The liquidity premium

(and why jelly always wobbles)

Should investors care about the ownership structure if the underlying assets are the same? Anthony Edmonds ponders this and other questions over a bowl of jelly

The other day I listened to an investment manager extolling the virtues of direct investments in sectors like infrastructure and property. He thought these made ideal assets for investors, particularly where they had long investment time horizons – like in KiwiSaver.

By Anthony Edmonds

One of the benefits the manager pointed to was the lower level of volatility that direct assets produced compared to their listed counterparts. The long-term nature of the cash flows associated with these assets also make them an ideal alternative to investing in long-term bonds (of which there are few in New Zealand), in terms of liability matching. As a bonus, these cash flows can be inflation-protected.

On the surface of it, I agree with his logic.

But it did get me thinking about whether the ownership structure of an asset can have an impact on the investment characteristics of an asset or asset class. For example, is listed property any more (or less) risky than its unlisted counterpart?

Further, the KiwiSaver transfer rules appear to discourage providers from offering direct assets as a standalone investment option. The rules stipulate that you can't lock investors into a KiwiSaver scheme or fund. When it comes to investing in direct assets this could increase the risk of investors experiencing a liquidity event like a fund suspension.

Do ownership structures impact on an asset's investment characteristics?

To explore this let's imagine there are two identical high-rise office buildings in a city. Everything about them is exactly the same, including the tenants and the terms and conditions of their lease agreements. However, building A is owned by a property syndicate while building B is listed on the sharemarket.

It is clear that both investments are essentially the same. However, the price of the listed one is far more volatile. This is because each day the sharemarket looks to establish a price for this investment and, depending on investor sentiment, the market price will move.

In contrast, the price of the unlisted asset will not move significantly (unless the building is revalued by a registered valuer), and therefore will display little or no risk in a traditional portfolio sense (where risk is measured by volatility).

This reminds me of jelly. Just because jelly doesn't wobble in a bowl in the fridge, it doesn't mean that it isn't wobbly. Quite simply, listed property appears more risky than direct property because it can be valued and traded each day.

If we return to our example of the two identical buildings, the ownership structure becomes irrelevant in terms of determining or influencing the overall return that each of these assets produces over the long term. The real risk, being the potential diminution of the cash flows produced by these assets (in both real terms and relative to other investment opportunities), is the same.

What should investors care about?

So should investors really care about how they get exposure to a sector over the long term? And should it matter whether this is listed or unlisted?

I don't think the answer is no. Investing in listed types of vehicles provides a number of benefits, including a greater degree of liquidity and transparency. Investors can also achieve far greater diversification through listed vehicles.

Let's consider the liquidity aspect. Imagine a scenario where global markets collapse and share prices fall by between 30% and 50% (sound familiar?). In this environment, direct assets would initially look like a fantastic thing to hold as the price of these hasn't fallen – at least not immediately or by the same amount. This is because listed markets tend to be far more influenced by investor sentiment, while direct assets are valued less frequently and often more conservatively.

But this could create some dilemmas for an investor in direct assets. For instance, their portfolio might get out of balance. In this scenario their weighting to listed assets like global shares would fall, resulting in an overweight exposure to direct assets.

Consequently, if they are disciplined in terms of rebalancing, then they might be forced to sell the direct assets – even if they don't want to. This highlights that the only time you might discover the true value (or risk) of your investment in a direct asset, is when you either sell it (if you can) or cash it in.

The (astute) investor's dilemma

If you can sell your direct assets at their last Net Tangible Asset (NTA) price, why wouldn't you? This creates a problem for each investor in a direct fund. When faced with a significant market correction, there may be a real advantage in handing in your redemption notice first. This becomes all the more real when you suddenly realise that you can potentially sell direct assets at NTA, while buying their listed counterparts at a deep discount. After all, the methodology to calculate the NTA is the same which means that this is an arbitrage opportunity which any rational investor would and should take advantage of.

This opportunity is alive and well in today's market. Take a listed property vehicle like the AMP Office Trust which was trading at around $0.82 on August 27, 2009, while the latest Net Tangible Asset backing is $1.02 at June 30, 2009.

People contemplating investing in re-emerging property syndicates should stop and consider the benefits of being able to buy the same types of assets in a listed form at a significant discount.

Where it becomes relevant for KiwiSaver funds is that in a falling market new investors in a direct property fund would be buying assets at NTA, when they could be buying the same types of investments at a discount on the listed market. In effect, the new investors are subsidising existing investors by injecting new capital at NTA.

In a falling market, investors in direct assets are often faced with the reality of not being able to sell their investment (some fund structures have a set maturity date). This in itself may be a good thing, as it disciplines people to truly think about the long-term nature of an investment and then go the distance. But let's return to the earlier point that, in the long term, the ownership structure will not materially impact the return of an asset or portfolio of assets, assuming things like the tax treatment of the structures is the same. This then means that listed assets do have one material advantage over their unlisted counterparts, as on any given day you can sell them. Granted this may be at a discount, but you can do it if you need to.

In my view, this liquidity is the key difference between investing in assets directly or through a listed structure.

KiwiSaver rules make it tough to offer direct investments

The rules governing KiwiSaver pose a real challenge for investment managers who offer direct assets. This is because one of the tenets of KiwiSaver is that you can change providers at any time. So if you were to offer direct assets under a KiwiSaver vehicle you couldn't lock people into them. This essentially means investment managers can't specify that investors will not get their money back for say 10 years, to reflect the illiquid nature of the underlying investment.

Currently under KiwiSaver, at any time, the investors could turn up en masse and ask for their money back. This would result in the direct fund experiencing a liquidity event. What's more, the type of market environment that would result in this will happen over the life of the scheme (which for KiwiSaver schemes is long).

In a market cycle where the value of all assets are falling, it makes perfect sense for investors to try to cash in their direct assets (at NTA). Furthermore, investors may be financially incentivised to take this arbitrage opportunity if they can then move to investing in the same types of assets at a discount via the listed market.

Interestingly, I don't think there is actually anything in the KiwiSaver fund rules stopping a provider offering direct assets as a standalone investment option. The lack of rules around this is interesting when you contemplate the potential that this type of structure is likely to run into problems because of the transfer rules. And this may be something that the government could consider in terms of the KiwiSaver rules.

As my friend the investment manager highlighted, these assets can offer real benefits. In addition to the obvious benefits already outlined, sometimes the only way to get exposure to certain asset classes, like infrastructure, is in an unlisted form. From the government's perspective, this could mean that the pool of savings created by KiwiSaver can be put to good use, creating both valuable and needed assets.

Until then, direct assets will only feature as small parts of the large providers' diversified funds. Providing you have the rules to govern them, there is a strong case to be made for allowing this type of investment in KiwiSaver. And perhaps this should be done ahead of time, rather than waiting for someone to prove the flaws associated with offering an illiquid direct investment option in a KiwiSaver wrapper.

Regardless, in investing in direct assets, the consequences of not having liquidity needs to be carefully considered by investors. And it should be remembered that direct assets are no less volatile than their listed counterparts – simply because the price of them doesn't wobble around each day. Just shut your eyes tight and think about jelly. A

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