Illiquidity Premia in Private Market Investments

The Case and Limitations for Private Equity and Private Income in Institutional Investor Portfolios

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Greatly Simplified History and Trajectories of Asset Allocations for Institutional Investors

- Balanced Portfolios (Objective: generate compelling risk-adjusted returns with risk diversification)
  - Wellington Fund (America's oldest balanced Fund)
    - 50%-50% US Stocks-US Bonds (1929-1970s)
    - 60%-40% US Stocks-US Bonds (1980s-2010s)
    - 2/3 – 1/3 US Stocks-US Bonds (2020s)
  - US Institutional Plans
    - 50%-50% US Stocks-US Bonds, Infrastructure (through the 1970s)
    - 60%-30%-10% US Stocks-US Bonds-US Real Estate (emerged in the 1980s)
    - 60%-20%-10%-10% Global Stocks-US Bonds-US Real Estate-US Private Equity
    - 60%-40% Growth (stocks and private equity) – Income (Bonds plus real estate, infrastructure, private credit) (emerging since the late 2010s)

Seeking the Illiquidity Premium in Private Market Investments

- Illiquidity Premium—The premium over comparable stock and bond investments which investors expect for investing into private markets investments (private equity, real estate, infrastructure, private credit)
- Quantifying the Illiquidity Premium—Varies greatly by asset class and by the management skill of the private markets managers and the institutional plan allocators
- Generally major plans target a 1-3% premium in their private market investments over stocks and bonds (2% at APFC)
- Lots of prevailing controversy regarding its quantification

New Dynamic: Balancing Expected Returns, Risk (Diversification), and Illiquidity

- Tolerance for Illiquidity—the longer the investment time horizon for a plan, the more illiquidity its portfolio can tolerate
- Opportunity Cost—Illiquidity in a portfolio also reduces a plan's ability to be opportunistic when facing new, appealing investment options
- Prevailing Allocations for Private Market Investments—Generally ranges between 20% - 50% among Sovereigns, Pensions, Endowments, and Foundations, in recent years
- Objective—Generate a critical improvement in your Plan's expected return while maintaining risk diversification and sufficient portfolio liquidity

Frequent Questions Regarding Private Market Illiquidity Premia

- Have some major plans avoided private market investments entirely by sticking with allocating between stocks and bonds?
- Has the illiquidity premium ever drifted negative for certain asset classes and with the experience of particular plans?
- What problems have plans faced when they lack sufficient liquidity in their portfolios?
- What are prominent examples of illiquidity premia successes and failures?
- How can plans assess the best ways to assess prospective future illiquidity premia by asset class and how can plans measure the effectiveness for realizing compelling illiquidity premia?