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ACCESSING ILLIQUIDS: THE SOLUTIONS FOR ATTRACTIVE AND ACCESSIBLE PRIVATE MARKET INVESTMENTS

1.3 ROUNDTABLE DEBATE

Accessing Illiquids: the solutions for attractive and accessible private market investments

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Carlos Vilares: The traditional vehicle for accessing private market assets is through close ended funds. The life cycle of a closed ended fund starts with an investment period of 3-5 years, during which capital is drawn from investors and deployed. The next 4-7 years, depending on the fund, is then the realisation or the distribution period when cashflows are generated, assets are sold, and capital is gradually returned to the investor until maturity of the fund.

One possible approach to reduce the time for which capital is locked up in such vehicles is to buy funds in the secondary market once they are already several years old, or even quite close to maturity, rather than investing in year zero. When the funds are close to maturity, we call these "tail end" funds. These funds would typically be between 5-10 years old, when you buy them in the secondary market and with 1-5 years remaining to maturity. They are already mature funds, having deployed all their capital and indeed it would be paying back already to investors. When several of these mature tail end funds are combined into a portfolio, you can end up with a maturity profile of perhaps 2-3 years being achieved, rather than 10 years, with assets that mature every few months which provide regular liquidity that the investor can choose to redeploy elsewhere or simply reinvest.

This first approach provides what we call an intermediate liquidity. We are not talking about daily liquidity assets. Equally, we are not talking about 10-year lock ups, but rather something in the middle.

When comparing a portfolio of tail end funds against an investment in a primary close ended fund at inception, there are several additional benefits that you might consider. Not only does this provide an asset with much shorter maturity, around 2-3 years, but there is an ability to buy assets at a discount from motivated sellers, creating a P&L mark up from day one. You also avoid the J-Curve, which is created by those long initial investment periods and instead you obtain immediate exposure to mature deployed portfolios. Additionally, you receive full visibility on the underlying portfolio, since capital is already fully deployed. Rather than handing over money to a manager and being unsure where they are going to deploy it on inception of a closed ended fund, you can actually do due diligence on all the underlying assets.

There is also the ability to build a portfolio of several tail end funds together in one segregated account, providing diversification across not only managers but also different asset classes. This approach can be a more palatable way to access illiquids, particularly for general insurers who struggle to justify locking up capital for 10 years in a traditional closed ended vehicle.

> WHEN COMPARING A PORTFOLIO OF TAIL END FUNDS AGAINST AN INVESTMENT IN A PRIMARY CLOSE ENDED FUND AT INCEPTION, THERE ARE SEVERAL ADDITIONAL BENEFITS THAT YOU MIGHT CONSIDER

The second approach is one of combining a portfolio of liquid assets with illiquid assets to create a blended portfolio. As an example of 50/50 portfolio split between liquid and illiquid assets, you could have core on the illiquid side could be senior corporate loans with perhaps some allocation to other areas as desired. The core of the liquid holdings could be global investment grade credit with perhaps some allocations to high yield, bank loans, or EMD.

This blended approach facilitates a portfolio which can be priced daily, and traded quite frequently, monthly or quarterly. From our analysis, in normal market conditions around 70% of the portfolio could be liquidated within a month and around 95% within 6 months. This could make a suitable solution for unit linked businesses with profits and general insurers, as well as the Defined Contribution and pension market more broadly.

Sara Benwell: In terms of the liquidity conundrum, how can some of the assets that you invest in provide insurers with a more liquid way of accessing these fundamentally illiquid assets?

Murtaza Merchant: In the private debt segment, the average life of these assets is 2-3 years. From a blend perspective of combining a liquid portfolio with an illiquid private portfolio, which also has some elements of liquidity, actually ensures that there is a solution which addresses some of the needs of the market.

Also, the other advantage is that you are bringing together a specialist manager on the liquid and illiquid sides who provide their own expertise in that portfolio to the investor. This is quite interesting and reduces the pressure on the illiquids through a specialist liquid portfolio manager managing those assets for the provision of liquidity.

Carlos: From the perspective of the secondary market and close ended funds, you can tailor a portfolio with a variety of characteristics using late-stage secondaries with a low average maturity. Effectively, what you are doing is finding assets where other investors have already done the early-stage work of committing capital, deploying it into a portfolio of assets. If these initial investors decide to sell at some point in the future (and indeed such secondary sales are becoming a significant portion of the market) then you can take on this portfolio of assets and hold it until maturity, whether it is 1-4 years.

This can allow you to pick up and choose the assets that you buy, the vintages you prefer - you may not want to invest in 2020 or 2021 but may instead prefer a 2015 or 2017 fund. You can also get diversification across managers. For example, you can say that you don't want to be concentrated in one manager and that you would like to have exposure to 3 or 4 different managers in different parts of the market.

After 2-3 years, most if not all of the underlying assets are sold, you can decide to either redeploy your capital elsewhere and do something else with it if new opportunities come up or just allow this to be reinvested in new secondary opportunities.

The point is that the investor now has control and flexibility but with the traditional close ended format you are giving up this control and flexibility to the manager. But by looking at the secondary market you do regain this and can really decide exactly what you are going to do and how you want to move those investments in much shorter order.

Sara: Fuad the solutions that are being discussed they aim to provide monthly or quarterly income or a shorter lock up of capital over 2-3 years. Does this overcome some of the challenges that you and Natalia had brought up earlier that are traditionally associated with illiquids?

Fuad Ahmed: Yes, I believe so for our existing portfolios that are invested in this area it is of interest. Potentially it does make more sense as a product where there is more of an ongoing need for liquidity, so that if you do have a certain pot of assets that are more liquid within that strategy then you can tap into this to meet policy holder demands for liquidity. There are of course issues with this as well. Would it work in normal times? Probably, but what happens in a crisis when everyone wants to hit the exit simultaneously? The question is how it would then stand up during these times.

It does come down to individual companies, their strategies, in particular their liquidity requirements, and certainly there are benefits to having many participants in the market.

Sara: **Natalia what is your view?**

Natalia Soboleva: The challenges always remain as there is no one size fits all solution. But this is a solution to be looked at, and the cost benefit analysis should be performed. It looks like the proposed solution, at least from an insurance perspective in Switzerland, should help to solve some of the issues.

Carlos: We are only able to discuss a couple of ideas but there are other ways of trying to tackle these problems. Investment trusts are a well-known structure and format and REITs (Real Estate Investment Trusts) have taken advantage of this kind of format in the past and there may well be other approaches as well.

Sara: **Is the illiquid space making any strides to address the transparency of transaction costs? And is this anything that you have seen or considered?**

Carlos: As the secondary markets for closed ended funds are becoming so much larger and more liquid, there are investors who are able to use the secondary market as not just a once in 20-year emergency scenario to sell some assets, but actually as more of a regular portfolio management tool. Clearly, we are not yet at the stage where transaction costs are anywhere near as low as in liquid markets. But equally, we are not where we were 5-10 years ago and indeed you can see that in normal markets, the cost of transacting has come down. There is also more demand for these assets, so if you are seeking liquidity and trying to sell an asset, there is a cost to this, but this cost has come down significantly and continues to.

On the flip side, as a buyer, you are of course looking to add these assets, which is an opportunity because you can add these assets at a discount typically to NAV.

> "what you are doing is finding assets where other investors have already done the early-stage work of committing capital"

Murtaza: It is possibly a smaller issue on the debt side than it may be on the equity side. Over time, the costs on the debt side are lower and not significant in terms of the transaction costs. Especially when we participate in the primary markets, there is often less an issue of buying the assets off the secondary, etc., so for us it is less of an issue.

Sara: Are there any other associated challenges and benefits that investors should think about when considering more liquid approaches?

Murtaza: There are a couple of challenges that stand out. The cost effectiveness of accessing these markets is key, and it is important that any solution addresses this challenge. In our strategy we have addressed this, for instance, the UK DC market has a very stringent fee charge cap and cost constraints. It is an important challenge to be addressed in private markets.

The fact here is that private markets are expensive. It is expensive to go out and actively source and originate those transactions. It is a balancing act between managing these costs and providing these opportunities to investors who have their own constraints in this area.

The other challenge is around meeting stringent regulatory requirements. Some investors are highly regulated, and it is a challenge for the private markets to navigate these regulatory requirements.

In our strategy, with the UK DC market, we have done this as it is a highly regulated market and we have been through the journey to provide a solution that meets these stringent regulatory requirements. It can be done and we have done it, but it does require a lot of effort to ensure that whatever is packaged and put together meets these requirements.

In terms of the benefits, the liquidity, access, and the benefit the illiquidity premium are all important. Another key point is around sustainability, which is something we are hearing more about from investors, and they are a driving force in these ESG requirements. What you get in private markets and what we have to offer is the ability for investors to be in control and be an active participant rather than a passive participant.

We have investors on the private side who come and tell us exactly what they want, and these investors are able to drive this much more actively than they can on the passive side. This is a conversation that we are currently having, and private markets do allow investors to drive this, which they already have been doing, and rightly so.

> “WE ARE NOT WHERE WE WERE 5-10 YEARS AGO AND INDEED YOU CAN SEE THAT IN NORMAL MARKETS, THE COST OF TRANSACTING HAS COME DOWN”

Sara: To what extent do you see these illiquids in private markets as helping you to meet your ESG requirements and fit within your wider sustainability strategy?

Fuad: As a UK life insurer, it is important for us to invest in communities in the UK and we can do this through our venture and growth strategies. We are not giving up on the returns, and there is an opportunity there - a funding gap and investor money that is required to

support fantastic UK start-ups - so this is an exciting part of our strategy.

Equally, the ability to have a more active role in general when we are investing in private equity is quite an important one. This can drive both on the environmental side, as well as the social and governance aspects.

The flip side of this is being able to look at a portfolio of legacy investments and understand what the exposures look like today. How is this working with our managers? How this could be improved? And where might those opportunities lie to actually add value from an ESG point of view?

As an area within the private market investment space, it is becoming a lot more important. We have found that for some managers, the alignment between our ESG approaches has varied with geographies, or at least it has done in the past. We are finding that there is more traction now globally for the importance of ESG as part of the investment process, as well as the reporting and risk management side in private markets.

tangible social, climate impact, then private markets are the most obvious place to start.

I imagine that we are probably at a place where renewables were 15-20 years ago. It was a very nascent market but there are many products and companies globally who are seeking to do interesting things in reforestation, seafood supply chains, and many other impact areas on the climate, social and environmental aspects. Many of these opportunities are going to be private, and they are probably very small now. The point at which they have enough scale for us to consider them as investments to finance and sell is approaching, hopefully not too far away, but investors who can help scale this up with some early-stage investment is going to be helpful. As these ventures grow, there will be more mainstream opportunities that many of the people listening today will have.

I don't know what the time scale will be, but I would guess that these opportunities might come in 3-5 years and beyond as some of these ventures scale up. This could be a very interesting and exciting next step for investors who are looking to allocate to illiquid but also make an impact.

> "it is important for us to invest in communities in the UK and we can do this through our venture and growth strategies"

Natalia: As with all other investments, we screen for ESG factors or other risks. Of course, depending on the nature of the business, it will add up to portfolios. On the other hand, you must consider the capabilities of the team i.e., their skills and knowledge and overarching group strategy. We have lots of guidelines and lock away on the ESG perspectives that will be screened for all of these factors. If the score is good, it will add up and benefit the total portfolio.

Carlos: The interesting factor on the ESG side is that there is clearly an ability in private markets to have more of an interest and interaction with management to get more transparency on strategy, etc. But if you take one step beyond ESG to real impact, where it isn't just about making sure that your current financial investments are ESG friendly, but also about allocating some capital to have a

Fuad: The impact strategies are taking off and becoming more mainstream. Within traditional private equity portfolios and other illiquid assets, managers are seeing the value creation side of ESG. It is important to make sure that when they take on a particular asset or company that they are thinking about how they are going to drive improvements in the ESG space from a financial benefit perspective in terms of the returns, both whilst they own the company, as well as upon exit.

For this reason alone, it is becoming crucial, and this is driven by investor demand fundamentally and what we are looking for in terms of sustainability.

> IT IS IMPORTANT FROM A DIVERSIFICATION AND RETURN POINT OF VIEW TO CONSIDER ILLIQUID ASSETS AS AN ALTERNATIVE TO MORE LIQUID ASSETS

Sara: To what extent has recent market volatility expanded the remit for the type of stress events that may eventually drive the need for liquidity?

Natalia: If you take the unit-linked business, the liquidity aspect depends on customer behaviour. We basically manage the assets on behalf of our customers, and I wouldn't necessarily say that customers want to step out at this point in time, but we definitely need more liquidity to consider this scenario.

We are in a strict regulatory framework and do have constraints. But right now, we haven't experienced this.

Fuad: In particular, our with profits business do have illiquid assets but there is a limit on that, so fundamentally we have already put a constraint in there to take account of these sorts of scenarios. Overwhelmingly, it is a liquid portfolio of assets.

Sara: With such low interest rates across the board, is there a corresponding argument that yield has become more important in some context and therefore there might be more drive towards illiquidity in the hopes of getting that illiquidity premium?

Fuad: From an SAA perspective we look at this from a long-term perspective, so we are thinking about a 5–10-year horizon in terms of the returns we are looking for. We have seen a trend that returns in general are decreasing in terms of expected returns over the long term. Therefore, this potentially encourages us to think about diversification and trying to expand into better assets.

Overall, we still have a liquidity requirement, we have a limit on how much we are going to put into illiquid assets. But it is important from a diversification and return point of view to consider illiquid assets as an alternative to more liquid assets.

Carlos: From the conversations I have been having with clients over the past few months, the market volatility has certainly given people a pause. Particularly if you are facing business interruption claims, where you need the liquidity in the short term. On the flip side, there has been an acknowledgment that daily priced assets are creating a lot of balance sheet volatility. It is not to say that the economic realities are different, but the quarterly marking process gives you some stability on the balance sheet, which is pretty interesting.

If you are going into private equity versus public equity, clearly there is still equity risk to the broader economy and business cycle. But you potentially are diversifying into different sectors that may not be well presented in public markets with different risk factors.

There is then a diversification angle as well, which I have heard from some clients as being a driver. Broadly, the yield is the fundamental driver, but some of these other points about diversification and the frequency of marking to market are quite interesting and come up a lot in conversation as well.

> THERE ARE SOLUTIONS AND STRATEGIES THAT ARE COST EFFECTIVE AND THAT ADDRESS ESG ISSUES

Sara: As a final comment, for the insurers on the panel, what should be the primary focus of the manager community in making illiquids more attractive, accessible and useful to insurers?

For the managers on the panel, for our insurer audience, if they are thinking about going down this route and haven't before, what should they be doing next, in order to take something from this conversation and move forward with it?

Carlos: For some years now, most insurers have thought that illiquids are an attractive place to be and they would like to do it but locking up capital for such a long time would be a big issue. Clearly, the conversation needs to develop around what the solutions might be, and this should be an ongoing conversation. It is not realistic to suddenly go from 100% daily priced liquid assets into 10-year lock ups in one step, and most clients are struggling with this. The solutions are out there, and managers need to be pushed to be more flexible, create new solutions, and be in partnership with our insurance clients. The days of just pushing a close ended 10-year fund and hoping everyone just buys it are behind us, particularly for the insurance market but more broadly.

Fuad: Keeping things brief, I would say fees and the extent to which those could be reduced.

Natalia: It would be fees, liquidity and impact considerations would be the three next steps to be looking at.

Murtaza: There are solutions and strategies that are cost effective and that address ESG issues. This is a market that is developing, and we as managers are trying hard and have some interesting ideas that have come about and that have been implemented. This is an allocation that is part of a portfolio. We are not going from a large portion or a majority of the insurers portfolio of investments being allocated to illiquid.

In terms of where we are today in the UK DC market, we have a small allocation in a large default portfolio, which is a baby step. This is where you start looking at how the allocation to this asset class works, because we have addressed the cost, liquidity, and ESG points. Once these have been addressed, the next step would be to think about it as an allocation in a larger portfolio.

Sara: Thank you all for sharing your thoughts on this topic.

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