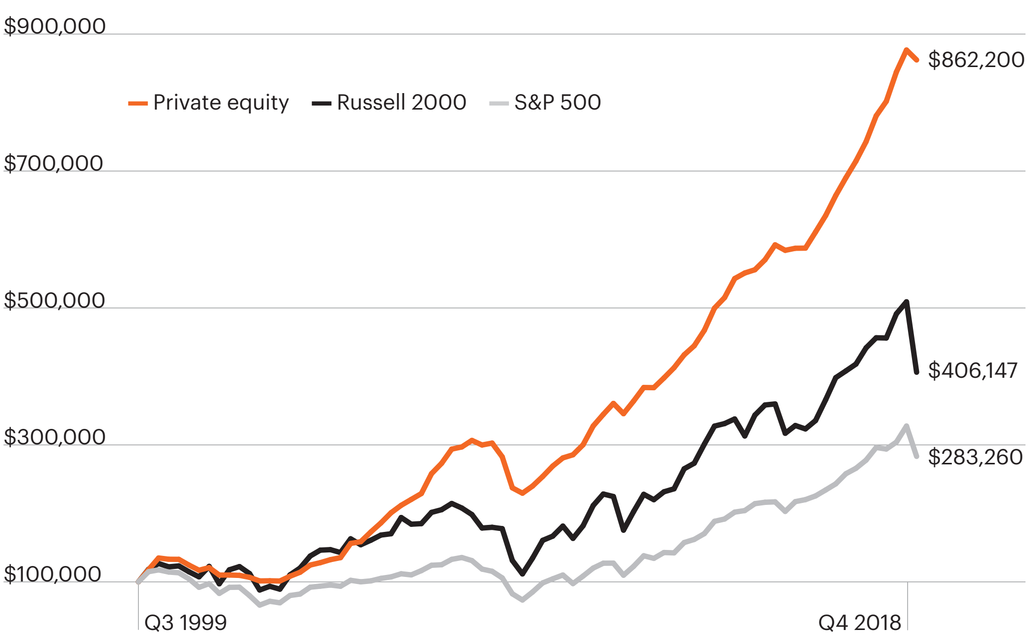
Institutions have historically turned to less-liquid investments for two key purposes: to generate a potential return or yield premium, and to smooth portfolio returns by adding investments with lower volatility or correlation to traditional investments.

Generating a return premium

Investors typically demand a higher rate of return in exchange for giving up liquidity. This is commonly referred to as the illiquidity premium. Illiquidity premiums can change over time. They tend to increase during times of market stress and narrow during periods of low market volatility.[9]

The return premium is well evidenced within the private equity market, which refers to investments in private companies whose shares are not listed on a public exchange. Private equity funds have outperformed the public markets on average by over 6% per year over the last 20 years while assuming a low amount of liquidity and other potential risks. In addition, small-cap stocks have generally outperformed their large-cap peers over the long term, demonstrating the return premium available in less-liquid securities.

GROWTH OF A HYPOTHETICAL $100,000 INVESTMENT (1999–2018)



Private equity funds have outperformed the public markets on average by over 6% per year over the last 20 years.

Source: As of December 31, 2018. Private equity is represented by Cambridge Associates U.S. Private Equity Index. Past performance is not indicative of future results.

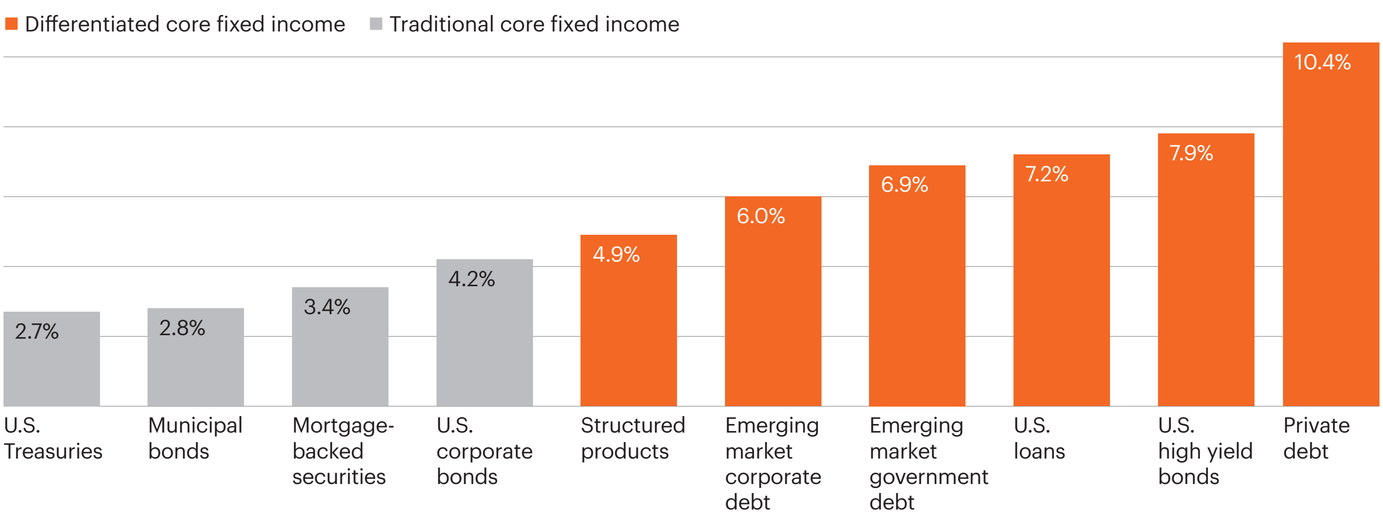
9 Alternative Investment Analyst Review, "Investment Considerations in Illiquid Assets," CAIA Association, Q3 2013, Vol. 2, Issue 2.

COMPARISON OF ANNUALIZED TOTAL RETURNS (AS OF 12/31/2018)

Index	10 years	15 years	20 years
Cambridge Associates U.S. Private Equity Index	14.07%	13.35%	12.03%
Russell 2000 Index	11.97%	7.50%	7.40%
S&P 500 Index	13.12%	7.77%	5.62%

The global credit markets present another example. A traditional fixed income portfolio, represented by the Bloomberg Barclays U.S. Aggregate Bond Index (Barclays Agg), yields approximately 3.5% in today's market. The assets underlying the index are all fixed rate, including U.S. Treasuries and investment grade municipal and corporate bonds as well as agency securities (Fannie Mae and Freddie Mac). Beyond the scope of core fixed income, there's a broad opportunity to generate a yield premium in assets such as high yield bonds, leveraged loans, emerging market debt, sovereign debt and asset-backed securities. These areas of the credit markets are often less liquid and harder to access compared to the more-liquid, traditional fixed income investments underlying the Barclays Agg.

COMPARISON OF CURRENT YIELDS ACROSS MAJOR ASSET CLASSES



Past performance is not indicative of future results.

Source: Bloomberg, as of December 31, 2018. Differentiated core fixed income refers to the income generated by non-core fixed income investments (including, but not limited to, emerging market government debt, high yield bonds, emerging market corporate debt and structured products). The yields of these investments may be higher than the those of traditional core fixed income investments (including, but not limited to, U.S. Treasuries, investment grade corporate bonds and U.S. municipal bonds). Investing in non-core asset classes may carry a variety of risks, including credit risk and liquidity risk. U.S. Treasuries are represented by the ICE BofAML 10-Year U.S. Treasury Index. Municipal bonds are represented by the ICE BofAML U.S. Municipal Securities Index. Mortgage-backed securities are represented by the ICE BofAML U.S. Fixed Rate CMBS Index. U.S. corporate bonds are represented by the ICE BofAML U.S. Corporate Master Index. Structured products are represented by the J.P. Morgan CLOIE Index and Clarity Solutions Group, LLC. Emerging market corporate debt is represented by the J.P. Morgan CEMBI Broad Index. Emerging market government debt is represented by the J.P. Morgan EMBI Global Index. U.S. loans are represented by the S&P/LSTA Leveraged Loan Index. U.S. high yield bonds are represented by the ICE BofAML U.S. High Yield Index. Private debt is represented by the Cliffwater Direct Lending Index (trailing four quarters income return).

Low correlation to traditional investments

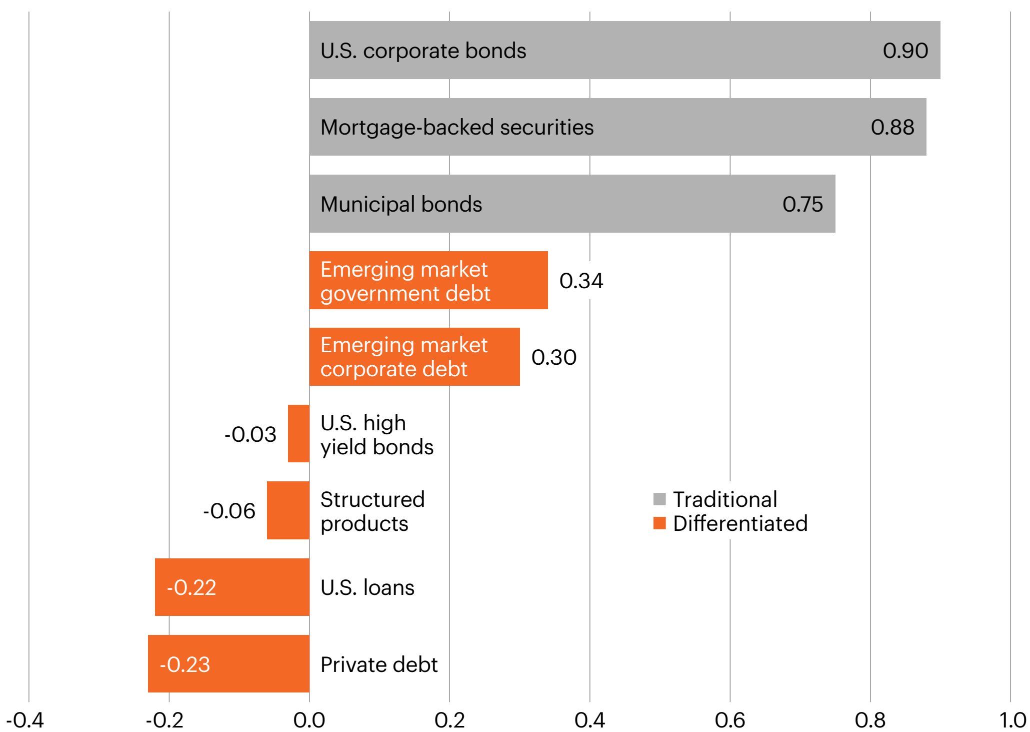
Finding low-correlated assets, or assets that do not move in relation to one another, is key to building diversified portfolios. Less-liquid and illiquid investments have historically exhibited lower correlation to traditional fixed income investments.

CORRELATION TO S&P 500 INDEX (1/1/2000–12/31/2018)

Source: Private equity is represented by the Cambridge Associates U.S. Private Equity Index.

The last five years reflect a shift from the previous 15 years for traditional fixed income investments, with lower returns and increased correlation to other asset classes.

CORRELATION TO THE 10-YEAR U.S. TREASURY (2013–2018)



Source: Bloomberg. December 31, 2012 to December 31, 2018. U.S. corporate bonds are represented by the ICE BofAML U.S. Corporate Master Index. Mortgage-backed securities are represented by the ICE BofAML U.S. Fixed Rate CMBS Index. Municipal bonds are represented by the ICE BofAML U.S. Municipal Securities Index. Emerging market government debt is represented by the J.P. Morgan EMBI Global Index. Emerging market corporate debt is represented by the J.P. Morgan CEMBI Broad Index. U.S. high yield bonds are represented by the ICE BofAML U.S. High Yield Index. Structured products are represented by the J.P. Morgan CLOIE Index and Clarity Solutions Group, LLC. U.S. loans are represented by the S&P/LSTA Leveraged Loan Index. Private debt is represented by the Cliffwater Direct Lending Index (trailing four quarters income return).

Diversification does not eliminate the risk of experiencing investment losses.

Improving risk-adjusted returns

Institutions have also long turned to less-liquid and illiquid investments to help smooth the returns of their portfolios to drive long-term performance. As illustrated in the hypothetical portfolios below, adding a 10% to 20% allocation of various less-liquid and illiquid investments to a traditional 60/40 portfolio would have helped to enhance returns or reduce volatility — sometimes both — over the last 20 years. For purposes of the illustration below, we use private equity and private debt as replacements for traditional stocks and bonds, respectively, as well as an allocation to private real estate. The blended portfolio of private equity, private debt and private real estate assumes an equal allocation among the asset classes within the 10% and 20% allocations.

IMPACT OF ADDING LESS-LIQUID AND ILLIQUID ASSETS TO A 60/40 PORTFOLIO (9/30/2004–12/31/2018)

		Return	Volatility	Sharpe ratio
Stocks/bonds	60/40	6.7%	8.58%	0.62
Private equity (PE)	55/35/10	7.5%	8.55%	0.72
	50/30/20	8.2%	8.56%	0.80
Private debt	55/35/10	7.1%	8.09%	0.71
	50/30/20	7.4%	7.62%	0.80
Private real estate	55/35/10	6.8%	7.99%	0.68
	50/30/20	6.8%	7.43%	0.74
Blended portfolio (PE/loans/real estate)	55/35/10	7.1%	8.21%	0.70
	50/30/20	7.5%	7.85%	0.78

Adding a 10%–20% allocation of less-liquid and illiquid investments to a traditional 60/40 portfolio would have helped to enhance returns or reduce volatility.

Source: The hypothetical 60/40 portfolio is represented by the S&P 500 Index and Bloomberg Barclays U.S. Aggregate Bond Index. Private equity is represented by the Cambridge Associates U.S. Private Equity Index. Private real estate is represented by a 50/50 allocation to the NFI-ODCE Index and the Giliberto-Levy Commercial Mortgage Index. Private debt is represented by the Cliffwater Direct Landing Index.

Sharpe ratio is an asset's excess return (the amount over the risk-free rate) divided by the standard deviation of excess returns. A higher value generally signifies a more attractive risk-adjusted return.

Past performance is not indicative of future results. This data is for illustrative purposes only and is not indicative of any investment. An investment cannot be made directly in an index.

2 Determine whether an active or passive management approach is appropriate

The next step after aligning an asset class with an investment objective is to focus on the management approach. Investors should consider which management strategy — active or passive — best helps maximize the return and/or diversification benefits of the selected asset class and manage the key risks associated with it.

Passive, or "index-style," investing seeks to gain broad, low-cost exposure to a financial market or asset class. Passive strategies, by definition, require that a market or asset class is large and liquid, with many buyers and sellers, in order to easily access and track the assets and performance of the underlying index. In contrast, actively managed investment strategies are designed to generate "alpha," or excess returns, relative to a benchmark. Less-liquid and niche markets may be better suited for an active manager where a market's opacity, complexity or inefficiency requires human analysis and decision making.

The following table compares some pros and cons of active and passive strategies as well as the ideal market attributes for each.

	Passive strategies	Active strategies
Ideal market attributes	• Large markets • Highly liquid, with many market participants • High trade frequency • High price transparency • Information shared widely and quickly	• Typically smaller, niche markets • Less liquid, with a small number of participants • Low trade frequency • Low price transparency • Limited public disclosure of financial information
Investment examples	• Large-cap stocks • Investment grade corporate/government bonds • Currencies • Commodities	• High yield bonds • U.S. loans • Emerging market debt • Structured products • Private corporate debt & equity • Private commercial real estate debt & equity

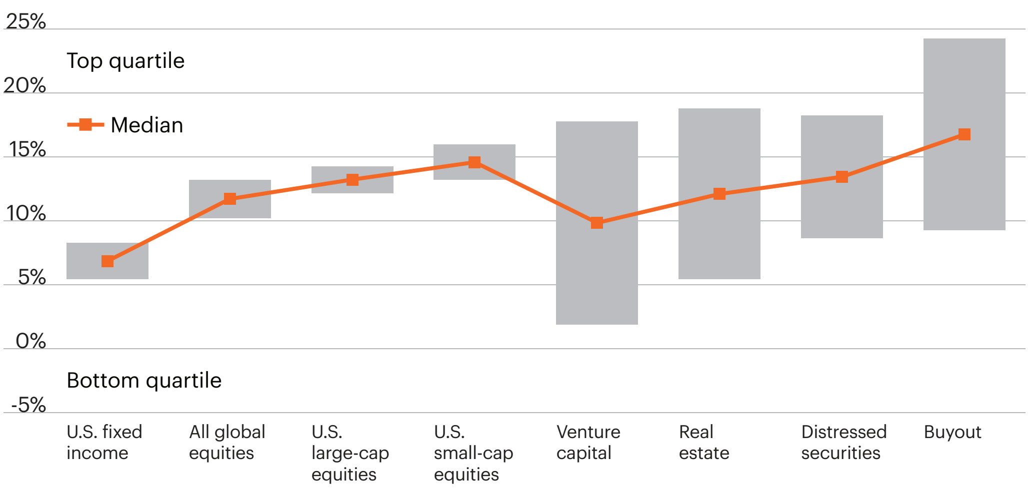
Comparing performance in less-liquid and illiquid markets

There's no denying that passive strategies have demonstrated their value in particular markets and economic conditions. Passively managed funds have benefited from generally benign market volatility as investors sought low-cost ways to gain exposure to the broad market strength over the last decade. Since the financial crisis, assets under management for passive strategies have increased dramatically. Over 45% of U.S. equity assets were in passive funds, which had inflows totaling $506 billion in 2018.[10]

Despite the rising adoption rate, the chart below shows that active management can have a more meaningful impact on the returns of less-liquid and illiquid investments than traditional liquid strategies. This point is perhaps best evidenced through the dispersion of average annual returns between top- and bottom-quartile managers across liquid and illiquid asset classes. From 2000–2015, the dispersion of returns for actively managed U.S. large-cap and fixed income funds was just 3% and 4%, respectively. Conversely, the average difference in annual returns between the top- and bottom-quartile fund managers investing in less-liquid and illiquid assets such as private equity (buyout) or distressed securities was 13% and 10%, respectively.

Research shows that active management can have a more meaningful impact on the returns of less-liquid and illiquid investments than traditional liquid strategies.

THE PERFORMANCE DIFFERENCE BETWEEN TOP AND BOTTOM QUARTILE MANAGERS



Source: Cambridge Associates, eVestment, as of Q3 2017. Data for alternative investments based on the average since-inception internal rate of return for vintage years 2000–2015 from Cambridge Associates. Data for traditional asset classes based on average compound annual growth rate for time periods 2000–Q3 2017, 2001–Q3 2017, etc., through 2010–Q3 2017 from eVestment Alliance database to match the alternative asset class time frame.

10 Morningstar 2018 Global Asset Flows Report, as of December 31, 2018.

3 Match the asset class and investment strategy with the right investment structure

Investing through the right fund type, or structure, is critical when investing in less-liquid and illiquid assets or strategies that require a long-term investment horizon. A mismatch between the liquidity of assets and fund structure may limit a fund's return potential or subject investors to unnecessary risks.

Defining the fund liquidity spectrum

Before discussing how investors can effectively match the liquidity of an asset and investment strategy with the appropriate structure, let's first review the liquidity spectrum of investment funds.

THE FUND LIQUIDITY SPECTRUM

LIQUID	LESS-LIQUID	ILLIQUID
Exchange-traded funds	Unlisted NAV REITs	Hedge funds
Publicly traded closed-end funds	Closed-end interval funds	Private equity/debt funds
Open-end mutual funds	Unlisted closed-end funds	Venture capital funds

Most retail-oriented funds are liquid and fall within the open-end or closed-end fund category. These funds are registered investment companies under the Investment Company Act of 1940, which requires fund issuers to disclose material information an investor would need to make an informed decision.[11] 1940 Act funds are regarded as having a high degree of transparency and investor protections given their:

- Public reporting requirements with the SEC
- Constraints on the use of leverage and derivatives
- Restrictions on certain transactions with insiders and affiliates
- Limitations on investing in other funds

Open-end funds

Open-end funds are commonly known as mutual funds, which continuously offer their shares and allow for daily investor redemptions at net asset value. Exchange-traded funds (ETFs) also fit within the open-end fund category but, with intraday liquidity, sit at the most liquid end of the spectrum. Open-end funds typically invest in highly liquid securities, including stocks, bonds and commodities. In fact, no more than 15% of an open-end fund's net assets may be in illiquid investments. With over $22 trillion invested in U.S. ETFs and mutual funds, the open-end fund industry has experienced robust growth over the past 25 years due to a number of factors, including asset appreciation, the growth of defined-contribution retirement plans and an aging U.S. population.[12] This growth also likely reflects investors' natural bias toward liquidity.

No more than 15% of an open-end fund's net assets may be in illiquid investments.

11 SEC, "The Laws That Govern the Securities Industry," https://www.sec.gov/answers/about-lawsshtml.html#invcoact1940.
12 ICI, 2018 Investment Company Fact Book.

Publicly traded closed-end funds

In contrast to open-end funds, traditional (publicly traded) closed-end funds issue a fixed number of shares to investors during an initial public offering (IPO). Following the IPO, the shares are traded on an exchange just like a stock. There are over 550 traditional closed-end funds in the U.S. today, totaling over $238 billion in assets.[13]

From a liquidity perspective, traditional closed-end funds differ from mutual funds in two primary ways:

- Closed-end funds may hold a significant portion of their portfolios in illiquid investments.
- The permanent capital base of closed-end funds helps ensure that the managers are not forced to sell assets to meet investor redemptions.

As a result, closed-end funds are better suited to invest in and manage illiquid assets or strategies that require a long-term hold period compared to mutual funds and ETFs.

Illiquid funds

On the opposite end of the spectrum are illiquid funds, such as hedge funds, private equity funds and venture capital funds. These funds typically invest in less-liquid and illiquid assets or employ investment strategies that require a long-term hold period. Investment in private funds has historically been limited to large institutions such as pension funds, endowments and sovereign wealth funds. Barriers to investing in institutional funds include:

- High investment minimums (often greater than $5 million) and eligibility standards
- Limited liquidity
- High fees
- General lack of regulatory protections

13 Morningstar, as of December 31, 2018.

Unlisted closed-end funds, interval funds and REITs

Sitting in between the extreme ends of the spectrum are unlisted REITs, closed-end interval funds and unlisted closed-end funds. Like traditional closed-end funds, interval funds and unlisted closed-end funds do not need to manage daily investor redemptions.

Unlisted closed-end funds, interval funds and unlisted REITs can invest substantial portions of their portfolios in illiquid investments. These funds offer shares on a continuous basis and provide investors the ability to redeem shares at defined intervals, typically monthly, quarterly or semiannually. The biggest difference between unlisted closed-end funds and interval funds is that interval funds must provide at least 5% liquidity to investors on a quarterly basis and up to 25% annually. Unlisted closed-end funds are not required by mandate to offer liquidity; however, many in the market today provide liquidity through quarterly tender offers.

A CLOSER LOOK AT INTERVAL FUNDS AND NON-TRADED CLOSED-END FUNDS

	Open-end fund	Unlisted NAV REIT	Closed-end interval fund	Unlisted closed-end fund	Private placement hedge fund
Publicly offered	Yes	Yes	Yes	Yes	No
Daily liquidity	Yes	No	No	No	No
1940 Act governance	Yes	No	Yes	Yes	No
15% limit on illiquid assets	Yes	No	No	No	No
1099 tax reporting	Yes	Yes	Yes	Yes	No
Leverage	No	Yes, subject to 300% asset coverage limit	Yes, subject to 300% asset coverage limit	Yes, subject to 300% asset coverage limit	Yes (no limit)
Investor suitability	No minimum eligibility	Subject to blue sky/NASAA guidelines	No minimum eligibility	No minimum eligibility	Generally, “qualified purchaser” ($5M of net investments)

Finding the right match

The discussion below brings together the two liquidity spectrums. In the simplest terms, matching similar levels of asset and fund liquidity is generally a sound approach. Matching opposite ends of the liquidity spectrum, however, requires a more cautious approach.

Given the high barriers to investing in private funds such as private equity, hedge funds and venture capital funds, the summary below focuses on investment vehicles designed to help individual investors access less-liquid and illiquid investments.

MATCHING ASSET LIQUIDITY WITH FUND LIQUIDITY

High asset liquidity, high fund liquidity

Investing in liquid assets through liquid funds, such as mutual funds and ETFs, is a sound approach for both fund managers and investors. The alignment helps ensure that a manager can easily buy and sell assets to meet investor requests to purchase or redeem their shares on a daily basis.

One potential drawback of liquidity, however, is that it can cause investors to make decisions based on fear or greed. The 20-year annualized return of the S&P 500 was 7.2% while the average equity mutual fund investor's return was just 5.3%.[14] The difference in performance suggests that many investors made decisions based on short-term market movements instead of staying invested for the long term.

High asset liquidity, low fund liquidity

Investors should refrain from giving up liquidity if a fund's investment strategy or underlying asset class doesn't warrant it. For example, it wouldn't be prudent to invest in a long-only strategy focused on U.S. large-cap stocks through a limited-liquidity fund. Why give up liquidity when U.S. large-cap stocks are highly liquid and the relatively low dispersion of returns among large-cap funds suggests a liquidity premium isn't prevalent in the investment strategy?

On the other hand, there are some situations in which high asset liquidity and low fund liquidity can benefit an investor. For example, an event-driven strategy often requires a long-term hold until the occurrence of a specific corporate event. A limited liquidity fund helps ensure a manager is not a forced seller ahead of an event which may serve as a catalyst to generate return.

14 Dalbar, 24th Annual Quantitative Analysis of Investor Behavior. Period ending December 31, 2017.

Low asset liquidity, low fund liquidity

Investing in less-liquid and illiquid assets through illiquid fund structures has been the preferred method for institutional investors seeking to access less-liquid and illiquid assets. Private equity, venture capital and hedge funds are some of the most common examples. The long-term, illiquid nature of these funds typically aligns to the highly illiquid nature of the underlying investments and strategies.

Non-traded closed-end funds and interval funds are not new investment structures, but they have grown in popularity as asset managers have increasingly turned to less-liquid investment structures to provide institutional-type strategies to a broader public investing audience. Like interval funds, non-traded closed-end funds provide other attributes of private institutional funds, including the use of leverage and derivatives, yet retain the investor protections required for 1940 Act funds.

Low asset liquidity, high fund liquidity

Investing in predominantly less-liquid and illiquid investments through highly liquid funds could be a recipe for disaster, especially during periods of market stress. Selling illiquid assets becomes increasingly difficult during turbulent markets as investors seek the perceived safety of liquid assets.

As witnessed during the financial crisis, falling asset prices resulted in a wave of investor redemptions across liquid and illiquid funds. At the same time, large global banks and other financial institutions were forced to sell assets to either maintain regulatory capital ratios or pay liabilities. The resulting selling pressure further fueled the decline in asset prices and made selling illiquid assets nearly impossible or possible at significantly distressed prices.

Even in more normalized environments, investing in illiquid assets through liquid fund structures poses significant risks for investors. A manager’s investment thesis and strategy may be ultimately proven right over the long term; however, investor redemptions can significantly impair a manager’s ability to execute its strategy. In extreme cases, redemptions may force a manager to sell assets at inopportune times, which can create losses for investors.

Summary

Investors relying on a traditional 60/40 portfolio to meet financial goals based on returns of the last 35 years—which includes one of the longest-running bull markets—may be setting themselves up for disappointment going forward. Today's investing environment poses serious challenges to investor expectations, and relying 100% on liquid assets in a typical traditional portfolio may mean the "safety" of liquidity will come at a cost. Understanding liquidity as it relates to both assets and fund structures can help investors make informed choices when constructing their portfolios.

Accessing and maximizing the return and diversification potential of less-liquid and illiquid investments takes a thoughtful approach to matching the liquidity of the asset class, management style and investment structure. A trusted financial advisor can help investors balance their liquidity needs when investing to reach their short- and long-term financial goals.

This information is educational in nature and does not constitute a financial promotion, investment advice or an inducement or incitement to participate in any product, offering or investment. FS Investments is not adopting, making a recommendation for or endorsing any investment strategy or particular security. All views, opinions and positions expressed herein are that of the author and do not necessarily reflect the views, opinions or positions of FS Investments. All opinions are subject to change without notice, and you should always obtain current information and perform due diligence before participating in any investment. FS Investments does not provide legal or tax advice and the information herein should not be considered legal or tax advice. Tax laws and regulations are complex and subject to change, which can materially impact any investment result. FS Investments cannot guarantee that the information herein is accurate, complete or timely. FS Investments makes no warranties with regard to such information or results obtained by its use, and disclaims any liability arising out of your use of, or any tax position taken in reliance on, such information.

Any projections, forecasts and estimates contained herein are based upon certain assumptions that the author considers reasonable. Projections are necessarily speculative in nature, and it can be expected that some or all of the assumptions underlying the projections will not materialize or will vary significantly from actual results. The inclusion of projections herein should not be regarded as a representation or guarantee regarding the reliability, accuracy or completeness of the information contained herein, and neither FS Investments nor the author are under any obligation to update or keep current such information.

All investing is subject to risk, including the possible loss of the money you invest.

To learn more about investing in alternatives, visit
fsinvestments.com

© 2019 FS Investments www.fsinvestments.com