Is Liquidity 'A Feature Or A Benefit' Of Closed-End Funds?

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Bill Kelly, president of the CAIA Association. Read the Q & A below as Bill discusses the importance – which he believes is mostly misplaced – that many investors place on having daily liquidity in their investments, even though they have no intention of touching the money in the short term. The result of these mis-aligned time frames is that investors pay a real price for liquidity they neither want and need; the offshoot of this thinking is helping to drive the expansion of new issues for closed-end and interval funds, Kelly says.

Bill Kelly

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: I'm talking with Bill Kelly, president and chief executive officer of the CAIA Association, about whether when it comes to closed-end funds liquidity is actually a benefit or just a feature. Welcome to The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry association that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today my guest is Bill

Kelly, president and chief executive officer of the Chartered Alternative Investment Analyst Association, CAIA, the CAIA Association. Which if you're an investor, you're probably aware that your fund managers have a credential called a chartered financial analyst. Well, this is a credential similar that specializes in alternative investments and many of the things that you're going to find in closed-end funds. If you want to get more information, CAIA.org. And if you want more information on closed-end funds, interval funds, and business-development companies, AICAlliance.org is the website for the Active Investment Company Alliance. Bill Kelly, thanks for joining me on The NAVigator.

BILL KELLY: A pleasure to be here, thank you Chuck.

CHUCK JAFFE: Bill, we've got something good that I hinted at, about whether or not liquidity is a feature or a benefit. But before we get there, I need to have you explain to our audience a little bit about the CAIA credential and why it is so important. And particularly in these times, why guys who have some other credentials are going, "Look, I want to make sure I have the alternative investment wherewithal and knowledge to function in this space."

BILL KELLY: A couple of [inaudible] there, Chuck. So first and foremost, some people might think that the credentialing bodies compete with each other, and it's quite the opposite. I compete with ignorance, and the less ignorance does, the stronger it gets, and anybody, credentialing or otherwise, who is trying to beat that back is my friend not my foe. But it's interesting, in the opening you describe the CFA, which in terms of known credentials in the financial services space, certainly that is the go-to credential. It covers a lot of ground historically in the traditional space, and that's how it began, as a credentialing base body starting in the early 1960s, although the association is a lot older than that. So fast forward to circa the 1970s-80's timeframe, the endowment model came into place which started in some of the large endowments, the Ford Foundation particularly and the Commonfund and the ivy leagues, where they looked at the duration of the call on their capital and they said, "Why shouldn't I line up my investing against the liabilities I have going into the future, where liquidity matters, less complexity, and the premium I can gather there matter to me more? And let's just do a better matching of liabilities versus assets." And out of that the endowment model was born, which not only brought in public equity and public fixed income, that never went away, but now you can get access through various wrappers into the private markets top to bottom, early-stage VC all the way up to buyout, real estate,

infrastructure, hedge funds, structured products. So there was no professional body that brought greater clarity to the space, and CAIA was born about 20 years ago. And while the curriculum in the exam, and we have about 6,000 candidates sit through the exam each year, 12,000 members around the world, we want people to think like an allocator. Think like the late David Swensen at Yale and think about matching the duration of those assets and liabilities, which I think sets us up quite well to the discussion at hand here today.

CHUCK JAFFE: It does, because investors really only look at liquidity as in can I trade it, can I get out of it, can I be out right now if I need to? But we're going to discuss this idea of liquidity can be a feature or it could be a benefit. I don't think that most people think about it that way. So which is it? Or maybe it's when is it one versus the other? Is liquidity a feature or a benefit?

BILL KELLY: I would say with limited exception I can't think of one, it will be a product feature. It's either liquid or not liquid or has liquid gates, so it is a feature to the product. But I think as an investor, and also is a product purveyor, we have to be very clear with the end client as to whether or not it is a benefit. If I go back to the GFC as an example, peak to trough the S&P drawdown 55% give or take, and the HFR indices in the hedge fund space drew down maybe 12%. Somebody might say, "Well, survivor bias." Forget that, it drew down substantially less than the S&P 500. So you come out of the other side of the GFC and the product machinery says, "I have a great idea. Why don't we take this very sophisticated product offering with no limitations on liquidity, no limitations on leverage, they're not very transparent, and let's jam them into a 40 Act mutual fund wrapper and expect that to end well." And it doesn't, because there now we're selling liquidity in most cases as a benefit, and it's just a feature of a 40 Act mutual fund. And if you want to think and act, as I said earlier like an allocator, like a David Swensen, you've got to think about what you're saving for. And if you're 35-40 years old and you're saving for retirement that comes in 20 or 30 years, next-day liquidity is not a page one concern. And I think we've got to have those tough conversations with the end asset owner who might be a little bit more mass affluent and explain what that really means. And not only do they need to get it, if you're in a commingled fund and you believe in it, but your neighbors to your left and right can get out on T+1, that's going to force a manager to be lugging around a lot of cash, causing greater liquidity events

like the market we're in today, and the uncorrelated return stream you were looking for is not necessarily there.

CHUCK JAFFE: Well, in fact this idea came up in a panel discussion that I was leading for the Active Investment Company Alliance. Where one of the portfolio managers was saying, "If you believe in the investment, you don't need to be worrying about, 'Hey, am I getting out right now?' He goes, "Think about all the costs you are paying to have liquidity. All the costs that you pay to say, 'Oh, this fund trades on a moment's notice,' when you don't care if it trades on a moment's notice." I don't think most people ever think about the fact that, wait, hold it, it's going to cost me money? I'm going to have drag, and friction, and all these other things that are real costs that will add up a lot when you talk about owning something for decades, when it is always told to us that if you're not available moment by moment that's a negative.

BILL KELLY: It is. And it's funny you mentioned the word decades, I think that's maybe spot on to an example I can give you. You mentioned a lot of things that conspire against the investor, market timing is probably the top of that list. We all think we do it well, but you could go to the smartest investors in the world and they will tell you they're incapable of doing it themselves, and yet we try. So J.P. Morgan put some stats out that I saw recently, and I think this ended for two decades, 20 years, ended maybe 2018-2019, so recent vintage. The 60-40 compounded at 6.5% during that 20 year period. Not bad if you stayed fully invented. The average investor though, Chuck, got 2.4% when inflation was running at 2.1%. So they've market timed themselves into a compounding rate that barely beat out inflation and remained 400 basis points worse than if they'd just sat in place in the 60-40. So we are going to experience bouts like we have today, and I think we are going to be in a period where there's a lot of issues that the Fed can't resolve. And you've got to make sure that you're fully diversified, and the old saying, the only thing that goes up in a down market are correlations, that's a short-term phenomena. As we get through the selling exercise we're going to start to see greater exposure of true diversification, and investors have really got to be thinking about the diversification, thinking about their risk tolerance, and try to ride through some of these storms. But if you're coming into this first quarter this year with 80 or 90% equity risk on the table, you're not in a good place from the get-go.

CHUCK JAFFE: We've seen growth in interval funds, we've seen growth in things that are maybe a little bit less liquid because liquidity is in its own way an enemy of certain processes. Will we wind up seeing that become much more mainstream? Because we use the word "alternative" for a lot of different things, but as I listen to this discussion I think, wow, there's a whole lot of people who are mainstream investors who this idea should appeal to them but it hasn't yet been marketed. So are we about to see an explosion in this once people figure out that, for some of my money liquidity is only a feature, it's not a benefit?

BILL KELLY: So I think this gives me hope maybe, Chuck, in my day job, that liquidity can be a benefit, maybe when there's less of it when your liabilities have a long-term fuse on it. But if you think about it, and this could be subject for an entirely different show, capital formation of value creation is happening in the private markets full stop. The number of public offerings are shrinking and the value creation is a private gain. So if you and I have responsibility for our own retirement, we've got to, through the regulators and legislation, be given greater access to the private markets, and to think we can replicate that in a T+1 vehicle is fallacy. So the wrappers do matter. And when I think about a target date fund that might have liquidity limitations because the DOL is allowing more liquidity, or BDCs or closed-end funds or interval funds, and they have quarterly tenders, this is definitely a step in the right direction. And we've got to be able to talk to the investors about in a money market fund where I've got a $1 NAV, I'd better have next-day liquidity. But when I'm trying to create and compound wealth in a private market, if somebody's going to come to me with a next-day liquid vehicle, I would say that is purely a feature and most undoubtedly not a benefit.

CHUCK JAFFE: Really, really interesting, Bill. And we came out of this not only with that education but with a topic for another trip on The NAVigator. So we'll make that return trip down the line, meanwhile thank you so much for doing this today.

BILL KELLY: My pleasure, thanks Chuck.

CHUCK JAFFE: This has been The NAVigator, a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, learn about my show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance, which is on Facebook and LinkedIn @AICAlliance. Thanks to my guest Bill Kelly, president and chief

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