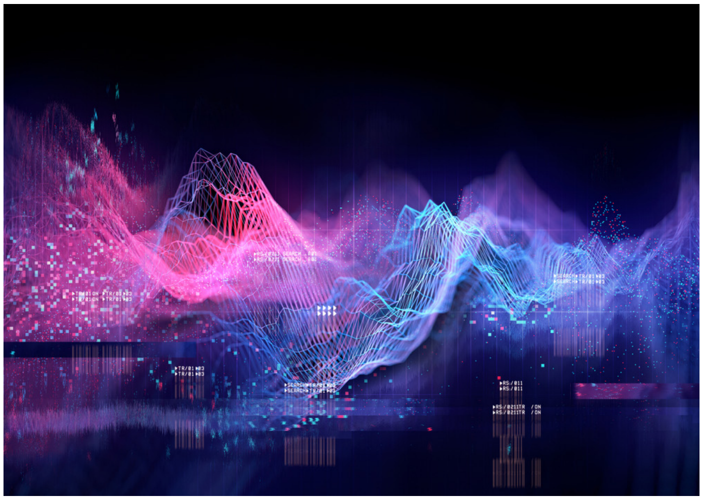
RBC Global Asset Management

Unlocking the illiquidity premium

BlueBay Fixed Income Team's Senior Portfolio Manager, Mihai Florian, and Head of Developed Market Special Situations, Adam Phillips, highlight how putting away capital into illiquid assets and private credit investments brings in higher expected returns and a likelihood to unlock the "illiquidity premium".



How has the appetite for illiquid/private market assets changed during the market turmoil of 2022?

Mihai Florian: During 2022, especially after the start of the Russia-Ukraine war, the liquid markets have suffered substantial declines while illiquid markets typically remarked the positions more slowly and perhaps not to the same extent. That meant LPs investors' illiquid positions had a larger proportion in their portfolio than originally constructed making it much harder for these investors to commit to new illiquid funds and strategies.

On the other hand, the GP investors (i.e. the fund managers) had a much wider investable universe given the overall price action. On the emerging market side we have tended to focus more on higher quality performing assets which provided the double digits returns that we're after.

Adam Phillips: Anecdotally in 2022 allocators to private strategies have become reluctant to make new commitments in part because they are concerned that their distributions from existing allocations will slow.

At the same time, we view the current market stress as being on a par with the Asian Crisis of 1998 and the Global Financial Crisis of 2008, and both periods led to sustained outsize returns in distressed strategies. The lessons from history suggest that LPs who continue to commit capital to private strategies during market cycle troughs reap the rewards subsequently.

Can illiquid/private market assets be transferred during an insurance transaction?

Mihai: Illiquid assets in our view are best suited for long-term investors like insurance companies. Looking at private credit products these are capital efficient under Solvency II for insurance companies. In some cases there are limitations on what type of institutions can hold these private credit assets (e.g. in certain jurisdictions only financial institutions can hold these assets directly). In other cases there are operational issues which insurance companies need to consider.

How can trustees decide whether illiquid assets are right for their scheme?

Mihai: Illiquid assets and specifically private credit, have had historically low volatility providing steady current income cash-flows. As we mentioned before, these type of assets are best suited for longer term investors whose liabilities are in the 3+ years period and who need steady cash inflows. Having the ability to lock capital for 5+ years allows such investors to gain an "illiquidity premium" which in our experience has been in the region of 300-500 bps (in EM) vs public, liquid markets.

Adam: We, as managers, spend a considerable amount of time focusing on time horizon, and on avoiding asset-liability mismatches within our funds. We believe that higher up the investment value chain, trustees will have similar considerations. Trustees will understand their scheme's time horizons and liquidity needs and within that framework may well decide to lock up a certain amount of their capital in exchange for the higher expected returns that private strategies offer.

RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **rbcgam.com**