# Is the illiquidity premium dead?

BROUGHT TO YOU BY THE MULTI-ASSET SOLUTIONS TEAM

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## Executive summary


- Each quarter, we survey managers across the New York Life Investments platform to gather views, identify priority themes, and pressure-test investment ideas.
- The rapid return of abundant liquidity and high valuations in private markets has been a focus for our U.S. managers. Despite the likelihood of modestly rising interest rates in the coming years, factors driving demand for private asset classes are likely to endure, raising concerns about future sources of return.
- The story is slightly different in Europe where decentralization, geographic fragmentation, and a still-maturing market provide ample opportunity to harvest an illiquidity premium, particularly in the mid- and lower-mid market.
- While the illiquidity premium may be durably lower in some markets in years ahead, the business risk premium for investors is alive and well.
- This piece examines how the oft-cited "search for yield" is playing out in a new economic cycle, how managers are adapting, and priorities for excelling in a highly competitive market.

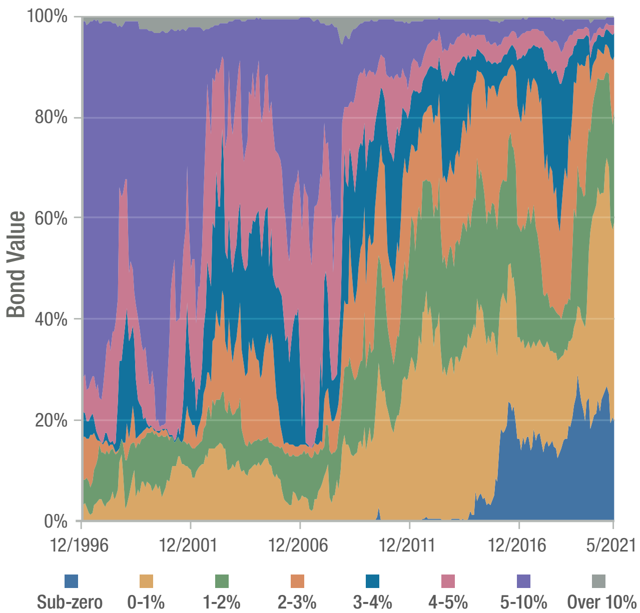

NEW YORK LIFE INVESTMENTS

# Pandemic disruption short-lived, search for yield persists

“Search for yield” was a common refrain in the wake of the 2008 financial crisis. Record-low interest rates and sluggish growth prompted a large and consistent flow of capital to higher-yielding asset classes, including private markets.

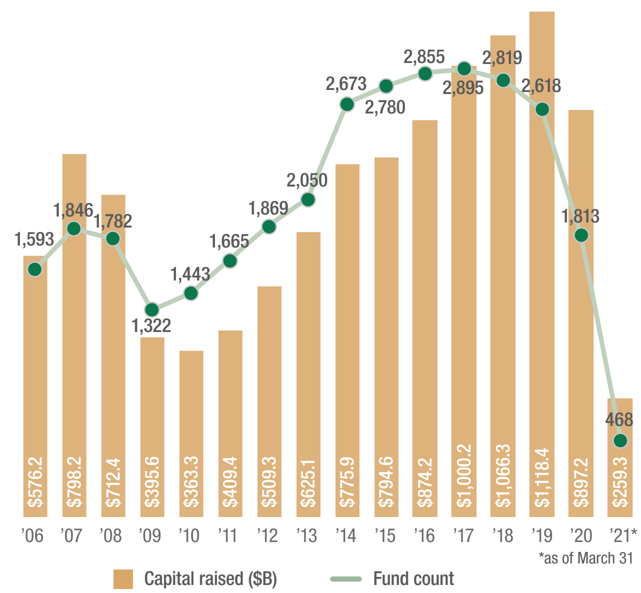
## The search for yield continues

**Persistently lower bond yields...**
Global markets bond value by yield ranges




Sources: New York Life Investments Multi-Asset Solutions, Bloomberg Finance LP, PitchBook, 6/30/21. Past performance is no guarantee of future results.

**...have led to a consistent uptrend in fundraising**
Private capital fundraising activity, $B




Sources: New York Life Investments Multi-Asset Solutions, Bloomberg Finance LP, PitchBook, 6/30/21. The COVID-19 pandemic impacted fundraising in 2020. As a result, 2020 fundraising volumes may not be indicative of a reversal in the fundraising uptrend.

Abundant liquidity increases opportunities, but also exacerbates competitive challenges. Even before the pandemic, pressure to put money to work led to increasing valuations across asset classes. High valuations reduced return potential and encouraged investors to take on more leverage and invest in lower-quality companies.

All the while, investors feared that a disruption to liquidity would bring a “reckoning” to risky investor behavior.

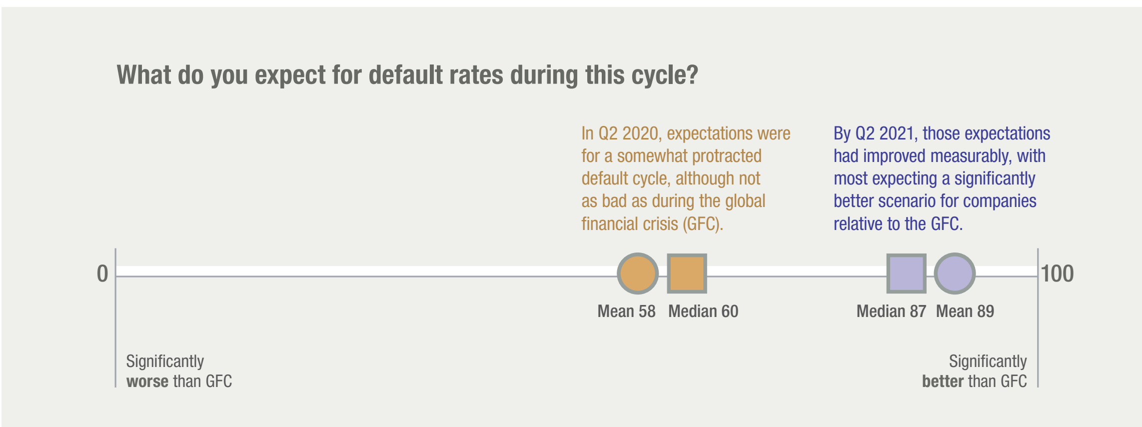
The COVID-19 pandemic appeared to be that reckoning, at least for a time. But swift monetary and fiscal support helped to stabilize the corporate environment. Company defaults, while numerous, were far below financial-crisis levels. Expectations for corporate defaults have all but moved into the rear-view mirror.

**PAUL BEHAR**
NEW YORK LIFE REAL ESTATE INVESTORS
(Real estate)

*The Global Financial Crisis acted as a receding tide that lowered all boats, regardless of asset class, sector, or geography. The COVID-19 pandemic prompted a very different dynamic; a sectorial and geographic bifurcation. Still, demand for quality assets in favored sectors is elevated and is resulting in fierce competition leading to compressed yields. Adding value requires anticipating future trends and making smart moves where we have a high level of conviction. In real estate, anticipating demographic trends, including migratory patterns, has always been important. The pandemic has accelerated some of those trends, to the benefit of those investors already positioned to capture that upside.*

## Portfolio managers' survey shows improved perspective on default rates

### Market data supports managers' perspective





Sources: New York Life Investments Multi-Asset Solutions, Quarterly boutique survey, Q2 2021, conducted June 1–June 7, 2021. Bloomberg LP, 6/23/21.

This dynamic has led investors to wonder: If the pandemic and corresponding zero-revenue environment couldn't shake up the scale of liquidity in private markets, what can? And if an abundance of available capital keeps valuations at record levels, can investors still capture the incremental yield they seek in private markets anyway? If not, why accept the longer lockup period?

In other words: Is the illiquidity premium dead?

Prudent investors will tell you that just when you start wondering whether market discipline will return, it tends to surprise you. While expansionary periods tend to be constructive for both underlying economic growth and liquidity, it is important not to become too complacent. Both cyclical and structural factors could result in a damaging liquidity shock.

## What could result in a liquidity shock?

**Black swan:**[1] An unexpected economic or geopolitical shock results in deterioration in economic (credit) and market (liquidity) conditions. Fiscal and monetary support may prove insufficient in maintaining orderly capital market functioning.

**Higher interest rates:** Stronger trend growth and higher inflation raise interest rates, potentially reducing attractiveness relative to public asset classes. For this to occur, we would need to see:

- *Stronger trend growth:* Sustained stronger productivity and labor force participation contribute to higher long-term economic growth rates, resulting in a higher cost of capital.
- *Stronger inflation:* If "transitory" inflationary pressures prove durable, higher policy and market interest rates would follow.
- *Receding international demand:* The "search for yield" is not a domestic phenomenon; global appetite for U.S. assets contributes to lower market interest rates. Its abatement, whether due to the emergence of relatively more attractive stores of value or due to reduced trust in U.S. policy stability, could weaken or reverse that effect.

**Market structure:** A regulatory, capital, or competitive dynamic reduces the attractiveness of private assets relative to public asset classes. Investors are left without options.

1. A black swan is an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. Black swan events are characterized by their extreme rarity, severe impact, and the widespread insistence they were obvious in hindsight.

Careful navigation of these risks is important to adding value to the multi-year lockup periods that private market investments require. But few investors consider these risks urgent, and many believe that demand can sustain a liquidity shock. The low-yield post-financial crisis environment pushed many investors to assess and develop comfort in private asset classes. Greater comfort with these higher-yielding asset classes makes a flight to public markets unlikely.

**JENN COTTON**
MADISON CAPITAL FUNDING
(Private credit)

*Private asset classes were less utilized before the Global Financial Crisis, in part because their risk factors and levers of value-add were less known. The global search for yield prompted more investors to consider and develop fluency in private asset spaces. This comfort may make it less likely that capital dedicated to the space evaporates. Alternative asset classes are often actively managed and offer unique attributes compared to other asset classes.*

Additional flexibility in some private markets, such as private equity, may also mitigate the risk of capital outflows from the space. Investors have created ways to break from traditional structures for those who need faster liquidity, or, by contrast, who want to hold strong businesses with attractive prospects for growth longer than their initial hold period. These innovations in funding have created additional comfort with the asset class and may contribute to its buoyancy.

## Beyond the illiquidity premium

With demand for private assets posed to persist, investors have to consider other sources of value creation. Just as declines in the risk-free rate have driven investors to assets benefiting from an illiquidity premium, a declining illiquidity premium means investors must leverage other sources of return.

## The building blocks of investor return

**Investor return**

**Market characteristic — Risk-free rate**

Investor's expected return from a risk-free asset over a period of time, often represented by U.S. Treasury yields.

**Market characteristic — Equity risk premium**

Excess return earned by an investor when they invest in the stock market over a risk-free rate. This return compensates investors for taking on the higher risk of equity investing.

**Market characteristic — Illiquidity premium**

Additional compensation required to encourage investment in assets that cannot be easily and efficiently converted into cash at fair market value.

**Manager's skill — Business risk premium**

Return generated by taking on the uncertainty of a company's future cash flows, which are affected by the operations of the company, its capital structure, and the environment in which it operates.

Opinions of New York Life Investments Multi-Asset Solutions.

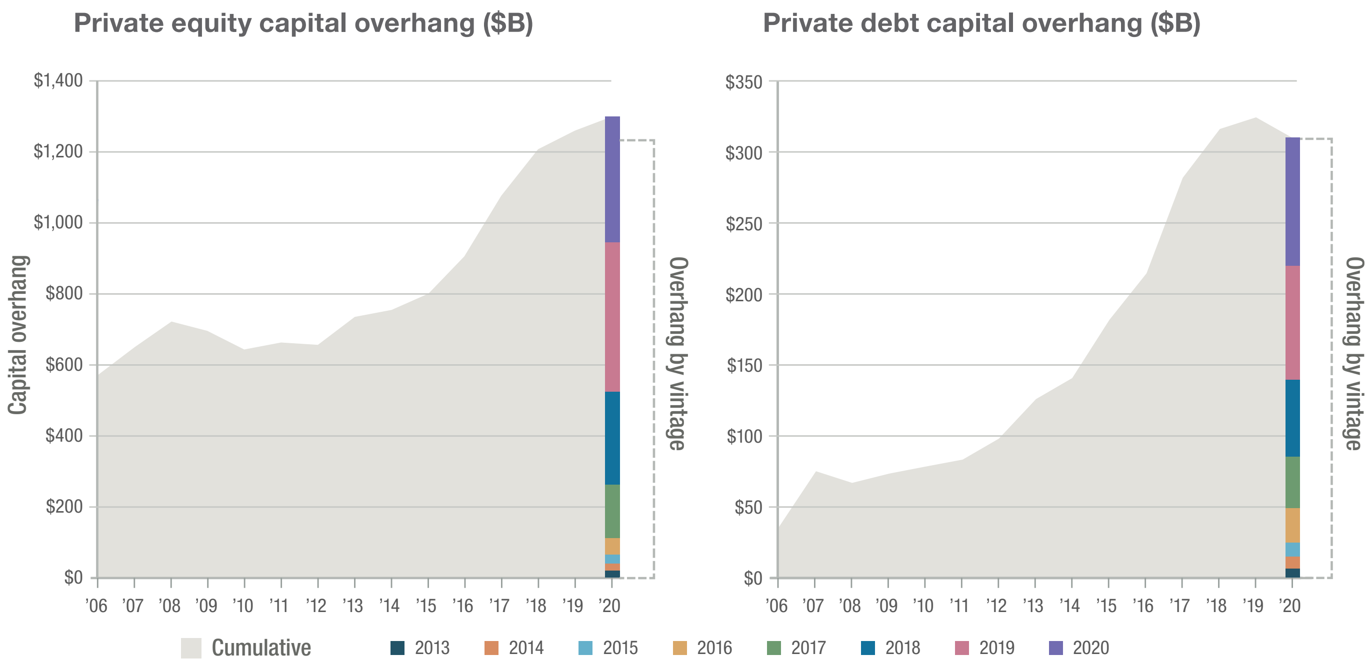
**CHRIS STRINGER**
PA CAPITAL
(Private equity)

*When making an investment, we consider all the building blocks of return. The risk-free rate, equity risk premium, and now even the illiquidity premium have declined amid persistently low interest rates and a global search for yield. However, investors' value-add need not be tied to these factors, which are outside of our control. There is ample opportunity to generate returns where investors can access innovation or an active business-building approach — opportunities that aren't available in public markets.*

## Generating business risk premium as valuations climb

Given the flood of capital to private markets, managers have record dry powder. This cash is being invested at record valuations, which creates challenges and increases competition for investment teams. Private markets managers are often “buy and hold” investors, with lockup periods of anywhere from 3-12 years; a lot can happen in the economic environment and capital markets during that period, reducing investors' margin for error.

### Record dry powder is unlikely to go anywhere fast




Source: New York Life Investments Multi-Asset Solutions, PitchBook Q1 2021 Private Fund Strategies, 9/30/20.

As a result, a manager's investment thesis needs to factor in not only broader capital markets considerations but specifically the value creation options for the business, including — but not limited to — what can be done to pivot if the macroeconomic cycle turns.

At the same time, investors in some markets face a dearth of alternatives. If the only way to capture additional yield is to lever up positions or move lower in quality, those positions require more rigorous due diligence.

**Credit evaluation is still key.** In debt products, protecting principal and generating income are primary goals. The return profile for investors is asymmetric: Upside potential is capped, while downside could mean a default scenario. The ability to evaluate credit can add significant value in periods of vulnerability. And while quantitative analysis is a vital component of this process, qualitative analysis — including an understanding of market dynamics and the borrower's levers of value creation — is just as important.

**Know what to avoid.** Modeling downside scenarios is a bit of art. Managers with long histories and deep knowledge of the market can refer to how similar business models have reacted during different crises. This experience is valuable not only in manager selection, but also within teams as they react to unforeseen challenges.

**Find a durable capital base.** Investors backed by a long-term, persistent capital base can leverage two benefits during various market periods: (i) opportunistically purchase well-priced assets in macroeconomic downturns and provide flexible, durable partnership to select borrowers facing near-term constraints, and (ii) more readily invest when tailwinds are strong and debt issuers have their choice of capital providers.

A long-standing approach to the market can also help in sourcing the best opportunities over time. In order to turn down unattractive deals, investors must have a strong pipeline that allows them to be selective. This takes time and infrastructure, which aren't always available for new entrants.

ARON DAVIDOWITZ
PRIVATE CAPITAL INVESTORS
(Private placements)

*Market dynamics being what they are, investors can't simply deploy dollars in private assets. They need to have access to the best deals from trusted partners. Relationships are about more than just doing deals. Proving that you can act as a counterparty of choice, capable of writing a large check, and likely to be there for future add-on deals or refinancing — across various market cycles — that's how investors source the best opportunities in today's environment and create mutual value for investors and issuers.*

**Don't race to the bottom**. With so much cash chasing deals, new market entry results in higher prices, elevated leverage levels, and weaker covenants—potentially lowering returns or elevating risk. Relying on good management teams with strong relationships and multiple levers of value creation can win hard-to-access deals without sacrificing covenants.

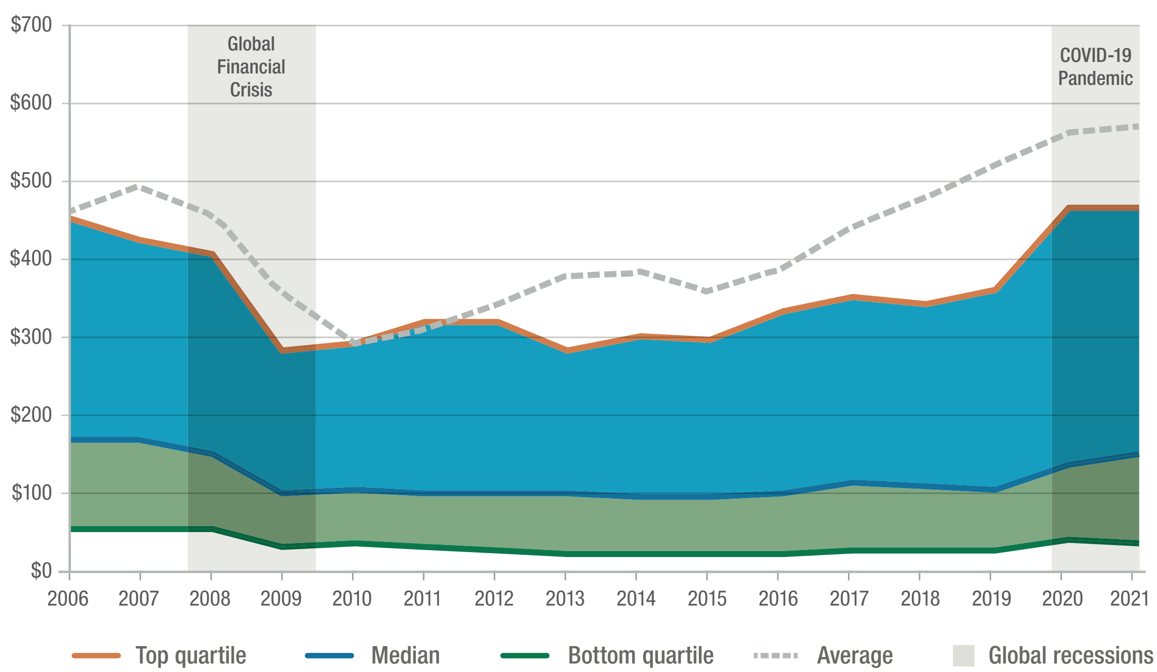
**Cutting costs isn't the only way.** A common concern about private equity is that managers cut costs to generate value. While this is one important lever of value creation, focusing on business growth may be a more sustainable approach. Investing in talent and operational excellence can be a stronger path to scaling cash flow. Working with borrowers on terms that allow them to adapt and grow may also add value.

**Consider the mid- and lower-mid market.** Pulling on those different levers of value is not always straightforward; that's part of the logic behind an illiquidity premium in the first place. In some markets, investors can trade in and out of deals and loans more quickly. For others, assessing opportunities, selecting managers, and evaluating solid borrowers can take years of infrastructure creation. This highly manufactured value-add can generate higher or more durable returns, but it's not available everywhere. In private debt, and private equity in particular, we consider the middle market to provide a stronger source of potential value-add.

**Leverage a repeatable playbook.** Both the Global Financial Crisis and the COVID-19 pandemic were highly unusual economic cycles with vastly different consequences. The next cycle will look different, too. The complexities of private capital give investment teams more opportunities to create value. How do you know if a buyer is capable of that? You can only do it by looking at the manager's history. Managers with a proven, repeatable playbook, tested across multiple market cycles and strong market reputation, are more likely to weather the next storm.

## Different cycles, different funding environments

**Private Capital Fund Size ($M)**




Source: New York Life Investments Multi-Asset Solutions, PitchBook Q1 2021 Private Fund Strategies, 3/31/21.

**Diversify by geography.** Not all markets are created equal, particularly for private credit. The U.S. is large, mature, and fairly homogenous in structure, making concepts discussed in this paper, such as the business risk premium and the middle market opportunity, particularly valuable for yield-seeking investors. The European market, by contrast, is more fluid — growing, maturing, and expanding where its U.S. peers are more rigid. It is also more fragmented, with documentation, origination strategy, and banking structure varying by country. This creates an opportunity for private credit partners who can navigate a decentralized region, offering distinct advantages to investors, including the ability to harvest an illiquidity premium.

**JAIME PRIETO**
KARTESIA
(European private credit)

*Harvesting an illiquidity premium has become more demanding for private U.S. investors, who instead must rely on trusted partnerships, business building, and careful credit selection to add value across market cycles. These same tools are valuable to success in European private credit as well. However, the European lower-mid market offers additional opportunities to private credit investors relative to the U.S. Leveraging disciplined and consistent positioning across European countries can result in better risk-adjusted returns. The adage that investors must take higher risk to generate higher return may not be true in this case.*

**Consider cross-asset relationships.** Some asset classes, such as private debt and private equity, are deeply intertwined. This link may result in correlated risks: Distress in one asset class can impact another. However, it can also create coordinated levers of value. Leveraging general partner (GP) relationships across asset classes could generate new opportunities.

# What's next?

There are always uncertainties in the investment environment, but they may be more pronounced after the COVID-19 pandemic. It's not difficult to consider *how* financial conditions could tighten, but ample policy support and available capital make it tempting to join the trends towards higher leverage, weaker covenants, and higher risk.

Instead, investors can leverage true business acumen to add value. While there may be debate about the persistence of the illiquidity premium, the business risk premium is alive and well.

All the while, the macro backdrop for private assets is strong. We expect robust growth, moderate inflation, and improving credit fundamentals in the coming years — all constructive for private investment. Low global yields likely mean that the "search for yield" is here to stay, which means flows to private assets are likely to continue.

But performance dispersion of private capital firms is wide. When testing new waters, it is essential to work with managers who have sailed in rougher seas.

## Definitions

**Alternative asset classes** typically refer to investments that fall outside of the traditional asset classes commonly accessed by most investors, such as stocks, bonds, or cash investments.

**Dry powder** refers to cash or marketable securities that are low-risk and highly liquid and convertible to cash.

**Environmental, Social, and Governance (ESG)** refers to the three central factors in measuring the sustainability and societal impact of an investment in a company or business.

**Excess return** is the return of a portfolio in excess of its benchmark where in excess is calculated geometrically by subtracting the benchmark's return from the portfolio's return in each period.

A **general partner (GP)** refers to the private equity firm responsible for managing a private equity fund. The private equity firm acts as a GP, and the external investors are LPs. The investors who have invested in the fund would be known as Limited Partners (LP), and the PE firm would be known as General Partner (GP).

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