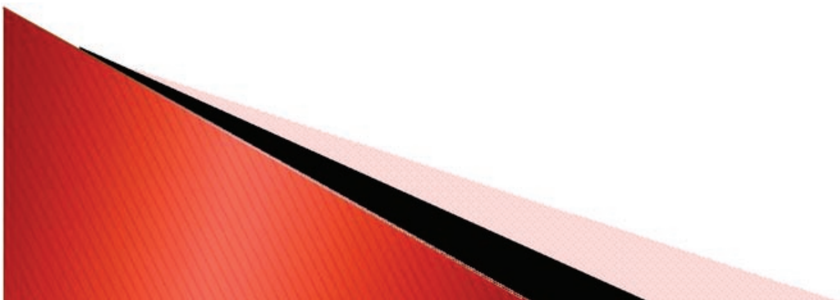
Passive Capital Management – Institutional Perspectives

Illiquid Investments: Returns, Risks & Opportunity Costs

As hedge funds and alternative investment vehicles gather more assets and receive more scrutiny, investors and regulators are starting to be more cognizant of various accounting practices that can inflate returns and reduce the volatility of reported returns. Since most alternative investment managers receive a performance fee based upon quarterly returns, how funds account for illiquid investments is critical. This article will discuss some of the issues related to non-marketable securities and how they can negatively impact investors. While most hedge funds and financial journalists present them as exclusive investments that will generate terrific returns, the reality is that illiquid securities come with real economic and opportunity costs. It is imperative to properly assess the risk profile and total costs of each investment individually and as part of the total portfolio.

An article in the CFA Institute's *Conference Proceedings Quarterly* by Clifford S. Asness[1] provides some interesting insights into the accounting for illiquid investments generally and distressed securities specifically. Mr. Asness notes that "…the upper line, representing the cumulative performance of the distressed funds, does not look like any security on earth; securities go up and down, but the distressed funds do nothing but go up." He goes on to explain that it appears as though the value of the underlying securities is being managed by slowly marking-to-market over time. This may not necessarily be bad unless an investor analyzes the monthly returns and comes to the conclusion that the investment is riskless given the smooth, consistent nature of the return profile. He summarizes by saying that "this type of practice occurs quite frequently, and the outcome is a portfolio that superficially looks far less risky then it really is." This lag in marking-to-market the value of illiquid investments is a very real issue for investors as this process can overstate underlying values and understate the risk profile of the investment.

Additionally, these accounting procedures are likely becoming more common. A recent article in *The Wall Street Journal* by Gregory Zuckerman and Scott Patterson[2] discusses how some hedge funds are now setting up "side pockets" which will hold investments that tend to be more difficult to value. While it is true that investments in non-marketable securities are more difficult to value, these side-pocket accounts provide a means for unscrupulous and greedy managers to postpone marking-to-market poorly performing investments. Given the quarterly performance fees inherent in the compensation arrangement, managers clearly have an economic incentive to show the best results possible. While this does not mean that all managers would use



aggressive accounting practices, it does mean that manager's best interests are not always aligned with those of the investors. Furthermore, Zuckerman and Patterson explain that "side-pocket accounts often have more onerous terms for investors, such as limits on their ability to withdraw their money…"

So it's important to realize that illiquid investments have real costs that aren't always well understood or quantified. Whether an investor pays higher quarterly fees due to inflated returns or bears the opportunity cost of owning an illiquid investment, there are unattractive aspects of owning non-marketable securities. Passive Capital Management estimates that the lack of liquidity resulting from "lock-ups" costs investors 2.9% annually. We understand that not all returns are created equally and supposedly attractive, exclusive investment vehicles have subtle economic and opportunity costs that belie conventional wisdom (or at least conventional sales pitches).

The team at Passive Capital Management understands how results are generated and structures institutional portfolios that capture returns from various risk factors in a cost-effective, tax-efficient manner.

By Scott D. Reinhardt, CFA

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[1] Clifford S. Asness, "The Future Role of Hedge Funds," CFA Institute's *Conference Proceedings Quarterly*, Volume 23, Number 2, June 2006

[2] Scott Patterson and Gregory Zuckerman, "Side-Pocket Accounts of Hedge Funds Studied," *The Wall Street Journal*, Page C-3, August 4, 2006

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