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Private Market Insights

A NEWSLETTER

The Cost of Liquidity

Opportunity cost—a simple idea from economics that many of us studied in school but that we naturally learned much earlier. It's the concept of give and take. In choosing one option, you forgo another, and there's an associated cost with that choice. This pervades every aspect of our lives and has for a long time.

The same principle exists and must constantly be evaluated in the world of investing. Giving up return for lower risk has been both a guiding principle and a common theme in building portfolios for decades. Similarly, when it comes to the private markets, a common theme that often dominates the conversation is the *illiquidity premium*—or giving up liquidity in exchange for higher return.

However, the flip side of the coin is much less talked about, yet arguably just as important. We believe that there is an associated premium in both the public and private markets—the difference is whether you are paying or receiving it. **In this edition of *Private Market Insights*, we aim to demonstrate that liquidity comes at a cost, and that its role in the portfolio ought to be reimagined.**

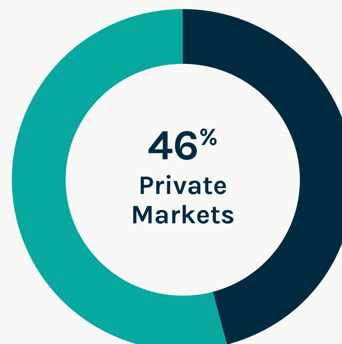
A brief history of liquidity in portfolios

Since the dawn of Harry Markowitz's 60/40 portfolio in the 1950s, the individual investor portfolio has largely been defined by some combination of liquid assets (usually stocks and bonds). For the remainder of the 20th century, that allocation worked quite well, offering investors an acceptable level of return and mild diversification. However, in the most recent down market in 2022, when both stocks and bonds plummeted, many started to rethink this framework. **This rethinking was largely due to public equity and debt markets becoming more concentrated and correlated.** In fact, after a negative correlation between stock and bonds in the first two decades of the 21st century, it has since soared to 0.73,[1] reminding some investors of the positive stock-bond correlations of the 1970s, 80s and 90s.

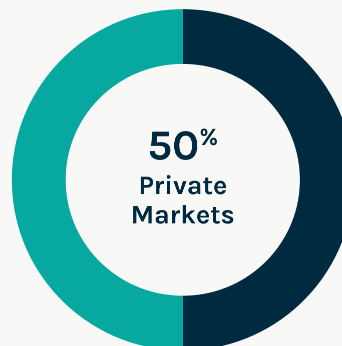
But there is more to the story than just correlation. David Swensen, father of the Endowment Model, is widely known for laying the groundwork for private markets in institutional portfolios. His model suggested that superior diversification was found outside of the public markets, and that illiquid assets offered higher returns over the long run. The Yale endowment he ran adopted this strategy in 1985. Suffice it to say that many endowments and institutions alike quickly followed suit. In fact, today, endowments of $1 billion or more are allocated ~46% to the private markets, while U.S. family offices are allocated ~50%. But why? Well, it turns out that Swensen was right, and in fact, his thinking is very much applicable to the individual investor. You see, the Endowment Model's framework was constructed on the premise that the liquid portion of the portfolio should align with the investor's short-term needs (i.e., current expenses). What was left over—the long-term needs—was allocated to illiquid, higher-returning assets that were designed to accumulate capital over time. A simple yet powerful model.

Institutional private markets allocation

$1B Endowments[2]



Family Offices[3]



While this may have been irrelevant to the individual investor 10 years ago, private markets are only becoming more accessible, driven primarily by the proliferation of evergreen (perpetual-life), semi-liquid funds that can feature affordable investment minimums and quarterly liquidity. As such, this idea of liquidity is even more important to (re)consider. Thus, our goal is to help you answer the question: **How much liquidity do I actually need in my portfolio?**

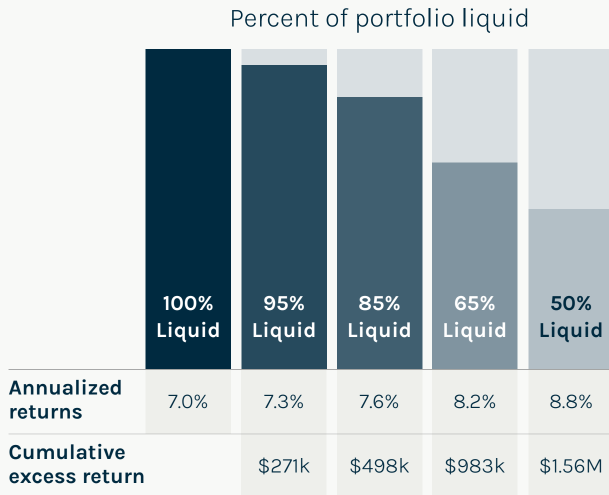
1. Represents correlation between MSCI World and Bloomberg US Agg between Jan 2021 and Sep 2024.
2. Source: UBS Global Family Office Report 2024.
3. Source: 2022 NACUBO-TIAA Study of Endowments (most current available). Data prepared February 2023 and scaled to exclude 3% cash and 3% other.

Past trends do not imply, predict or guarantee future results.

The first cost of liquidity: upside

So, let's circle back to that idea of an *illiquidity premium* we mentioned earlier. Just how much excess return have investors received in exchange for liquidity? Below, we examine the return profile of a handful of portfolios across the liquidity spectrum.

20 years of historical returns, by liquidity profile



	100% Liquid	95% Liquid	85% Liquid	65% Liquid	50% Liquid
Annualized returns	7.0%	7.3%	7.6%	8.2%	8.8%
Cumulative excess return		$271k	$498k	$983k	$1.56M

Source: Bloomberg, Burgiss, NCREIF. Analysis range: Sep 2004 – Sep 2024 (earliest available). Liquid investments include a 60/40 split between global equities and fixed income (pro rata). Illiquid investments include a blend of private equity, private credit, private real estate and private infrastructure.

See endnotes for indices used

* On a $1 million initial investment, compared to the 100% liquid portfolio.

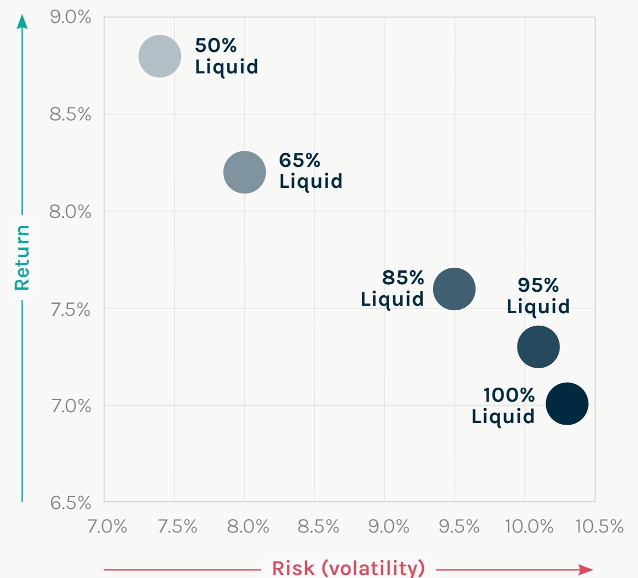
Over the past 20 years, subscribers to the 60/40 model have done well to earn a 7% annualized return. But what did they miss out on? A lot! Depending on how much illiquidity was taken on, returns improved dramatically. Even small amounts of illiquidity, corresponding to seemingly small jumps in annualized returns, have big dollar gain differences when compounded over time.

> $1 million invested in a 50/50 liquid/illiquid portfolio would have achieved $1.5 million in excess return over the 100% liquid 60/40 over 20 years.

This is why institutions have such substantial allocations to the private markets: Over the long run, it has rewarded many handsomely.

Generally, across asset classes, private markets have offered a higher level of return per unit of risk. On the risk-return chart, any movement up and to the left represents a more efficient portfolio. We can see that every incremental allocation to private markets moves the portfolio in that direction. In fact, the 50% liquid portfolio was able to gain ~200 bps of excess return and reduce volatility by the same amount. In other words, the fully liquid investor missed out on ~200 bps of return per year and in the same breath took on ~200 bps more in volatility in the portfolio! Less return, more anxiety… ouch.

Risk and return, by liquidity profile



Portfolios correspond to portfolios above. Volatility is not the only measure of risk. Be sure to evaluate all risk factors of the private markets.

See endnotes for indices used

But maybe a 50% liquid portfolio isn't realistic for you and your clients. But what about 95%? 85%? 65%? Well, once you break the 100% liquidity constraint, the difference between 5, 10, 15 or 30% illiquidity quickly becomes more digestible.

The second cost of liquidity: downside

All this talk about return and premiums—what about the downside? Aren't private investments riskier than stocks and bonds? This is another misconception bred from the illiquidity premium framework. Yes, there are certain risks that come with having your money tied up longer. But again, how much are you risking your and/or your clients' wealth when it is T+1 liquid?

We already looked at volatility of returns, which is one of the measures of risk. It does well to convey the certainty, or lack thereof, that accompanies returns. But to give a clearer picture of risk, we often look to periods of stress in the markets to see how investments perform on the downside. **History has shown that during market duress, liquidity comes at a dear price.**

It is in these times especially that the illiquidity of private markets acts in the best interest of the investor. In a world of completely liquid portfolios, market shocks result in millions of investors exercising their liquidity—often at the worst times and usually to their and everyone else's peril. (When you want liquidity, so does everyone else.)

Meanwhile, private markets investors have largely stayed invested, and in turn experienced a fraction of the panic and losses associated with these downturns. What many may not fully appreciate is that the effect of a crash on investors' portfolios is twofold: It crushes the current value of the portfolio, but it also hinders the portfolio on the way back up. Gains and losses are not created equal, as the return required to recover from losses is not linear.

> Losing 50% of value is not as simple as gaining back 50%. You must gain back double your losses (100%) just to get back to where you started!

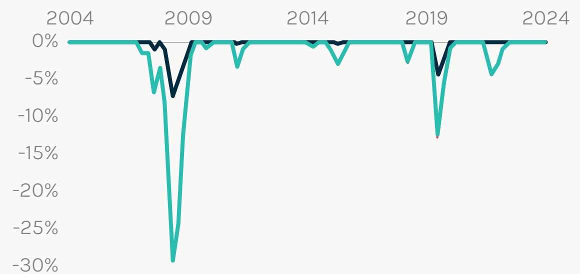
Avoiding this is critical to long-term wealth preservation and has surely been a key player in private markets' outperformance over time.

Max drawdown of public vs. private markets

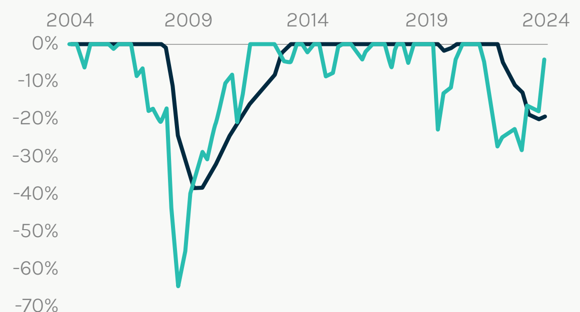
Private — Public

Equity

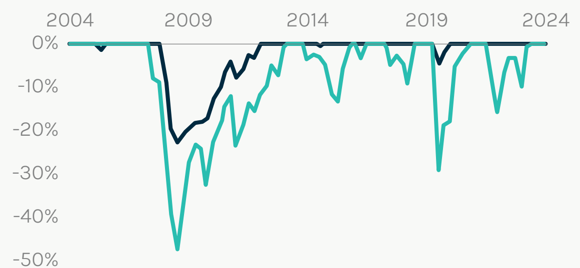
Credit



Real Estate



Infrastructure



All data quarterly. Analysis range: Sep 2004 – Sep 2024.

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The real opportunity cost

The unspoken opportunity cost of liquidity—historically—is simple: **Exchange the opportunity for better long-term performance, higher risk-adjusted returns and better downside protection for next-day liquidity**. Does that sound like a worthwhile tradeoff? In some cases, yes. There are real reasons to keep a portion of your wealth available for both the predictable and unpredictable things in life. However, in many cases, we would argue that that portion is rarely 100%. For this reason, we believe investors would be prudent to shift allocations to match true liquidity needs (i.e., that which is not needed tomorrow ought not be invested as such). Whatever that percentage is for you, it may be worth revisiting how much you're paying for liquidity.

ADDRESSING THE TOPIC OF LIQUIDITY WITH YOUR CLIENTS

There is no "one size fits all" solution to addressing liquidity needs with your clients. Factors like investment objectives, risk tolerance and time horizons are all important to consider. So how do you redefine the concept of liquidity for clients that have been investing in public portfolios for decades? In our view, it starts with education and finding the right asset managers to help guide your conversations. The beauty of private markets lies in their versatility—from fund structures to types of products to risk-return profiles. Thus, the powerful roles education and manager selection play should not go unnoticed.

For more from FAST on implementing private markets into your portfolio, read **"Out with the Old and in with the New: A 50% Private Markets Portfolio"**

—Financial Advisor Solutions Team (FAST)

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Private Market Insights

Timely insights and education to help you make informed decisions

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About the Financial Advisor Solutions Team (FAST)

FAST offers resources and one-on-one support to help navigate the complexities of private markets investing. The team's goal is to empower investors to confidently incorporate private markets investments into portfolios. The educational content, research and analytics that FAST delivers are designed to enhance the understanding of the benefits of private markets investments. FAST is a skilled and knowledgeable team of professionals who can answer questions and foster more informed decisions.

END NOTES

Private equity represented by Burgiss Buyout Index. Public equity represented by MSCI World. Private credit represented by Cliffwater Direct Lending Index. Public credit represented by S&P UBS Leveraged Loan Index. Private real estate represented by NCREIF ODCE Index. Public real estate represented by NAREIT All Equity REIT Index. Private infrastructure represented by Burgiss Infrastructure Index. Public infrastructure represented by S&P Global Infrastructure Index.

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