EDUCATION

Profiting from the Capital Void

EXECUTIVE SUMMARY

Amid the market upheaval of the global financial crisis, liquidity was the rallying cry of the day and many investors turned away from longer-dated investments. Those events – and the resulting fear – are still fresh in the collective market memory, and many investors have shunned illiquidity risk. Regulation has also pushed natural buyers of illiquid assets to become sellers.

Today, the opportunity to profit in less-liquid assets is flourishing for investors with proactive capital deployment mechanisms, the appropriate liquidity horizons, and the courage to buck the market's myopic liquidity-seeking trends. Further, these opportunities are not confined to long-dated private equity investments with a seven to ten year horizon. They can increasingly be found in an area we call the intermediate "capital void," in assets that often require an investment horizon of just three to five years (see Exhibit 1). Beyond a structural illiquidity premium, sudden shifts in the amount and sources of capital being deployed in certain market segments have meaningfully amplified the alpha-generating environment.

In five years, when looking back at investment returns, we believe the number one differentiator is likely to be the degree to which institutional investors eschewed the fad of daily liquidity and took advantage of their long-liability horizons to supply capital in the liquidity void. The structural advantages of hedge funds, including extended notice periods, less frequent redemptions and liquidity protection mechanisms, can be key advantages that allow managers to capture the illiquidity premium by investing in these opportunistic investments. However, an investor must be active in negotiating and managing the alignment of incentives to capture these opportunities and avoid potential pitfalls.

Today, the opportunity to profit in less-liquid assets is flourishing for investors with proactive capital deployment mechanisms, the appropriate liquidity horizons, and the courage to buck the market's myopic liquidity-seeking trends.

Exhibit 1: Capital Void within Investment Time Horizon

Years

< 1	1	2	3	4	5	6	7	8	9	10
Hedge Funds, Fund of Funds, Long Only Funds			**Capital Void Remains**			Overlap		Private Equity, Real Estate		

Count On Us

Mesirow Financial®
ADVANCED STRATEGIES

THE CAPITAL VOID

Historically, long-only mutual funds and most hedge funds have gravitated around an investment horizon ranging from daily liquidity to a maximum of about two years. More recently, there has been much attention given to "liquid alternatives," that purport to engage in hedge-fund-like activities yet provide daily liquidity. On the opposite end, the longer-term sphere has been dominated by other forms of alternative investments, including private equity, real estate and infrastructure. These investments require tying up large sums of money for seven to ten years, if not longer, to harvest potentially attractive returns.

A "sweet spot" for capital deployment has emerged in the middle, for investors willing and able to commit capital for three to five years. Potentially higher returns are available for investors with more flexibility around liquidity and time horizons, as well as the ability to move quickly to capture fleeting opportunities.

Hedge funds have increasingly been filling this capital void, extending their investment horizons from historical norms. Recent examples include:

- Distressed areas of the sovereign and municipal credit markets
- Activist equity co-investments
- European middle market senior secured corporate loans

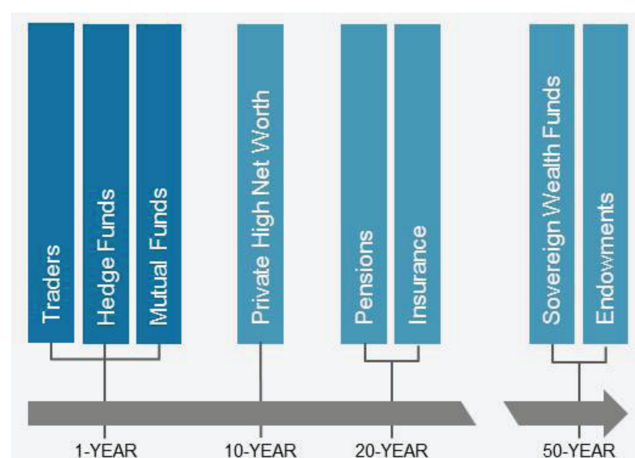
While attractive investments may be difficult to find in markets dominated by short-term geopolitical and economic uncertainty, these unique, intermediate-term structures may provide very compelling risk/reward opportunities for institutional investors with appropriate investment horizons.

WHICH INVESTORS ARE BEST POSITIONED?

Investors that have predictable, low variability and, most importantly, long-term liability structures are well positioned to take advantage of opportunities in the capital void. This includes Sovereign Wealth Funds, Endowments, Insurance Companies, Pension Funds and individual investors whose primary focus is on inter-generational wealth transfer (see Exhibit 2).

Many of these investors have used long duration liability structures as a competitive advantage, allowing them to invest large portions of capital in private equity investments. However, fewer have transitioned to a focus on the opportunity made available in the three to five year capital void. We believe it is an area ripe for the picking, due to both the structural illiquidity premium and a decreasing supply of capital within this intermediate liquidity horizon.

Exhibit 2: Investor Time Horizon Open to Opportunities within Capital Void[1]



Source: Based on "Making Good Investment Decisions," Morningstar, 2012

WHERE HAS THE STRUCTURAL ILLIQUIDITY PREMIUM HISTORICALLY BEEN HARVESTED?

While we acknowledge that the illiquidity premium has rarely been as attractive as it is today, it has been a consistent companion of successful opportunistic investors for decades. While it is commonly believed to exist in the private equity asset class, research confirms its persistence elsewhere. Below we survey a number of research contributions on the topic of harvesting the illiquidity premium.

Illiquidity Premia in Restricted Stocks

Amihud, Mendelson and Pedersen (2005)[2] found that a reduction in stock liquidity results in a reduction in stock prices and an increase in expected stock returns. The study reviewed eight published articles on restricted stock discounts from 1971 through 2003, using restricted stock as a way of isolating the effects of illiquidity and its enhancement on realized returns. The research led to several conclusions:

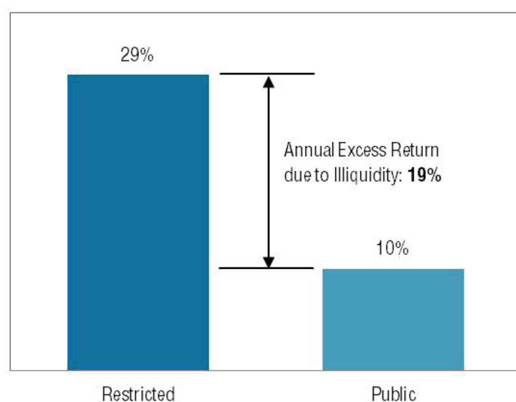
- Generally, restricted stock discounts over the pre-1990 period in the U.S. (before the SEC dropped a registration requirement for block sales) were around

1/3 of the value of the equivalent publicly-traded stock – meaning asset prices were held artificially low during periods of restricted trading (see Exhibit 3).

- Post-1997 studies (after the SEC lowered the minimum holding period from two years to one year) found similar behavior, but lower discounts that ranged from 13% to 21%.
- A study focused on Chinese markets found an illiquidity discount of up to 86% for restricted stocks.

To illustrate the impact a discount of 1/3 has on excess return, consider the following. Assume that the annual return on the publicly-traded stock is 10%, and that the restriction period is 2.5 years (including restrictions on the rate of unwinding the position). Then, the annual excess return due to the illiquidity of the restricted stock is 19%.

Exhibit 3:
Assumed Annual Return of Publicly-Traded Stock vs. Restricted Stock



Source: Amihud, Mendelson and Pedersen (2005)

Illiquidity Premia in Corporate Bonds

Numerous studies have suggested that illiquidity plays an important role in corporate bond valuation, lending credence to the idea that the level of yield spreads cannot be fully explained by credit risk.

- Chen, Lesmond and Wei (2005)[3] found that less-liquid bonds earn higher yield spreads and that an improvement of liquidity causes a significant reduction in yield spreads. The liquidity effects are apparent for both investment-grade and speculative-grade bonds, with larger effects for speculative-grade bonds.
- de Jong and Driessen (2012)[4] estimate that the total liquidity risk premium is around 0.6% annually for U.S. long-maturity investment-grade bonds and around 1.5% annually for speculative-grade bonds. The study also found very similar evidence for the liquidity risk exposure of European corporate bond prices.
- Dick-Nielsen, Feldhütter and Lando (2011)[5] analyzed the liquidity components of corporate bond spreads during 2005-09. The spread contribution from illiquidity increased dramatically with the onset of the subprime crisis. While the liquidity component for investment-grade bonds before the crisis was estimated to be smaller than prior studies, a slow and persistent increase pushed the component to a much higher level after the crisis. A-rated bonds, for example, went from 4.4 basis points to 92.6 basis points. The effect was stronger, but more short-lived, for speculative-grade bonds – the liquidity component went from 117.1 basis points to 420.5 basis points.

Illiquidity Premia in Hedge Funds

Numerous studies[6] have provided empirical evidence for the existence of illiquidity premia in hedge funds.

For example, Agarwal, Daniel and Naik (2006) found that funds with a higher degree of managerial discretion – using longer lockup, notice and redemption periods as proxies – delivered attractive performance. Managers with higher flexibility can invest in arbitrage opportunities that may take time to become profitable. Also, such managers may not be forced to engage in asset fire sales.

This return premium results from a structural advantage of funds with longer-horizon investment frameworks, which we will discuss in more detail below. It is also confirmed in a recent analysis of private versus liquid alternative assets.

Illiquidity Premia: Private vs. Liquid Alternatives

A recent study by consultant Cliffwater[7] analyzed return data from firms that manage both private and liquid offerings under the same general alternative strategy (see Exhibit 4). Across strategies, the average difference in return between private and liquid alternative product offerings was found to be 0.98%, annualized. Not surprisingly, event-driven and market neutral strategies had the highest premiums for illiquidity. Macro and managed futures strategies had the lowest. However, as the study pointed out, these strategies operate in the most liquid markets.

Exhibit 4: Performance Comparison of Private vs. Liquid Alternatives

	Average Difference between Private and Liquid Alternatives	
	RETURN	ALPHA
All Strategies	**0.98%**	**0.97%**
Event Driven	2.26%	1.65%
Market Neutral	2.24%	2.15%
Equity Long/Short	1.07%	0.96%
Credit	0.95%	1.08%
Multi-Strategy	0.61%	1.32%
Managed Future	0.48%	-0.24%
Macro	0.22%	1.49%

Note: Data spanning 10 years through March 2013
Source: Cliffwater

To put that illiquidity premium of 98 basis points into perspective, consider a $50M investment. The impact of compounding that premium over 2 years translates to an additional $1M in returns. Over 5 years, the excess return is $3M.

CAPTURING THE NEW ILLIQUIDITY PREMIUM: RECENT EXAMPLES

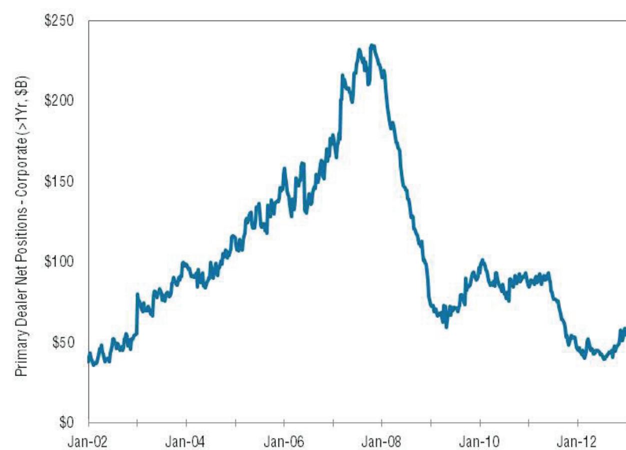
Less-liquid opportunities often arise due to structural inefficiencies in the marketplace. These can be due to either a change in the asset itself, or in the segment of buyers of the asset. Catalysts on the asset side tend to be items such as ratings downgrades, distress, de-listing or some other change in liquidity or asset complexity. On the buyer side, the underlying asset is often deemed un-investable by a structural segment of market participants due to a regulatory restriction, liquidity restriction or another change in market convention. In many cases, the opportunity arises quickly and then dissipates as less constrained investors respond to the inefficiency.

Investments in such trades have been successful in the aftermath of the global financial crisis, with the most successful investors employing a truly opportunistic approach to investing. We believe such investments will continue to be attractive, as structural inefficiencies exist as a result of other major market events, such as the European debt crisis.

In addition to the continued supply of such investments, there is also a notable lack of capital to invest as a result of today's expanding regulatory environment. Policymaker actions following the financial crisis have compressed the supply of capital in the marketplace – especially in the three to five year capital void. Among the many provisions of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act was a restriction on the amount of inventory banks may hold on their balance sheets. Primary dealer positions, for instance, had already plunged in 2008. Instead of rebounding during the recovery, these positions shrank another 57% from March 2011 through July 2012 as a result of the new regulations (see Exhibit 5).

The U.S. non-agency residential mortgage-backed securities ("RMBS") market stands as a primary example of a less-liquid opportunity. A material decline in home prices and the slow economic recovery had fueled negative sentiment that continued into 2012, despite slowly improving fundamentals. When home prices began rebounding in the second half of the year, hedge funds began adding exposure to U.S. non-agency RMBS. Housing fundamentals significantly improved during 2013-14, leading to material value-add to hedge fund portfolios from these structured credit investments.

Exhibit 5: Impact of Financial Crisis, Expanding Regulatory Environment on Sources of Capital



Note: In April 2013, primary dealers began reporting corporate security net positioning by sub-categories (commercial paper, investment-grade, below investment-grade). As a result, these data points are not comparable period-to-period.
Source: Federal Reserve Bank of New York

Exhibit 6: Additional Inefficiencies and Catalysts behind Unique, Opportunistic Investments

	STRUCTURAL INEFFICIENCY	POTENTIAL CATALYSTS
Broad HF Investment Theme of 2012: U.S. non-agency RMBS	• RMBS experienced significant price dislocation in H2 2011	• Improving default rates • Rebounding home price
Unique, Opportunistic HF Investment Theme of 2012: Low dollar price, low cash flow and longer duration non-agency RMBS	• RMBS experienced significant price dislocation in H2 2011 • Lack of dealer liquidity, mark-to-market risk and, in some cases, low carry had kept prices low for specific tranches of RMBS	• Improving default rates • Rebounding home prices • Significant upside potential based upon the expectation the lowest quality borrowers had already defaulted, leaving behind higher-quality and more resilient borrowers. Those remaining loans may have lower defaults or better recoveries in the event of default.

Source: Mesirow

It is important to understand that RMBS was a broad hedge fund investment theme. While these structured credit investments captured the structural illiquidity premium, there were idiosyncratic areas of the market where outsized alpha opportunities presented themselves to the most informed and opportunistic suppliers of capital. In many cases, these were specialty hedge fund managers.

Within the U.S. RMBS market in 2012, the most unique, opportunistic investments involved concentrated exposure to low dollar price, low cash flow and longer duration non-agency RMBS (see Exhibit 6). These investments produced the most attractive returns during 2013 and 2014, maximizing return per unit of risk (especially as detailed analyses of pooled or even individual mortgages were conducted and refined).

Europe serves as an example of a current area of opportunity. Once again, there remain a number of idiosyncratic areas where investors are attempting to maximize risk-adjusted returns.

Market participants have discussed in recent years the potential opportunity set within Europe amid bank deleveraging. European banks have been motivated to reduce non-core assets. The investment thesis has centered on the idea that banks would sell assets at attractive prices to investors such as hedge funds.

Market participants have found that European banks have more selectively conducted sales as asset prices have appreciated and regulators have created a framework to facilitate measured steps in the deleveraging process. Sales ratcheted higher in 2014, led by deleveraging efforts in the commercial real estate market, despite a notable pause ahead of the release of asset quality review ("AQR") and stress test results. However, a still unsettled European financial system is likely to result in fits and starts in the deleveraging process across a wider variety of assets in the months and years to come.

Still, within Europe there have already been a number of unique areas of opportunity available to hedge fund managers with specific expertise. These areas include distressed corporate asset liquidations and dislocations in stressed retail funds designed to raise capital for real estate markets. In each of these scenarios, there is a capital void brought about by a structural change in the asset and an ensuing flight from the asset by a segment of holders. In the best cases, managers seek assets that not only have price appreciation potential, but also are producing a stream of cash flow through some means of ongoing interest payment or amortization.

CONCLUSION

The low-hanging fruit in public markets made available in the aftermath of the global financial crisis has largely disappeared. Bond yields are hovering near historic lows and U.S. equity markets are now approaching levels of overvaluation by historical measures. As a result, the opportunity cost of less-liquid alternative investments has decreased. At the same time, structural pockets of illiquidity are being created by changing regulations, changing market convention, and the illiquidity hangover of the global financial crisis.

Hedge funds have helped fill these capital voids, in particular the intermediate-term segment of the investment

horizon. One of the pragmatic disadvantages of hedge funds often cited by market participants is illiquidity, or the fact that hedge funds do not typically offer daily or even monthly liquidity to investors. The terms also often include long notice periods and gating provisions. That said, one of the structural advantages of hedge funds is... illiquidity. Gating provisions, extended notice periods and lower redemption frequencies allow hedge fund managers to broaden the scope of investments and capture the structural illiquidity premium by investing in less-liquid assets. They also can offer wide-ranging flexibility and the ability to be opportunistic when price dislocations occur.

Considering the complexity, expenses and liquidity implications of such investments, an institutional investor must navigate its investments with hedge fund managers carefully. An investor must not only attempt to maximize return per unit of risk while capturing less-liquid opportunities, but take every measure to properly align incentives with the manager. We believe the most prudent features of such structures include:

1. Capital call structures, with fees only on called capital
2. Generally lower management fees, with higher fees paid only for performance generation
3. Incentive fees paid only on returned capital, not unrealized gains
4. Cumulative hurdle rates
5. Sufficient investment horizons to allow amortization and patient selling

An allocation to less-liquid investment strategies can be extremely valuable due to the potential to generate attractive returns and diversify a portfolio of public market securities. Identifying sound investments within this sphere requires significant due diligence, as well as the experience and skill to understand and parse complex nuances. The implementation and maintenance of such a portfolio may present challenges, including additional analysis and expertise, proper fund manager selection, and delayed returns of capital. However, the benefits can potentially far outweigh these risks when properly managed.

Institutional investors often seek advice or management from an outside party who has built infrastructure and has the expertise to effectively monitor and manage these more complex investments. In multi-manager hedge fund strategies, this is particularly true since such strategies can cover a wide spectrum of investments, and thus require a wide array of experience and specialization.

1 Source: “Making Good Investment Decisions.” Morningstar. 2012.

2 “Liquidity and Asset Prices”. Amihud, Yakov, Haim Mendelson and Lasse Heje Pedersen. Foundations and Trends in Finance. Vol. 1, No 4 (2005).

3 “Corporate Yield Spreads and Bond Liquidity”. Chen, Long, David A. Lesmond and Jason Wei. April 21, 2005.

4 “Liquidity Risk Premia in Corporate Bond Markets”. De Jong, Frank and Joost Driessen. Quarterly Journal of Finance, Volume 02, Issue 02, June 2012.

5 “Corporate Bond Liquidity Before and After the Onset of the Subprime Crisis”. Dick-Nielsen, Jens, Peter Feldhütter and David Lando. Journal of Financial Economics 103 (2012), pgs. 471-492.

6 “Role of Managerial Incentives and Discretion in Hedge Fund Performance”. Agarwal, Vikas, Naveen D. Daniel and Narayan Y. Naik. 2008 (Revised), “Hedge Fund Liquidity and Performance: Evidence from the Financial Crisis”. Schaub, Nic and Markus Schmid. September 2012, “Share Restrictions and Asset Pricing: Evidence from the Hedge Fund Industry”. Aragon, George O. Journal of Financial Economic, Volume 83, Issue 1. January 2007.

7 “Performance of Private versus Liquid Alternatives: How Big a Difference?” Cliffwater. 2013.

Disclosures

The information contained herein is for informational and educational purposes only. It does not constitute an offer to sell or a solicitation of an offer to buy an interest in any product offered by Mesirow Advanced Strategies, Inc. Any offer can only be made to those whose eligibility to invest has been determined only in jurisdictions where such offer is permissible and only through the appropriate offering materials for the product, which contain important information concerning risk factors and other material aspects of the investment.

Certain of the information contained herein represents or is based on forward-looking statements or information, including descriptions of anticipated market changes and expectations of future activity. Forward-looking statements and information are inherently uncertain and actual events or results may differ from those projected. Therefore, undue reliance should not be placed on such forward-looking statements and information. Past performance may not be indicative of future results, and any investments described in this document may lose value.

Hedge funds engage in securities trading that is speculative and involves a substantial risk of loss. Hedge fund performance may be volatile. An investor could lose all or a substantial amount of their investment. There can be no assurance that an investment in hedge funds will be profitable or that any investment will achieve profits or avoid incurring substantial losses. Investment results may vary substantially over any given time period. Past performance/results are not necessarily indicative or a guarantee of future results.

Risks of hedge fund investing include (but are not limited to) market, tax, operations, event risks, use of leverage, lack of liquidity in markets, use of derivatives, volatility of returns, restrictions on transferring interests, credit and regulatory risks, unrelated business taxable income, manager risk as well as risks associated with specific investment strategies and asset allocations, including illiquidity, manager independence, strategy concentration or correlation and systemic market risk. Additionally, commodity trading involves a substantial risk of loss.

Opinions, statements or thoughts are subject to change at any time without notice and do not constitute the rendering of legal, tax, accounting or other professional advice. Each investor should consult their own professional advisor regarding the possible tax, legal or other consequences of entering into any investments or transactions described herein. These materials are for the use of the person to whom they are given by Mesirow, and such persons' professional advisors only. These materials may not be forwarded or otherwise disclosed or distributed by such persons. Registration with the U.S. Securities and Exchange Commission as an investment adviser does not imply any minimum level of skill or training. The Mesirow Financial name and logo are registered service marks of Mesirow Financial Holdings, Inc. All rights reserved.