Property and the illiquidity premium

As non-classically trained investment operatives, over the years we have found the question “why” to serve us extremely well. Over the last 10 to 15 years, given market performance, we have constantly questioned why unlisted assets are expected to provide a return premium over their listed peers.

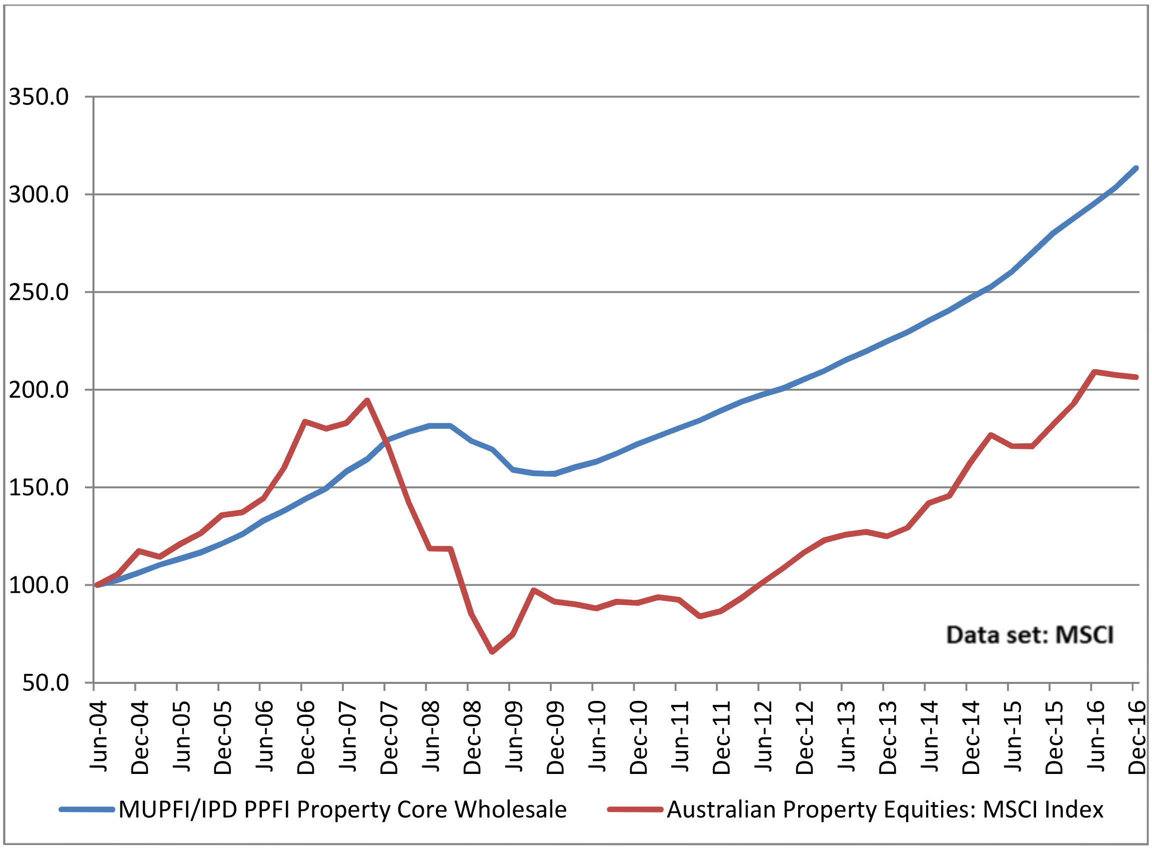
Classical investment theory defines the illiquidity premium as compensation for the loss of control (or liquidity) to exit an investment position at a desired point in time. This is sound logic if markets always trade upon fundamentals; however once behavioural forces come into play this theory seems to deviate.

Interestingly, our research for this article left us thinking that the mortal sin of investing is having investors lose control of their equity (i.e. locked funds). While we appreciate the sensitivity of the loss of control, we would have thought the mortal sin of investing was to lose the capital. The distinction between these two will become clearer in a moment.

Our experience is in property. Historically unlisted property has provided a return premium of between 100 and 300 basis points (bps) over listed property as recompense for a loss of control and poor (or no) liquidity. Interestingly, property is a fantastic asset class by which to assess this illiquidity premium concept as the listed and unlisted property markets in Australia are deep and generally well researched.

Figure one illustrates the returns from listed property and unlisted (core) property since 2004. This data captures the pre-and post-Global Financial Crisis (GFC) markets, so is a strong representation of the impact of the cycle.

Figure one: Pre-Fee Cumulative Returns (June 2004 = 100)



Source:MSCI

Pre GFC, the listed market was trading at a premium to its unlisted counterpart, clearly at odds with the illiquidity premium – then the listed market was savaged during the GFC.

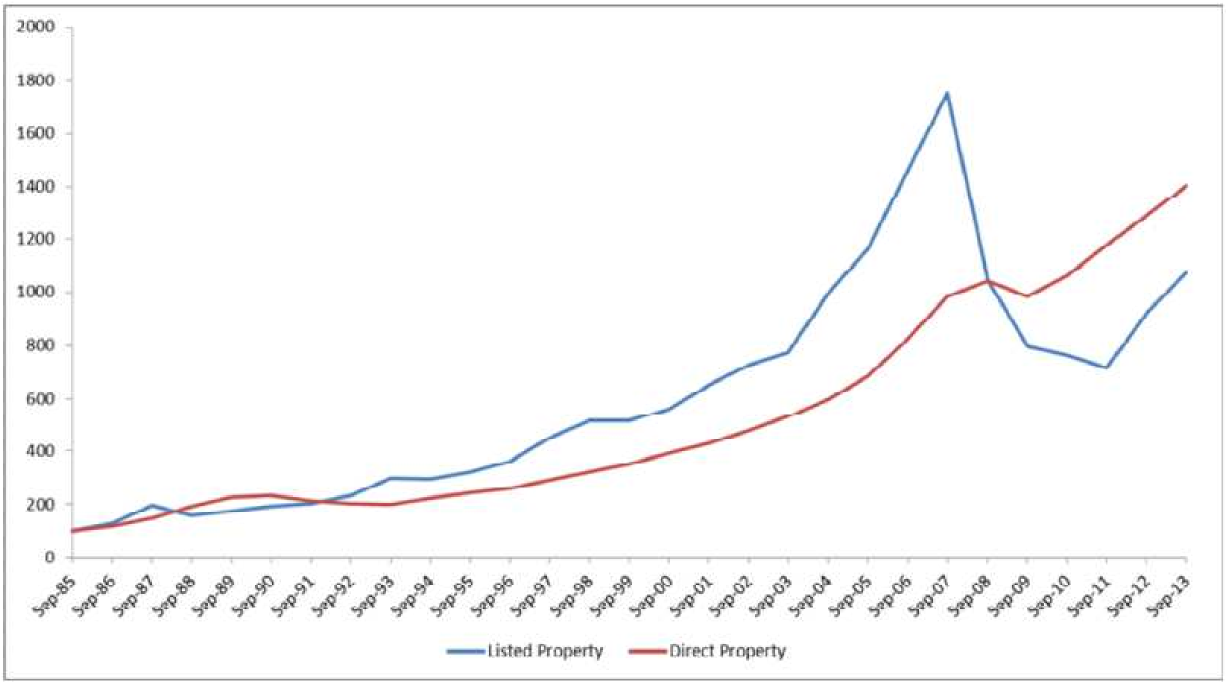
Herein lies the disconnect – in boom markets the liquid market appears to trade at a premium to its unlisted counterpart, and then in a market correction, the liquidity sees prices savaged. Figure one indicates that during the GFC, peak to trough listed property lost ~70% of its value whereas unlisted property only declined ~20%.

On this basis, there is an argument that liquid investors should obtain a premium for the price volatility of their investment. Interestingly the listed market also took almost 10 years to regain its pre GFC values whereas the unlisted space took only 3 years.

This position is further supported by the chart in figure two, which is based on S&P, ASX, PCA and MSCI data. While this chart is a few years out of date, it is the trends that are relevant.

In 17 of the 28 years covered, listed property trades at a premium to unlisted property, and more to the point, with significant price volatility. If you were to extend this chart to today, listed property would have had a return premium in 17 of 31 years, which is still more than 50% of the time. This appears at odds with the illiquidity premium theoryas for the majority of the period the liquid market has traded at a premium.

Figure 2: Listed property versus direct (unlisted) property

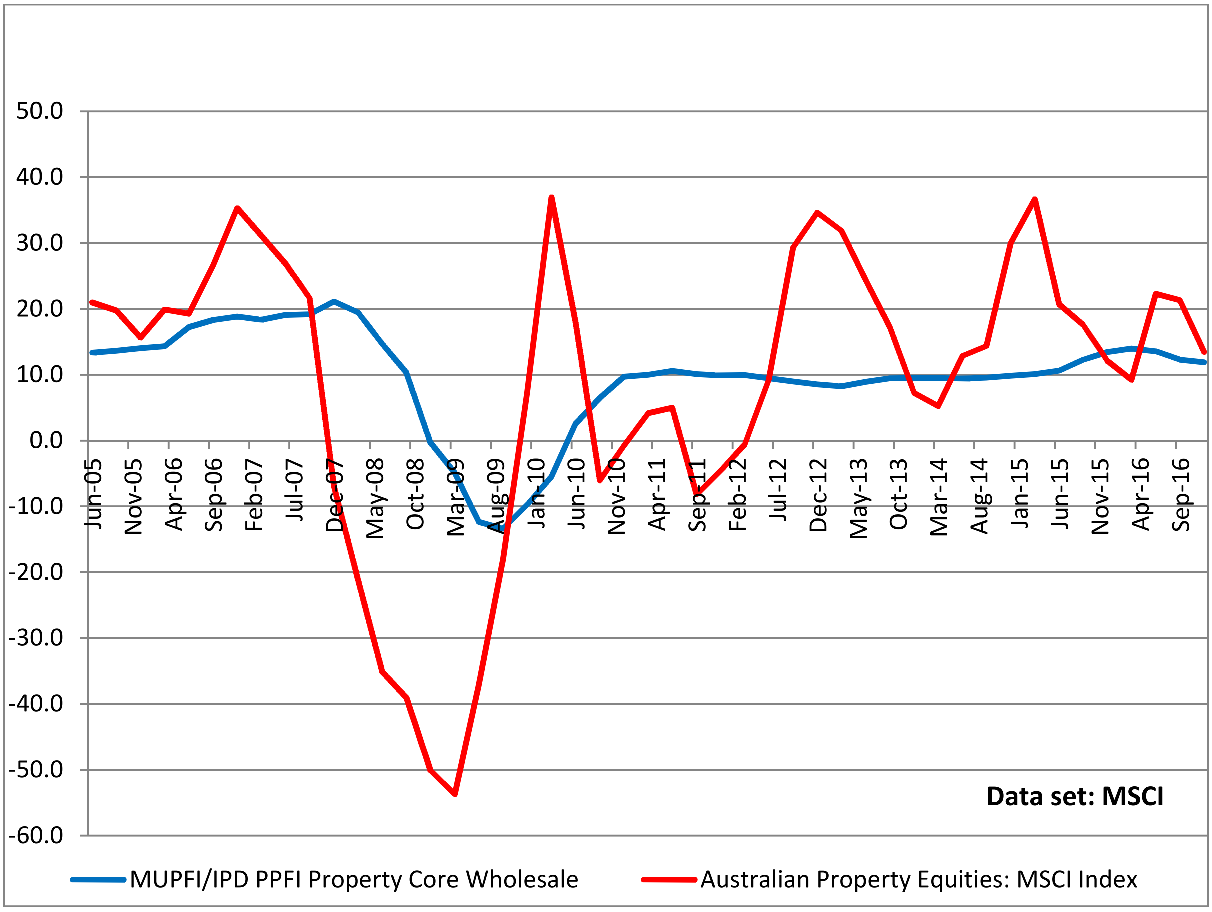


Source: Atchison Consultants

Now consider our earlier point that losing equity should be the mortal sin of investment, not losing control of the equity. There were a number of unlisted funds that were “frozen” or “locked” during the GFC, which saw many investors lose the ability to manage their equity. While this is a less than optimal outcome, freezing these funds may have been the best preservation strategy for the equity at that time. Certainly these charts indicate that being in an unlisted fund saw ~50% of the equity value preserved in the unlisted sector versus its listed peer. We consider that a reasonable outcome even when factoring in the loss of equity control.

Figure three illustrates year on year returns of the listed and unlisted property markets. The listed market shows massive price volatility and ventures into loss territory three times, as opposed to the unlisted sector which has far more stable returns and ventures into loss territory only once.

Figure three: Pre-Fee Rolling Annual Returns (% per annum)



Source: MSCI

If the return expectation for a particular investment is a function of the risk the investor takes on, figures one to three indicate there is an argument that listed property should provide a return premium to compensate investors for the market risk during irrational periods (both bull and bear markets).

To be clear, we are not arguing one position over the other. Rather we contemplate whether traditional thinking about the illiquidity premium may need to be reconsidered. Periods of exuberance or correction tend to see liquid markets surpassing the fundamental level of the underlying asset(s).

On this basis, investors need to be very clear as to why they are selecting one investment structure over another. Structural differences tied into the same asset class can provide very divergent performance and therefore investors need to be clear about their objectives when taking a particular investment position.

Clearly there are arguments for and against the illiquidity premium. Listed and unlisted markets both have an important role to play in investment portfolios, but the nature of each is shifting. Investors must ensure they understand the changing facets of property market structure and performance, and consider whether portfolio theory and exposures need to be reviewed and/or adjusted to reflect these changes.

Relying purely on classical investment theory when making asset allocations can be dangerous. As always, drill down into the data and see if the reality matches the theory.

About Forza Capital

Forza Capital is a private investment firm established in 2010 by seasoned sector performers Adam Murchie and Ashley Wain. They provide property investment solutions to high net worth individuals, private client advisory firms and family offices.

Forza Capital is a client centric business structured to align both investor and business interests and is performance driven, patient, and focused on servicing discerning investors looking for the best possible property investment opportunities.