Performance of Private versus Liquid Alternatives: How Big a Difference?

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Interest in alternative investments as a diversifier to traditional asset classes has been high and now extends beyond large institutional investors to retail investors and defined contribution plans. Institutional investors most frequently invest in alternatives through private partnership vehicles that generally possess initial lock-ups of one year or more, and restricted (quarterly, annual) redemption opportunities thereafter.

However, adaptation to the retail market has led most alternatives managers to modify their investment approach to accommodate the required liquidity demands from retail investors. Today most alternative products offered to retail investors have daily or weekly liquidity.

Until now, no one has examined whether, or to what extent, investors in liquid alternative vehicles forego return in exchange for better liquidity, compared to equivalent investment in institutional private partnership vehicles. Our study answers the "liquidity discount" question as applied to alternatives.

We find that returns for liquid alternatives on average trail private alternatives by approximately 1% annually. The discount is persistent across time but varies inversely with market stress. For example, the discount declines when market stress increases, consistent with the notion that investors value liquidity more during periods of market stress. The discount also varies by alternatives strategy and the type of liquid vehicle chosen.

Study Data

Our findings are based on monthly net-of-fee return data from 109 investment firms that manage both private and liquid offerings under the same general alternative strategy. While we believe that there exists upwards of 400 investment firms that might potentially qualify for our study, data collection challenges led us to focus our study on a subset of the entire universe. However, the firms in the study are generally larger and known to most industry participants. As such, we can also authenticate information reported by the managers from independent sources.

We next create private/liquid pairs matching the private partnership offering[1] with a liquid offering. Firms may have multiple pairs if they offer more than one liquid offering. We distinguish five different liquid offerings:

1. *40 Act Fund*: a U.S. exchange-listed, open end mutual fund with daily liquidity.
2. *SMA*: Separately managed accounts can offer better liquidity terms than the private partnership. In most cases, the SMA's in our study were managed for large investors, but a few investment firms gave us their track record that is part of a fund-of-funds.
3. *UCITS*: Undertakings for Collective Investment in Transferable Securities is a European regulatory structure that is similar in some ways to U.S. 40 Act funds. The first UCITS directive came in 1985. Today, hedge fund strategies wrapped in UCITS funds are sometimes referred to as Newcits. Like 40 Act Funds, certain security, leverage, and liquidity tests must be met to quality as UCITS.

[1] Private partnerships are generally onshore or offshore.

4. *Platform*: These are privately negotiated commingled fund structures, usually hosted by a large bank, broker/dealer, or wealth manager. They generally offer similar liquidity to UCITS. Most offer weekly liquidity, but some are daily.
5. *Listed Security*: This is a listed version of a hedge fund (most often the London exchange), or a closed-end fund. Listed securities may trade based on more than movement of the underlying net asset value of its holdings. This is true of closed end funds, which often trade at a discount (or premium) to NAV.

The 109 firms in our sample provided a total of 148 pairings. Some firms offered the same strategy in more than one liquid form and other firms offered more than one strategy.

Findings

Exhibit 1 summarizes the findings of our study.[2]

Exhibit 1: Performance Comparison of Private versus Liquid Alternatives:
Ten Years ending March 2013

	1	2	3	4	5	6	7	8
	Average Difference Between Private and Liquid Alternatives				# of			Median Return
	Return	Risk	Beta	Alpha	Pairs	Std. Dev	T-Test	Difference
All Strategies*	0.98%	0.17%	-0.01	0.97%	148	3.68%	3.23	0.86%
Equity L/S	1.07%	0.01%	0.00	0.96%	49	4.04%	1.86	0.52%
Credit	0.95%	1.01%	-0.01	1.08%	22	4.86%	0.92	0.71%
Market Neutral	2.24%	-0.87%	-0.01	2.15%	10	2.84%	2.50	0.94%
Multistrategy	0.61%	-0.03%	-0.20	1.32%	3	4.43%	0.24	2.18%
Managed Futures	0.48%	0.79%	-0.01	-0.24%	22	2.01%	1.11	0.42%
Macro	0.22%	-0.21%	-0.06	1.49%	23	4.10%	0.26	0.86%
Event Driven	2.26%	0.55%	0.05	1.65%	15	1.71%	5.14	1.60%

* Three strategies (Commodities, Currency, and Short-Biased) are not shown because they contain just 4 pairs and deemed not significant. The 4 pairs are included in the "All Strategies" sample.

Across all 148 pairs and covering all strategies, the average difference in return between private and liquid alternative product offerings is 0.98%, annualized. Expressed differently, the average investor is paying, in reduced return, approximately 1% per year for the preferential liquidity found in retail oriented alternative products versus their institutional private partnership counterparts. We cannot say whether 1% per year is a “fair” exchange for the liquidity offered, but it is not inconsistent with other public-private liquidity comparisons such as yield differences between private and public debt. It does seem to us that both private and public clienteles can view our findings favorable to them.

The 0.98% overall finding in Exhibit 1 is not consistent across individual strategies. Event driven and market neutral strategies look to have the highest cost for liquidity, while macro and managed futures show the lowest cost. The need to stay with more liquid names in the case of event driven managers and limits on leverage in the case of market neutral managers might explain the higher price for liquidity for those two strategies. Macro and managed futures strategies operate in the most liquid markets. Also,

[2] Returns in column 1 are calculated based on the difference in total net-of-fee returns for private and liquid vehicle pairs covering the longest overlapping period, and annualized. Risk in column 2 equals the differences in standard deviation between each private and liquid pair, averaged and annualized across all pairs. Beta values in column 4 equal the difference between private and liquid return betas using MSCI ACWI as the independent variable, and averaged across all pairs. T-bill returns are subtracted from vehicle and ACWI returns in calculating beta and alpha. Alpha in column 4 equals the difference in intercept terms, annualized and averaged across all pairs. Column 6 measures the standard deviation of the 148 paired return differences reported in column 1. Column 7 provides the T-value testing the hypothesis that the differences equal zero. Values above 2.0 indicate statistical significance that the difference is not zero.

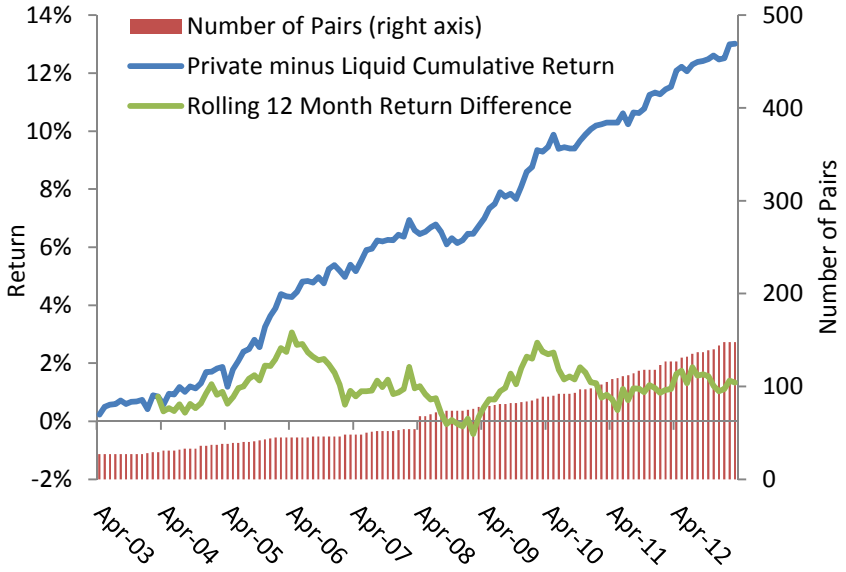
their private partnership liquidity terms are often the most generous. Both factors probably explain the smaller return differences.

Column 6 reports the standard deviation of return differences. Higher values likely suggest a broader range of strategies within the strategy. For example, the 0.95% average return difference for credit strategies is consistent with our expectation. However, the 4.86% standard deviation in individual credit pair outcomes is the high and suggests a wide range of pair results, which we believe is correlated with the diverse liquidity and quality of underlying credit holdings among credit managers.

In columns 2 and 3, we also show differences in risk – both total risk and beta – between private and liquid alternative pairs. We can reasonably conclude that the riskiness of private and liquid alternatives is roughly the same. This also implies that alpha, which measures risk-adjusted excess return, is roughly similar between private and liquid alternatives. If the difference in total return is 0.98% and the difference in alpha is 0.97% -- virtually identical – then we can conclude that the liquid alternatives investor is paying for better liquidity out of alpha rather than other sources of return. This is the finding we would have expected.

Exhibit 2 shows how differences between private and liquid alternative returns vary across time.

Exhibit 2: Cumulative Difference in Performance of Private versus Liquid Alternatives:
Ten Years ending March 2013



The bars at the bottom of the graph report the number of pairs existing at any point in time. There were fewer than 50 pairs (right axis) at the beginning of the period in April 2003, but the number grew to 148 as of March 2013. The green line shows rolling 12 month return differences between private and public alternatives and the blue line reports cumulative differences in returns.

Rolling annual differences in return do vary, but not by much. They grew to around 3% on two occasions (2006 and 2010) and became negative – liquid alternatives outperformed private alternatives – on one occasion. Not unexpectedly, the negative difference occurred during the 2008 Financial Crisis when the market placed a premium on liquidity. As such, we would expect that assets in liquid vehicles would have preferential pricing relative to assets in private illiquid partnerships. That seems to apply to alternatives as well.

Finally, we examine whether the liquidity discount is the same across different liquid platforms. We find that the return difference is the greatest for platforms, where the average difference in return is 1.68% and statistically significant. The larger difference may be due to higher fees that typically are associated with this liquid vehicle. On the other hand, we found much lower return differences for 40 Act funds and UCITS, equal to 0.43% and 0.55%, respectively. However, results for the 40 Act funds and UCITS are

not statistically significant due to fewer pairs. Our observation is that in more recent years when more pairs are available, the return differences between private partnerships and 40 Act and UCITS liquid vehicles is closer to the overall 1% average.

Conclusion

The growth of alternative investments in the retail market is dependent upon the introduction of product offerings that have daily or weekly liquidity because that is what that market requires. It has been an unanswered question whether alternative investments that have been successful in the institutional market with limited liquidity can be adapted to the retail market with its demands for more liquidity, lower fees, and various investment restrictions.

We answer this question by examining net-of-fee performance for 109 larger and better known investment firms that offer their investment strategy in both private partnership and liquid vehicles. We find that the average cost of better liquidity in retail products is approximately 1% annually for the same investment manager. Individual results vary across strategy, time, and vehicle but do so in a way largely consistent with investor expectations. We believe that the 1% performance deficit found in our study will be viewed by both private partnership investors and retail investors as a reasonable price to pay for enhanced liquidity.

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