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Investment perspectives

Private markets – taking stock of liquidity risk

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The investment time horizons in some private markets are changing. In this article, we profile four key private markets and examine the liquidity considerations for each.

After the hard-fought challenges of 2020, it's encouraging that the overall funding position of defined benefit (DB) schemes improved over 2021. Market movements played a big part, thanks to another strong year for equity markets. But while this is undoubtedly a cause for cheer, it has caused other issues to emerge – not least, the liquidity and time horizons in investment portfolios. These issues are especially pertinent for schemes targeting buy-out.

Such schemes need to ensure they have the liquidity required to act, and also to carefully consider the time horizons for investments. However, within some private markets, investment terms are getting longer. Illiquidity is a common feature of private markets, and the reason why they usually offer a return premium. But now, given some investors' shorter time horizons, a liquidity mismatch is emerging, limiting opportunities in private markets.

Even investors that are less time constrained still want to access the best opportunities – which means keeping up with evolving markets. That involves considering if a market is best accessed through debt or equities or through closed or open-ended funds, given considerations such as extension risks.

To help understand these considerations, this article revisits key private markets and weighs up the liquidity considerations for investors. Please note, these are brief market profiles – in future editions of Investment Perspectives, we will explore each market in more depth.

Private equity

An investment in private equity can represent a commitment of 12 to 16 years. During the initial investment period, the investment team will typically spend three years looking for suitable companies to invest in. The next five to six years are used to make the companies more profitable and sustainable by improving their operations, making management changes or financial improvements. At this point, we're nine years into the investment period. The final three years of the fund's life are spent selling the companies, which can be a lengthy process.

It's worth noting that the investment period can extend beyond the typical 12 years. This might be due to the sale of some companies taking longer than expected or, in some cases, the fund may hold some cash beyond the fund life to meet any tax or legal obligations due after the sales have completed. A two-year extension is typically built into the legal documentation, and more often than not, it is required.

The timescales outlined above would apply to a primary market fund, but another option is to invest in a fund of funds. Fund of funds offer diversification benefits by investing in several private equity funds. Given the differing fund lives of the underlying funds, the investment period can extend to 15 or 16 years.

Client context

Given the lock-in period and the higher risk involved with private equity investments, we tend to see a higher allocation to private equity in client portfolios that have a long investment time horizon or a large funding gap. For closed DB pension schemes, as the funding position improves, we suggest reducing the allocation to private equity and looking to other asset classes with a shorter time horizon.

Property

Direct property, by its nature, is a longer-term investment. Core property is very income driven, with total returns dominated by the income component, and only some capital growth. Most investors have invested in core UK property funds focused on the main UK commercial sectors (offices, retail and industrials). These are usually open-ended funds, with dealing terms varying from daily to quarterly subscriptions and redemptions typically being monthly to quarterly.

However, the UK core property fund market is suffering net outflows as more pension schemes de-risk. Consequently, there's no guarantee that redemption requests can be met, leading to liquidity issues. It's also worth remembering that some funds were 'gated' (closed to redemptions) during the early months of the pandemic. Higher-risk funds (i.e. value-add or opportunistic) tend to be closed-ended, with fund terms of 5–10 years plus the option for extensions.

Finally, many investors use the secondary market to trade in and out of property funds. This can be cheaper as it avoids stamp duty, but sellers may have to accept sizeable discounts to sell holdings, especially in closed-ended funds.

Client context

Investors should not be considering investing in property on a short or medium-term basis. This is a long-term investment; although some fund structures offer the option for liquidity, it is not guaranteed. Investors should be prepared to invest for at least a full market cycle.

Private debt

Private debt (or direct lending) funds are typically closed-ended structures with a term typically of 6–8 years. Like private equity, there is an initial investment period, usually 3–4 years, when committed capital is drawn down and invested. Loans are privately negotiated, issued with a floating-rate basis, and provide funding to medium-sized companies in the US and Europe. Such companies tend to be rated below investment grade, although these assets are rarely rated by a credit agency.

Private debt is usually secured (backed by assets) and sits high in the ranking order in the issuing companies' balance sheets (meaning lenders would be repaid before shareholders). Given the private nature of this asset class, there is no established secondary market. Consequently, investment is done on a buy-and-hold basis.

Client context

We typically recommend private debt to clients who are willing to commit for 6–8 years. It can form part of a useful income solution, with negligible interest-rate risk given its floating-rate nature. However, early vintages of some direct lending funds are activating their extension rights and extending the fund term, leading to higher levels of illiquidity than initially planned. This should be taken into account when clients consider investment.

Infrastructure

Generalist infrastructure funds (i.e. those investing in assets beyond renewables) tend to be closed-ended, meaning there is no liquidity until the end of fund's term. Such funds will often take time to draw investors' capital down, with the investment periods for many closed-ended funds being 3–4 years. Accessing the fund before its term would mean accepting a discount on the secondary market.

We are seeing an increase in the number of open-ended generalist infrastructure funds. Such funds may take 2–3 years to draw capital from investors. Some of these open-ended funds have 3–5-year lockups, so no redemptions can be made until that lock-up period is over.

Individual infrastructure funds (primary funds) are usually structured like private equity funds, and invest in a diversified portfolio of assets/projects. UK investors typically invest in UK, European or global funds.

For those interested in renewable infrastructure, exposure can be gained via a generalist fund, but the extent of the exposure can vary greatly. There's a growing number of dedicated renewables funds – these tend to be closed-ended with fund terms in excess of 10 years (often longer).

Client context

To benefit from the longevity of asset lives and potential inflation protection, the assets should ideally be held for the medium-to-long term. Listed infrastructure is an option for those wishing a more liquid choice, but it is not one we typically recommend as an alternative to private infrastructure.

Key takeaways

In summary, private markets continue to offer attractive risk-adjusted returns for investors. However, liquidity constraints may preclude some DB schemes from investing, due to the length of the fund terms versus their endgame. Closed-ended funds require a lock-up of capital from investors and, while fund terms have lengthened over time, many schemes are better funded and targeting buy-out sooner than the fund terms allow.

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