

HEALTH WEALTH CAREER

SEEKING RETURNS IN PRIVATE MARKETS

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“Of the maxims of orthodox finance, none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of ‘liquid’ securities. It forgets that there is no such thing as liquidity of investment for the community as a whole.”

– John Maynard Keynes

INTRODUCTION

In an environment of low yields and low-to-moderate risk premia, we believe investors need to look beyond traditional liquid asset classes¹ (equities and bonds) in order to generate meaningful returns. In particular, investors should be open to the potentially attractive and diversifying return sources available in illiquid asset classes (or private markets).

“Many investors with a long time horizon arguably place too great a premium on liquidity”

Many investors with a long time horizon arguably place too great a premium on liquidity (they fetishize liquidity, to paraphrase Keynes) and thereby cut off a large and potentially rewarding opportunity set. For investors that are unclear on their need for liquidity, a helpful first step can be to undertake a “liquidity budgeting” exercise, which should provide clarity around the extent to which an investor can tolerate illiquid assets within its strategy. A liquidity budgeting exercise will consider the cash-flow needs of an investor over time, its need for short-term liquidity to meet collateral requirements on derivative exposures and the impact on asset allocation flexibility due to illiquid holdings. This exercise will necessarily be investor-specific and will lead to very different answers for different investors.

Starting from an assumption that an investor can tolerate some level of illiquidity, this paper considers the different drivers of return available to investors in private markets.

¹ We define liquid assets as those that can be easily liquidated without having a substantial impact on the price that can be realized.

WHY BOTHER WITH PRIVATE MARKETS?

Given that private markets investment requires investors to tie up some portion of their assets for a number of years, adds to an investor's governance burden and usually comes with additional fees and costs, it is reasonable to ask why anyone would choose to invest in private markets. The short answer is because private markets can provide exposure to return drivers that are simply not available in liquid markets. These return drivers might be attractive either because they appear to offer greater compensation for risk than might be available in liquid markets (especially when traditional risk premia are compressed) or because they are expected to provide a different return profile to other parts of an investor's portfolio (for example, they are diversifying).

Private markets can provide exposure to return drivers that are simply not available in liquid markets.

The primary return drivers available to private markets investors include the following:

- **Illiquidity premium:** the expected compensation for providing finance to projects for which there is a limited supply of capital due to the general preference for liquidity¹ among the wider investment community
- **Complexity premium:** the returns available to investors that are willing and able to analyze and participate in more complex transactions

- **Hands-on value creation (or direct asset management):** the returns available to private markets investors that are able to change the nature of the underlying asset in order to improve its return profile
- **Other factor exposures:** Depending on the nature of the underlying asset, an investor may also obtain exposure to factors such as size and value premia.

Although most attention is typically focused on the existence and size of the illiquidity premium, the complexity premium and hands-on value creation are likely to be just as important (if not more important) in determining the overall return an investor achieves in private markets. In addition, it is extremely difficult to disentangle the impact of these return drivers on asset performance and therefore to isolate the size of any one component. We consider the illiquidity premium, complexity premium and "hands-on value creation" in further detail below.

ILLIQUIDITY PREMIUM

In simple terms, the illiquidity premium is the excess return that compensates an investor for supplying capital that cannot be easily liquidated at short notice. This concept has a strong intuitive appeal, especially if the average investor in the economy has a relatively short time horizon, places some value on the flexibility offered by liquidity or does not have the capacity to bear illiquidity risk. Another way of viewing the illiquidity premium is as compensation for exposure to a "liquidity risk factor," which tends to be rewarded in an environment of improving liquidity conditions (for example, 2009–2015) and suffers in a liquidity crunch (for example, 2007–2008).²

² This is analogous to the idea of an equity risk premium providing reward to investors for exposure to the "equity risk factor," which tends to be rewarded when the corporate sector is performing strongly and suffers in a recession.

It is worth noting that an illiquidity premium is likely to be present in many parts of the public and private markets. For example, small cap stocks and credit assets tend to provide some reward for their relative illiquidity versus more liquid public market assets. However, the illiquidity premium is likely to be found in greater size in private markets.

Illiquidity premium will vary in size over time.

It is important to recognize that the illiquidity premium, like all risk premia, will vary in size over time. At times, when there is a limited supply of funding for illiquid projects, the premium is likely to be large and vice versa. Identifying the size of the illiquidity premium at any point in time is difficult, and commitments to private market funds often take a number of years to deploy. We therefore believe most investors should build an allocation over time rather than either attempting to achieve full allocation quickly or waiting for the perfect entry point. Sophisticated investors should be able to adjust the pace of investment to scale exposure to illiquid assets (and to different segments of the opportunity set) up and down as market conditions evolve.

Measuring the size of the illiquidity premium is highly problematic for a number of reasons: It is often difficult to find directly comparable liquid and illiquid assets, there are significant data issues since most private markets databases rely on self-reported data, and it is often difficult to separate the illiquidity premium from other factors (such as manager skill, leverage and value/size biases). We should therefore treat claims as to the historical or future size of the illiquidity premium with a degree of caution. That said, many empirical studies conclude that an illiquidity premium does exist, with the size of the premium being estimated

as anywhere between 0% and 3% p.a., depending on the asset class, time period, data source and methodology. Many studies also note that the illiquidity premium may be materially eroded by the higher fees in private markets mandates. We provide further comment on some of the academic research in this area in the appendix.

COMPLEXITY PREMIUM

In the same way that investors expect to be rewarded for investing in less liquid assets, investors should also expect some compensation for investing in more complex transactions. The complexity premium is much less discussed and analyzed than the illiquidity premium but may be an important factor in how private markets investors are able to achieve returns superior to those that might be available in the public markets. Intuitively, if a given transaction involves a greater degree of complexity than a typical public markets investment (for example, a privately negotiated loan with nonstandard terms and multiple parties), this will naturally reduce the supply of capital from investors willing to participate in the deal, thereby improving the forward-looking risk-adjusted return available to those that are willing to undertake the necessary due diligence (possibly including the need for significant legal expertise).

Investors expect to be rewarded for investing in less liquid assets.

The realization of a complexity premium will clearly have a strong relation to manager skill – blindly investing in complex transactions without the necessary analysis or with poor judgement will undoubtedly result in poor returns. However, the existence of complex transactions (more prevalent in private markets) should create an additional source of return that can be harvested by skilled managers.

Manager skill or “alpha” is not a single, homogenous return source.

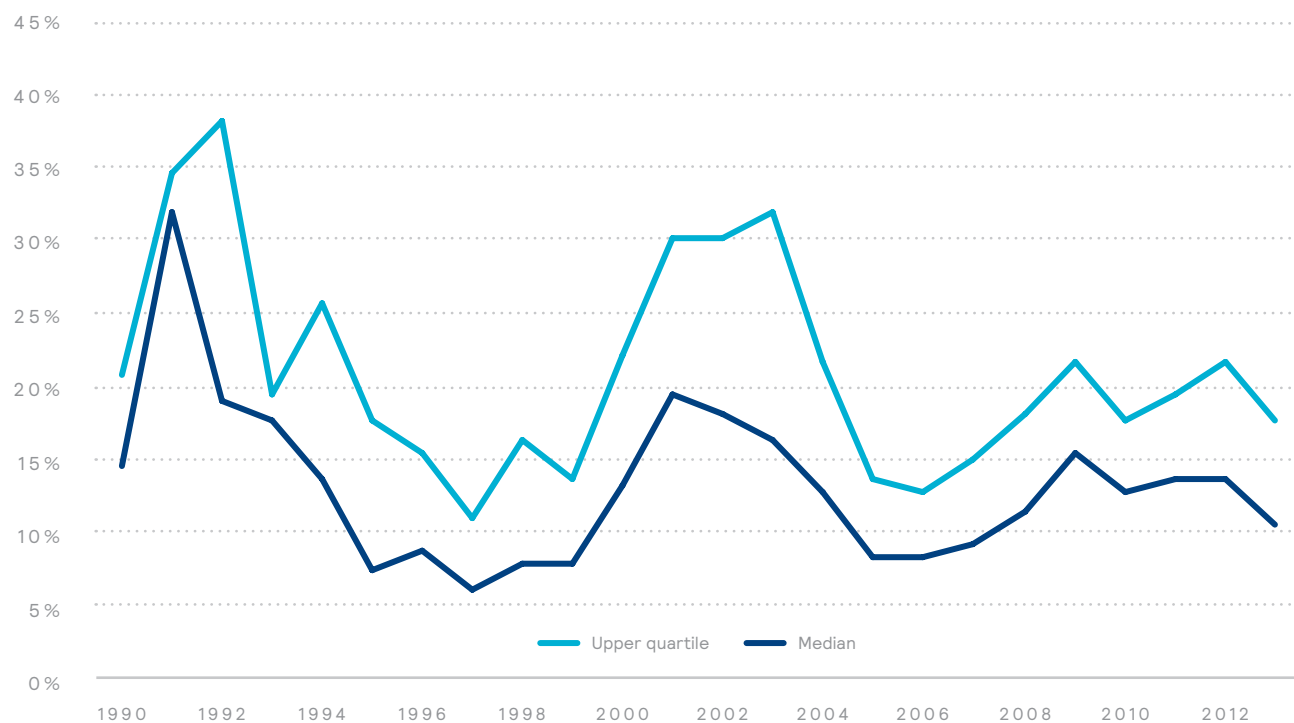
HANDS-ON VALUE CREATION

Returns from manager skill (or “alpha”) are often treated as a single, homogenous return source. However, the types of trade/investment that can be made by an equity manager, a hedge fund manager, a real estate investor or a private equity investor are very different. Thus, the nature of manager alpha in each of these areas might have very different characteristics. In particular, private markets investors have a significant advantage over public markets investors in that they typically have a much greater degree of control over the underlying assets. For example, a real estate investor can refurbish a property, and a private equity investor will often have a significant level of influence over the business

strategy of companies in which they invest. We use the term “hands-on value creation” to distinguish this form of private markets alpha from traditional manager alpha found in the listed markets. The effect of this greater level of control of the underlying assets is to create the potential for higher levels of manager alpha.

This has been borne out historically in high levels of dispersion between different private markets funds, as illustrated in Figures 1 and 2, below. The private equity analysis shows that the difference between the median and upper-quartile manager is often as large as 10% p.a. or more, whereas the comparable figure in the listed global equity universe would typically be around 2%–4% p.a.

FIGURE 1
DISTRIBUTION OF PRIVATE EQUITY BUYOUT FUND RETURNS (UPPER QUARTILE VERSUS MEDIAN)

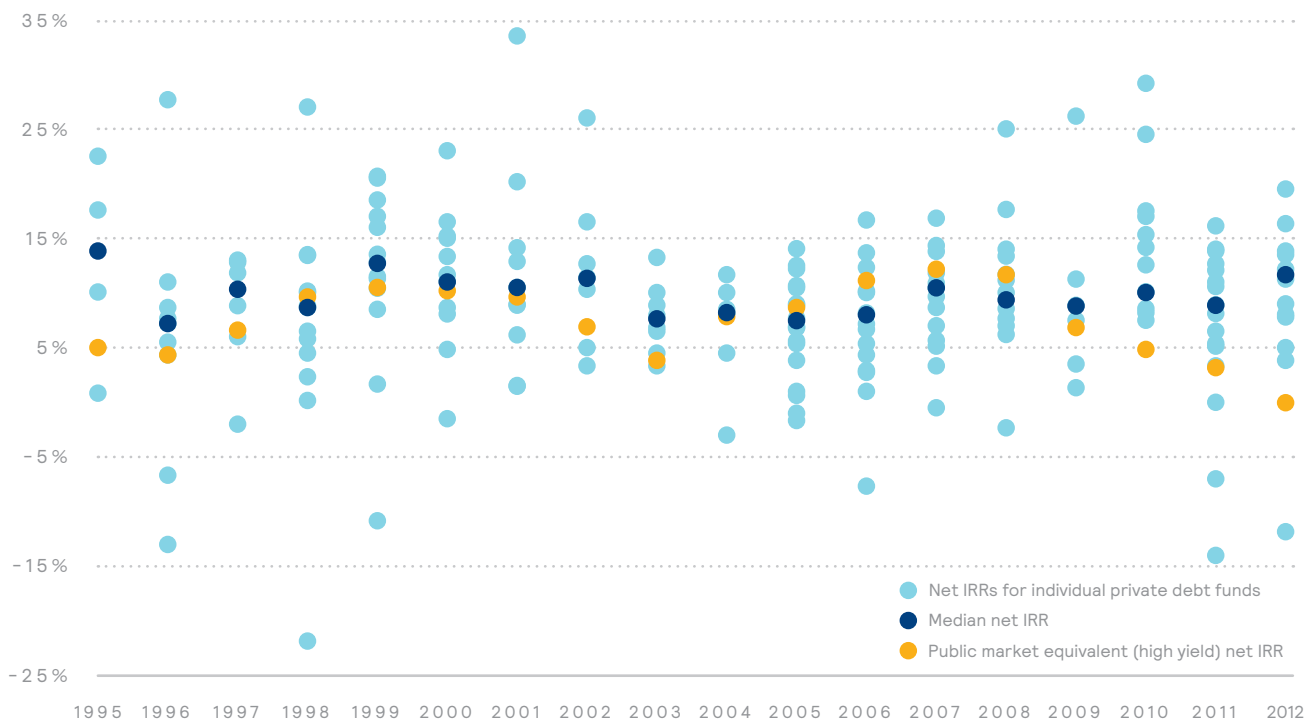


Source: Private iQ®, Global Buyouts, September 30, 2016

The analysis of private debt funds makes a similar point, illustrating the wide range of returns achieved by different funds launched in the same vintage year (light blue dots), with the best performers substantially outperforming the median return (dark blue dots). This chart also illustrates the variability in the performance differential between the median private debt manager and the public market equivalent, which has been both positive and negative but with a tendency for a nontrivial level of outperformance from private markets exposure over time.

It is worth noting that access to “hands-on value creation” may be the primary reason for seeking exposure to certain parts of the private markets opportunity set. For example, it is difficult to argue that a significant illiquidity premium exists for large cap buyout investors for the simple reason that many of the underlying companies are purchased on the public market. Rather, such investors are arguably accepting a reduced level of liquidity and higher fees (within a buyout fund) in return for exposure to an attractive and persistent form of manager alpha only available to private investors.

FIGURE 2
DISTRIBUTION OF NET IRRS FOR PRIVATE DEBT FUNDS BY VINTAGE YEAR



Source: Preqin, Bloomberg, Mercer estimates. Data as at 31 December 2015.

RETURN EXPECTATIONS

As noted above, it is difficult to arrive at robust estimates for the various return drivers that a private markets investor has access to and particularly difficult to disentangle their individual effects. However, based on the historical data and our own multi-decade experience of investing in private markets, we believe a well-diversified private markets program populated with best-in-class managers should be able to deliver a return premium (above a comparable public market exposure) of around 1%–4% p.a. (net of fees) over a full market cycle.

IMPLEMENTATION CONSIDERATIONS

Private markets can provide exposure to a number of attractive sources of return for long-term investors, but smart implementation plays a big part in the realization of those returns. Given the large dispersion in underlying manager returns,

access to skill and sufficient diversification by manager is critical to success. In addition, fees and costs, which are typically much higher than in listed markets, will erode the investor's net return and therefore require careful management.

The returns on offer to private markets investors, driven in part by the size of the illiquidity premium and the nature of the opportunity set, will vary substantially over time. However, as with any asset class, it will be difficult to identify an ideal entry point in advance. This issue is compounded by the fact that deployment of private capital typically takes a number of years, thereby diluting the impact of identifying the "right time" to invest. We therefore recommend that investors seek to build a diversified program of private markets exposures (designed to meet their specific objectives and risk tolerance) without trying to make large "on/off" allocation calls.

CONCLUSION

We believe the private markets represent an important part of the global opportunity set for long-term investors, offering exposure to a diversifying mix of return drivers. One driver of the returns from a private markets portfolio will be the illiquidity premium, but this is by no means the only reason for investing. Just as important a

determinant of success in private markets is the ability to identify and access the highest caliber managers. We suggest that investors consider their tolerance for illiquidity and look to put in place well-diversified rolling programs of private markets investments in a risk-controlled and cost-controlled manner.

APPENDIX

MEASURING THE ILLIQUIDITY PREMIUM

WORDS OF CAUTION

A number of academic studies have analyzed the empirical data in attempts to support or refute the existence of an illiquidity premium and to measure its size. Before we turn to the existing literature, we first highlight a number of the difficulties related to such quantitative assessments.

First, the illiquidity premium is not directly observable, because it is intertwined with a host of other factors, such as skill, size, value, leverage, etc. Second, there is a potential issue of data quality because private markets performance is typically self-reported, suffers from survivorship biases and subjective estimates and is of low frequency. This is not the case in most liquid markets, where historical prices reflect actual realized transactions. Third, the illiquidity premium will fluctuate over time (depending on economic conditions and the supply and demand for private capital) and vary across asset classes. There will therefore be periods in which the compensation for bearing illiquidity will be high as well as periods in which the risk is not adequately compensated (it may even be negative at times).

In order to disentangle the illiquidity premium from overall private markets outperformance, econometric methods such as multivariate regressions have been used to decompose returns to contributions from various sources. Although these methods suffer from the issues inherent in all statistical analysis (such as the use of assumptions and models that may not reflect reality), their output can be useful in understanding the broad nature of historical relationships and interactions. Issues with the data quality are typically addressed by focusing on larger data sets with cash-flow based returns, leaving somewhat less scope for subjectivity. We outline below a selection of the key findings from recent research in this area.

EMPIRICAL RESEARCH

The results from the literature vary, but generally favor the existence of nontrivial compensation for bearing illiquidity risk. There is fairly widespread acceptance of an illiquidity premium in small cap stocks (though de Jong and Driessen [2013] note that this effect has diminished over time) and corporate bond markets. The data issues noted above limit the strength of conclusions that can be drawn in relation to unlisted markets, but de Jong and Driessen (2013) note that “for private equity, there is no empirical evidence for a compensation for the expected illiquidity of the investments, but there is some evidence for a liquidity risk premium similar to that in hedge funds.”

Similar findings were provided by Franzoni, Nowak and Phalippou (2012), who analyzed the CEPRES database of buyout funds and concluded that private equity investments have a significant exposure to a liquidity risk premium of 3% p.a.

In a recent review of the literature (2016), Markwat and Molenaar (both of Robeco) emphasize the challenges in conducting empirical analysis on this topic and conclude that “within some asset classes more illiquid assets appear to deliver higher returns than liquid alternatives. In contrast, academics struggle to find evidence on liquidity premiums between asset classes.”

Our review of the research literature suggests there is empirical and theoretical support for the existence of an illiquidity premium but that it is difficult to separate from the other factors driving returns to private markets investors and therefore impossible to quantify.

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