Key Wealth Institute

Key Questions

November 16, 2022

"Isn’t Private Equity Illiquid?"

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It is. But to some investors private equity illiquidity is an asset, not a liability.

Generally speaking, a private equity fund pools capital from investors to acquire controlling or minority stakes in unlisted, privately held businesses. A typical private equity fund requires investors to commit capital and subsequently fund this commitment in periodic contributions during the fund’s investment period. Businesses are then bought, improved and (ideally) sold for a profit, with sales proceeds distributed back to fund investors. In other words, these closed-end funds are self-liquidating.

Compared to investments in public equities – either through direct stock ownership, a mutual fund or an exchange-traded fund (ETF) – closed-end private equity funds typically do not offer fund redemptions or investor liquidity. The rationale is that capital stability is important for managers undertaking their strategy to improve or grow the businesses they have acquired over a reasonable period of time, often measured in years, without the additional burden of meeting investors’ redemptions. This is the core of private equity illiquidity.

The literature on the topic frames private equity illiquidity as a risk factor for which investors should be compensated. Academics label it the “illiquidity premium,” or the excess required return in private equity compensating investors for locking up their capital. Historically, private equity investors have earned roughly 2-5% annualized excess return over public markets for the illiquidity they accept.

Unappreciated Benefits

But some observers ask if illiquidity has unappreciated behavioral benefits not traditionally considered in the required illiquidity premium. Some even argue that private equity can make sense with an illiquidity *discount* (i.e., expect lower returns versus public markets). They argue that private equity illiquidity – or the inability to sell – has an unaccounted-for benefit by forcing investors to stay invested regardless of market conditions. That is, being forced to stay the course helps investors avoid emotionally driven panic selling when markets are down.

The data from mutual fund and ETF fund flows tend to support this theory. The heaviest outflows in equity funds over the past 20 years happened in 2008-09 and 2020 – exactly the wrong time to be selling. For those investors, the ability to sell proved to be a costly mistake.

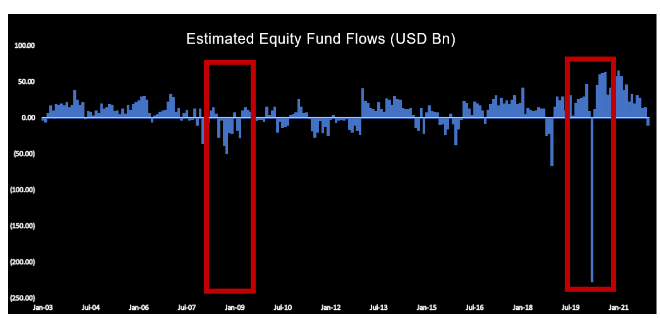

Chart Source: Morningstar

But what about private equity secondary markets, where investors can source liquidity from specialist investment funds that buy their fund interests? This is a growing market but remains a costly source of liquidity for the seller as transactions typically take place with a meaningful discount to net asset value (NAV) – anywhere from 5-40%. Here again selling is a costly affair for portfolio returns.

Key Takeaways

The bottom line is that equity investing in either public or private markets should be considered for the long term. Inopportune selling based on fear is a well-documented behavioral bias that can be detrimental to portfolio returns.

As a result, illiquidity in private equity might be thought of as a source of excess returns not only because it allows the managers the ability to undertake their strategies and unlock value in an underlying business over time, but also because it constrains investors from selling equity at the wrong time.

For more information, please contact your advisor.

About the Author

Justin Tantalo has 15 years of experience in investment management, both in Asset Allocation and Fund Management. As a Senior Vice President with Key Private Bank, Justin applies his expertise in Asset Allocation and helps oversee the equities and alternatives third-party manager research effort. Justin received an MA in Economics from the University of Waterloo (Canada) and BA in Economics from the University of Western Ontario (Canada). Justin is a CFA Charterholder.

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