Wealth Management
PH&N Investment Counsel

Stu's View

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The liquidity conundrum

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Often overlooked, "liquidity risk" is how easily an asset can be converted into cash. During these volatile markets, we're managing portfolios to ensure they have adequate liquidity – while still benefiting from the important benefits offered by less-liquid assets.

There are four principle investment risks that you are likely to encounter as an investor:

1. **Interest rate risk relating to bonds and other fixed-income investments**
2. **Credit risk also relating to fixed-income investments**
3. **Company-specific risk, which is the best-known type of risk, and relates to equity investments like stocks**
4. **Liquidity risk, which is probably the least-understood type of risk (and the focus of this week's newsletter)**

Liquidity refers to how easily an asset can be sold for cash without the sale affecting its price. This week, we will discuss the need for portfolio liquidity, and how sufficient liquidity is a necessity to remaining invested through these volatile markets. Over the last few weeks, there have been varying degrees of illiquidity, as investors scrambled for liquidity (i.e. cash).

There is a liquidity risk spectrum, which we illustrate in Chart 1. Low levels of liquidity risk are associated with investments that you can easily convert into cash without having much of an impact on the price of what you're selling. At the other end of the spectrum, investments that have less liquidity present a risk to investors, as these instruments cannot be sold for cash in a timely manner without materially impacting the price. In order to compensate investors for this risk, they demand compensation, higher returns through a "liquidity premium" or "liquidity risk premium."

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The liquidity risk premium can increase or decrease over time as a function of changes in real interest rates, the economy and other factors (Chart 2).

The liquidity risk premium in Chart 2 is observable here by looking at the interest rate spread (differential) between two fixed-income securities with similar credit risk. This is fairly easy to do in the public bond market. The liquidity premium is not so easily observable in other markets. As such, investors may use a measure similar to that in Chart 2 as a general proxy for the liquidity premium with other investments. As you can see in Chart 2, the observable liquidity risk premium has increased most recently as economic growth has come to a standstill with the COVID-19 outbreak, and investor demands for liquidity have increased (i.e. the premium to hold illiquid assets has increased), while still well below the levels observed in 2008, likely as a result of large amounts of central bank liquidity available today.

Private markets – higher expected returns with higher liquidity risk

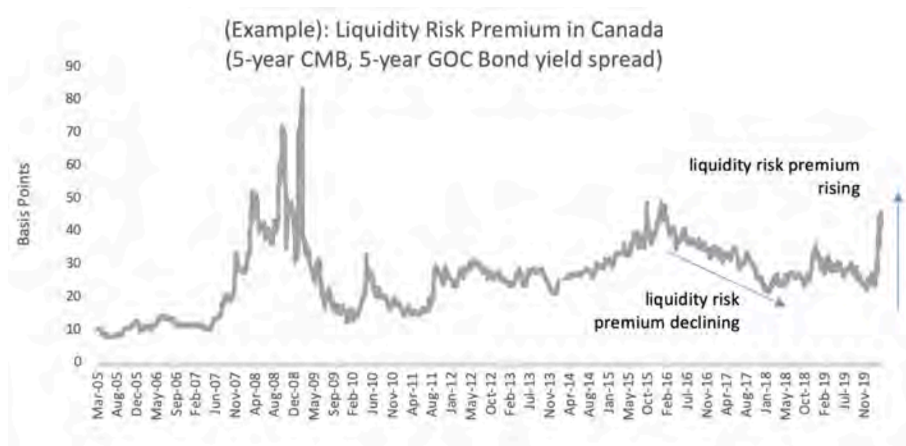
Over the last decade, investors have been increasing allocations to private assets (e.g., private lending assets, real estate, infrastructure, private equity and hedge funds), seeking higher expected returns via the illiquidity premium and other return factors, and also as a way to diversify portfolios given what have been low correlations between private and public markets.

There is a liquidity spectrum, even across private markets. Some private market investments require capital commitment for a number of years (a "lockup period"). Some lockup periods can be as long as 15 years, depending on the underlying investment. In some instances, not all of the initial capital allocated to a private market fund can

Chart 1: The liquidity risk trade-off

Source: RBC PH&N Investment Counsel Inc. The chart is for illustration purposes only.

Chart 2: Liquidity Risk Premium (spread, 5-year CMB yield vs. the 5-year Government of Canada bond yield)



Source: RBC Global Asset Management. A more pure measure of liquidity risk premium is provided by a look at Canada Mortgage Bonds (CMB). These bonds are issued by the CMHC which comes with a full Federal guarantee from the Government of Canada. When we view the spread between the 5-year CMB yield versus the 5-year Canada yield they both have identical Federal credit and differ only in liquidity.

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be withdrawn for a certain period of time. After the initial lockup period, investors can only redeem their shares at certain periods. In the case of most hedge funds, lockup periods can range from three months to three years, although not all hedge funds impose lockups. In addition to lockup periods, investors may be required to give advance notice before any redemption. This minimum notice period is known as redemption notice. Redemption notice periods range from 30 days to one year, although the most common notice periods are 30, 45 and 60 days. Some hedge funds do not impose a minimum redemption notice period.

Yet there are implicit benefits to the lockups as well. Investors have some assurance that they are investing alongside others with similar time horizons and they may not suffer from the impact of having to liquidate at a moment's notice and force the sale of assets at an inopportune time. Also, by not having the ability to liquidate investment capital, private equity fund managers are, in theory, better equipped than their public market counterparts to stay invested and be longer-term shareholders. They typically are not forced sellers in a bear market, or during a recession. Investors are likewise unable to materially alter their original investment strategy based on emotion, and usually at inopportune times.

Portfolio construction – balancing the liquidity conundrum

At RBC PH&N Investment Counsel, Investment Counsellors create customized portfolios for clients that are tailored to meet their financial goals and objectives, within the confines of time horizon, risk tolerance/capacity, unique circumstances and the need for liquidity. Liquidity is simply another risk factor like volatility that we need to manage and diversify. Portfolios may contain allocations to include less liquid, or illiquid investment instruments for a variety of reasons. We have access to both public market and private market assets to build portfolios. Our investment process ensures we look to understand how the specific investment can provide the portfolio with an improved risk-adjusted return, while also ensuring there sufficient sources of liquidity in other parts of the portfolio to meet ongoing cash needs, or a reasonable amount of liquidity in case of unforeseen event.

Investing in private equity in the time of COVID: risks and opportunities

How might the current bear market impact private equity asset values, and what opportunities might lie ahead for long-term investors? Private equity is a broad term which commonly refers to a type of equity investment in an asset in which the equity is not freely tradable on a public stock market. A private equity fund is an investment in a pool of discretionary capital that, in turn, makes equity investments in companies that are generally privately held or in securities that are not listed on a public market exchange.

Unlike a mutual fund, a private equity fund is an exempt market security and as such it is not required to give you a prospectus (a document that describes the investment in detail and gives you some legal protections regarding the fund), publish financial information or to notify the public of any change in its business and you may not receive any ongoing information about the private equity fund. No securities regulatory authority has evaluated or endorsed the merits of exempt market securities or, if applicable, the disclosures in any disclosure document it has prepared. You may never be able to sell the exempt market securities and even if there is a market for the sale of the exempt market securities, there may be restrictions for a specific period of time on your ability, and additional financial costs, to resell the exempt market securities. Private equity funds are more risky than other securities and not suitable for all investors.

Near-term challenges

Broadly speaking, private equity valuations, and net asset values as of the end of March 31, 2020, are unlikely to reflect any impact from the current environment. This may on the surface appear to be a safe-haven asset class that has been spared from the carnage of the public markets to date, but there is a lag in reported valuations of course. Investors in private equity should expect earnings and distributions to be lower in the coming quarters with a lagged impact. It's likely that not until July reporting is out that some of the COVID-19 impact will be visible. Similar to public equity companies, investors should expect that private companies were drawing down revolving credit facilities to build up cash positions as activity slowed, so financial leverage is increasing. In addition, there is likely deferral of capital expenditures, hiring freezes, furloughs and layoffs. The impact of these are likely to play out over several quarters. From what we can see, it is clear that deal-making activity has slowed, which may result in fewer capital calls and distributions over the medium term, but that remains to be seen.

Investors in private equity may expect capital calls in the near term to fund previous deals held on fund credit facilities. As some private equity investors experienced in 2008–2009, multi-year capital commitments reduced portfolio liquidity, and capital calls during liquidity droughts forced them to sell other assets at inopportune times to satisfy the calls. This particular illiquidity risk – commitments implying lost flexibility and implicitly sold options – had been underestimated in good times.

Broadly speaking, over long time periods, returns to private equity have outpaced those in public equities, as well as during the financial crisis in 2008 (chart 3).

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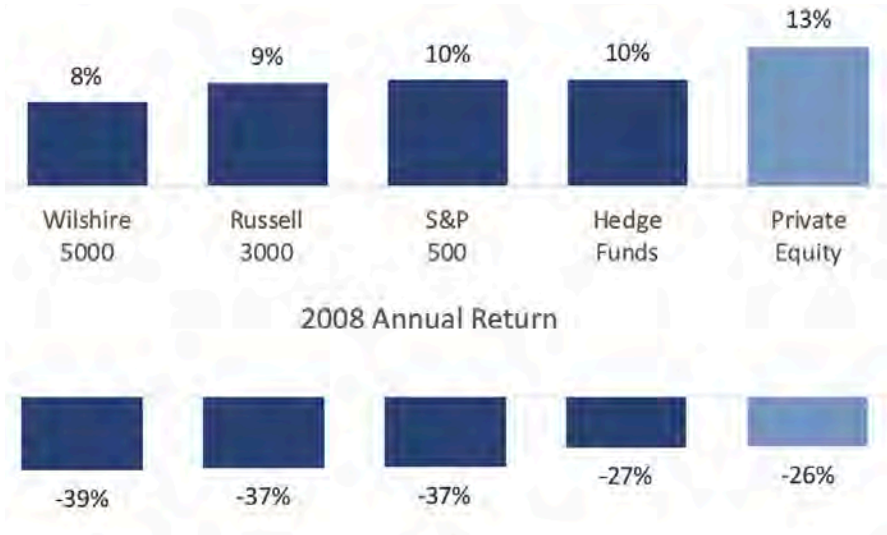
Opportunities for long-term investors

Similar to public equity markets coming out of the COVID-19 crisis and bear market, there might be opportunities for private equity investors as a result of the COVID-19 crisis. Private equity investors are typically not sellers in a market like this, as they are more focused on long-term cash-on-cash return, versus daily marked to market positions. Private equity funds with a sizable portion of cash that is waiting to be deployed may find more opportunities than in the recent past to invest. This could create some positive longer-term investment returns for certain funds. It's important to know also that private equity funds are usually invested over 4-5 years (fund of fund structures over 7-8 years), so portfolios are naturally hedged from a timing standpoint. Prior to the slowing economic backdrop, some older vintages may have already realized substantial returns, while the younger vintages have dry powder to play offense in an improved valuation environment.

Chart 3: Long-term returns (1992-2019)



Reprinted with permission from GoldPoint Partners, LLC. Annualized returns as of December 31, 2019 Source for Public Indices: Bloomberg. Pooled return and 2008 annual return for Wilshire 5000, Russell 3000, S&P 500, and HFRI Equity Hedge Total indices. These may not be indicative of the broader market. Source for Private Equity: Cambridge Associates LLC. Includes pooled returns and 2008 annual return of 1992-2019 North American buyout funds of all fund sizes. Pooled returns represent the net return calculated on the aggregate of all cash flows and market values as reported by individual fund managers in their quarterly and annual audited financial reports. These returns are net of management fees, expenses and performance fees that take the form of carried interest. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results.

Update: What we are watching

The narrative in the market has subtly changed from panic to cautious optimism. China has been gradually relaxing social distancing measures and normalizing since the beginning of March. Countries in the West could follow suit in the coming month(s). The market is reading signs that social distancing measures and lockdowns may be having a positive impact on "the curve".

What We Are Watching

Factor	Result
Significant disease containment	Mostly
Major government stimulus	Mostly
A decline in the number of new daily cases in Italy	Yes
A decline in the number of new daily cases in the U.S.	No
A decline in the daily global fatality rate	No
A decline in the total number of people actively sick	No
Development of an important therapeutic treatment for COVID-19	No
End of quarantining = No, China starting to return to work	No
A return to economic growth	No
Development of a vaccine	No

Much as we're hopeful about the improvements over the last week, we still expect the bear market to continue on. We cannot say with any degree of certainty for how much longer, or how much further asset prices will decline from here, if at all. Instead we are focused on our process: systematic, strategic rebalancing to take the emotion out of it and avoid trying to time the market. Plus, we can ensure we remain well diversified across a number of factors, including liquidity risk.

As always, and especially during this time of stress, we welcome any, and all, of your questions related to financial markets and the impact COVID-19 may have on your investment portfolio, at any time. As we move through this period of uncertainty, we promise to consistently provide you with relevant market and portfolio updates, and wish you and your family all the best.

Be well,
Stu

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Wilshire 5000 Index: The Wilshire 5000 Total Market Index measures the performance of all U.S. equity securities with readily available price data. Approximately 5,000 market-capitalization-weighted security returns are used to adjust the index. The Wilshire 5000 base is its December 31, 1980 capitalization of $1,404.596 billion; therefore, the index can serve as an approximation of dollar changes in the U.S. equity market in billions of dollars.
Russell 3000 Index: The Russell 3000 Index is a capitalization-weighted stock market index, maintained by FTSE Russell that seeks to be a benchmark of the entire U.S stock market. It measures the performance of the 3,000 largest publicly held companies incorporated in America as measured by total market capitalization
S&P 500 Index: The S&P 500 Index includes 500 companies across many sectors of the U.S. economy. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The index is designed to measure performance of the broad US economy through changes in the aggregate market value of the largest US companies.
HFRI Equity Hedge Index: The HFRI 500 Equity Hedge Index is a global, equal-weighted index of the largest hedge funds that report to the HFR Database which are open to new investments and offer quarterly liquidity or better. The index constituents are classified into Equity Hedge, Event Driven, Macro or Relative Value strategies.