Illiquid Investments: Getting the Formula Right

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Alternative investments have the potential to enhance portfolio returns and reduce risk, but it isn't easy to determine which alternative works best—and how much of it to own. To get accurate answers, it's necessary to look beyond traditional asset-allocation approaches.

The typical asset-allocation approach focuses on risk/return trade-offs in a one-dimensional way that fails to capture alternatives' unique attributes—including illiquidity, leverage, the lack of relevant indices, difficulty in rebalancing and tail risk—that don't have relevant public market equivalents. To get the alternatives formula right, investors need to incorporate new risk factors in portfolio construction.

Understanding the Nature of Alternatives

To design an effective asset allocation, it's critical to fully understand the diverse types of alternatives investors have to choose from. These include real estate, private equity and credit, hedge funds and real assets such as timberland and commodities—each with its own benefits and drawbacks.

Alternative strategies can invest in private markets, have unique return drivers and possess diverse return relationships with broad markets (known as betas). They may also use differing amounts of leverage and take on distinctive levels of risk. And they can be illiquid, requiring investors to have a long-term bias.

Even strategies in the same alternative category can behave quite differently, but there are commonalities among some alternatives—notably, return drivers, betas, correlations, leverage and risk—that allow for more precise classifications that can help in asset-allocation design.

Illiquid Alternatives Require New Dimensions in Portfolio Design

For many years, correlations have been viewed as the primary asset-allocation driver. That approach may be acceptable for liquid markets, where daily price information and transparent, well-understood markets are the norm. But how should investors tackle investments that aren't transparent and liquid?

Think of it this way: An investment that's valued only once a month will likely show a low correlation to liquid public markets. But does that low correlation really come from the underlying investment's behavior or simply the fact that it's illiquid and infrequently valued?

Most conventional asset-allocation approaches don't appreciate this liquid-illiquid distinction. Instead, they assign illiquid alternatives the same degree of low correlation to traditional stocks and bonds—simply because they're illiquid. But there are differences in practice.

A hedge fund that invests in publicly traded securities but within an illiquid structure will likely have a higher correlation to global stocks and more pricing liquidity than a commercial real estate venture that buys apartment buildings. Commercial real estate should be treated as less liquid and less correlated to public securities than the hedge fund. Conventional asset allocation doesn't make this distinction.

Expanding on Traditional Asset Allocation

So, how do we build on conventional approaches to asset allocation to address the unique characteristics of illiquid alternatives?

1) Asset Class

The starting point is the basic tenet of traditional asset-allocation approaches—asset type. This involves assessing investors' risk/return profiles to determine the appropriate percentages to allocate to stocks, bonds and alternative investments.

For years, this approach has been effective, but a steady flow of new products has created a deeper pool for investors to choose from. As this has happened, advanced technologies have enabled the development of more precise models that consider other dimensions of portfolio construction.

2) Investment Purpose and Liquidity

A second dimension involves evaluating the investment purpose and liquidity of each investment. We can group investments into three broad buckets—return-seeking, diversifying and risk-reducing. With alternative investments, we can drill down even further into income and growth providers.

The amount allocated to each of the three broad buckets is determined by investors' return expectations and risk tolerances. But it's also important to account for liquidity and cash needs, goals and other factors such as portfolio tail risk, leverage and cash-flow potential. Gauging tail risks is particularly important with alternatives, because illiquid strategies can magnify the conditions that create difficult equity markets.

3) Spending Needs

Investors who are tapping their portfolios for spending needs face two additional risks: liquidity shortfalls and allocation drift. In general, it's a good idea to avoid any allocation decision that results in more than a small probability of running out of money—especially when allocating heavily to illiquid alternatives.

Allocation drift risk is harder to avoid. Any portfolio with illiquid investments will see its allocations change as the value of illiquid investments rises or falls. But illiquid investments can't be sold on the spot, so it can be hard to get a handle on allocation drift. Also, drift in illiquid allocations can be magnified if an investor is spending at higher rates than from the liquid parts of the portfolio, which could be rapidly depleted. That's why it's important to set acceptable allocation ranges when investing in illiquid alternatives.

Illiquid alternatives can bring substantial benefits to well-diversified portfolios, but incorporating nontraditional investments also requires nontraditional thinking in asset-allocation decisions. Instead of relying on the classic factor of correlation alone, investors also need to consider the impact of illiquidity on other components of the investment profile, from spending to access to capital.

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