

Whole of fund liquidity caps – too simplistic?

It is not uncommon for funds to manage allocations to illiquid assets by imposing a cap on illiquid assets on a whole of fund basis. For example, no more than 25% allocation to illiquid assets. While this approach is simple – in our view a more nuanced approach is more effective.

What’s wrong with this approach?

Firstly, liquidity isn’t binary. Assets aren’t liquid or not. There is a continuum. A single bucket for illiquid assets creates a notion that all forms of illiquidity are equal. As the analysis of the impact of foreign currency denominated illiquid assets shows, this is clearly not the case.

Second, a single bucket for illiquid assets is likely to drive a disproportionate share of illiquid assets to be higher risk/growth assets. This approach can create a behaviour of not wanting to “use up” valuable “illiquidity capacity” on lower risk/lower returning assets. However, if 25% of the fund is all allocated to illiquid growth/high risk assets it implies significant constraints in rebalancing between growth/defensive. A high allocation to illiquid growth assets effectively places the burden for rebalancing within the growth part of the portfolio on listed equities.

Finally, there is a big difference between foreign currency denominated illiquid assets and Australian dollar denominated investments. A foreign currency denominated asset can change in value just because the exchange rate has moved. A fall in the exchange rate increases the Australian dollar value of the asset (and, hence, its weight in the portfolio). This has two implications:

- It is difficult to target a specific whole of fund level of illiquid assets if a significant proportion of those assets are foreign currency denominated. Exchange rate moves can cause large asset allocation movements; and
- where those assets are currency hedged there is a substantial second-round effect on liquidity and asset allocation from funding hedge payments.

Potential for Large Asset Allocation Movements

To provide an example of the significances of this effect, in 2008 the Australia dollar went from US\$0.97 to US\$0.62 in less than three months. This would have increased the A\$ value of all US\$ denominated investments by more than 50%.

Take an extreme example –where a fund with a 25% pre-shock illiquids allocation that is entirely foreign currency denominated, has a 50% currency devaluation - this shock would see the illiquid allocation jump from 25% to 33% in less than three months. That is more than 8% overweight (excluding hedging effects – see below).

By definition, a significant overweight to illiquid assets is very difficult to remedy.

Currency Impact on Illiquids Allocation - No Currency Hedging						
	Pre Shock Allocation		Currency Shock	Post Shock Allocation		Overweight
	\$	%		\$	%	
Liquid Assets	75	75%		75	67%	
Illiquid Assets	25	25%	50%	37.5	33%	8%
	100			112.5		



Currency Hedging Effects – the so called “Denominator Effect”

Where those assets are currency hedged there is a substantial second-round effect on liquidity and asset allocation from funding hedge payments. It is normal for funds to hedge a significant portion of the currency risk on overseas illiquid assets. Not the least because currencies are quite volatile and currency effects can easily swamp the underlying returns of these assets.

However, for illiquid assets it is not possible to fund currency hedge gains or losses by trading in the underlying asset. This means hedge losses have to be funded by selling liquid assets – resulting in a “denominator effect” where illiquid asset proportions rise because liquid assets are used to meet hedge payments. This is quite powerful, taking the example above but assuming the overseas assets are fully currency hedged, the funding of hedge losses would see illiquid allocations jump from 25% to 37.5%, a very extreme outcome which would require a sale of a third of the illiquid portfolio to remedy!

Currency Impact on Illiquids Allocation - With Currency Hedging							
	Pre Shock Allocation		Currency Shock	Hedge Loss	Post Shock Allocation		Overweight
	\$	%			\$	%	
Liquid Assets	75	75%		12.5	62.5	62.5%	
Illiquid Assets	25	25%	50%		37.5	37.5%	12.5%
	100				100		

Conclusion

These simple and albeit extreme examples highlight that a simplistic whole of fund cap on illiquid assets isn’t a particularly effective risk management tool. Not all illiquid assets are created equal! It is much better to have separate caps for growth versus defensive illiquid assets as well as for foreign currency denominated assets. This not only delivers better control of overall liquidity it has the side effect of driving greater diversification.

For example, if you wanted to limit the deviation from target asset allocations from an exchange rate shock to a 5% overweight, this model would suggest a cap on foreign currency denominated illiquid assets of around 10%.