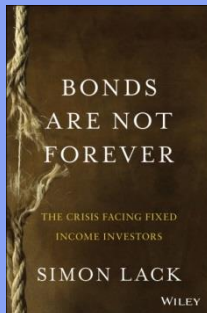




In Pursuit of Value

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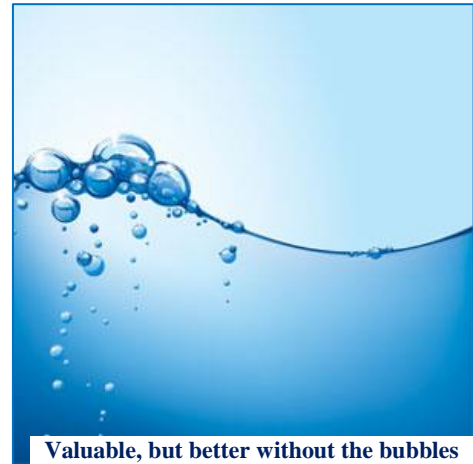
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Liquidity

A couple of months ago Roger Ibbotson and I were both presenters at a CFA Conference in Toronto. Ibbotson is a professor of Finance at Yale School of Management and also chairman of Zebra Capital Management, an investment firm whose style of investing reflects his work. [*Liquidity as an Investment Style*](#) was the title of his presentation, based on his recent academic paper.

Investors like liquidity. Not everybody agrees on its definition; for some it is measured by volume. This superficial metric is used by proponents of High Frequency Trading (HFT), since they argue more volume is always good for investors. The issue of HFT's utility to markets is complex, albeit more widely debated thanks to Michael Lewis's book *Flash Boys*. But measuring volume alone is too simplistic because it doesn't capture potentially adverse activity by algorithms that can increase the costs of trading for others. The actual transaction cost incurred by an investor is a more useful measure, although devilishly hard to measure precisely. Some look at the bid/ask spread to estimate this; institutions that trade heavily use more sophisticated tools that compare their actual transaction prices with market prices prior to their activity to estimate their cost to trade.

Private equity investors often set their return target with reference to returns in public equity markets, such as 5% over the return on the Russell 2000 (a small cap index more reflective of the companies that private equity funds finance). Our strong preference for the flexibility to change our minds makes private investing highly unattractive, so we only invest in publicly listed companies. It's not that we trade a lot – in fact, far from it. But liquidity reduces the penalty for mistakes and their early recognition allows redeployment of capital to more attractive places. Investment relationships with private equity managers can last ten years or more, and if the actual outcome doesn't resemble the glossy brochure shared at inception, it can truly feel like purgatory.



Valuable, but better without the bubbles

Liquidity as an Investment Style takes the view that less liquid stocks offer higher returns than more liquid ones. If liquidity is desirable then it makes sense for investors to set higher required return targets for securities whose entry and exit is more costly. This is not news for most people, but Ibbotson's paper seeks to measure the additional return illiquidity offers. It goes on to posit that illiquidity itself can be a source of "excess return". There are some factors that are already acknowledged to be a long term source of return. Value Investing is one (variously defined, but generally a focus on stocks with low P/E ratios or sometimes low Price/Book Value). Momentum is another, which consists of buying what's going up and dumping what's going down. Such concepts work more often than not, but by no means all the time. The idea that Illiquidity could be another factor like these is interesting, although personally I'm less comfortable with it. The lower return that liquid stocks offer (think of it as the "liquidity discount") provides the holder with the comfort of an easy exit should they so decide. Stocks are not just sold because of bad news. Sometimes investors need cash for reasons quite unrelated to what they're selling, maybe for reasons that were not anticipated. A self-styled long term investor owning illiquid stocks to profit from this may be surprised to find their outlook is not as long term as they thought. Liquidity provides the flexibility to change your mind, and in that respect is different than the factors such as value or momentum listed above.

*SL Advisors, LLC
focuses on
identifying securities
that are trading at a
discount to intrinsic
value.*

Moreover, when you dig into the research it turns out that the illiquidity return has a very narrow source. It comes from a handful of stocks in the bottom quartile of liquidity suddenly becoming momentum stocks, no doubt because of a positive development. The vast majority of illiquid stocks stay that way; over the period covered (1972-2011), just 1% jump from the bottom to the top quartile, more than doubling in value as they go (returning 109%). Another 3.5% jump to the next highest quartile, returning 61%. So if you own the bottom quartile of stocks you might expect that 4.5% of them will generate just over a 3% excess return (that is, 1% X 109% added to 3.5% X 61%). That's a good portion of what the phenomenon is worth, and such a narrow source of return likely means that it varies substantially from one year to the next. If the annual returns to illiquidity vary widely, investors are likely to experience markedly different outcomes from seeking to exploit it. This also makes it much harder to persist with the strategy during the inevitable disappointing years, and means it's probably hard to profit from the concept.

Nonetheless, it is an interesting perspective and worth reading if you care about such things. That illiquidity should offer higher returns is widely accepted in Finance.

Not everybody agrees, however. To find the naysayers we must revisit a topic I have covered before, non-traded Real Estate Investment Trusts (REITs). This particular backwater of Wall Street seems to harbor many of the things that give Finance a bad name. Non-traded REITs (NTRs) are notable for underwriting fees as high as 15% (paid by the investor and shared with the broker recommending the investment); additional fees when the NTR buys properties, maintains them and sells them; numerous conflicts of interest; and no public market liquidity. As registered securities they can be sold to anybody. As unlisted securities they don't draw much research because there are no commissions to be earned from trading. Their multiple investor-unfriendly features are why their sponsors operate in that regulatory gap: an illiquid security whose sale would normally be restricted to sophisticated investors, but whose SEC registration renders them publicly available.

While the illiquidity of NTRs ought to mean they have a higher expected return (i.e. need to be sold to investors at a lower price to compensate), some proponents have sought to turn this hitherto unattractive feature into a selling point. Sameer Jain is the Chief Economist of American Realty Capital (a big distributor of NTRs). Jain is a graduate of both MIT and Harvard, so presumably has a passing familiarity with financial theory. And yet, on a [website](#) recommending his chosen sector he lists as one of the advantages, "Illiquidity that favors the long-term investor". As he goes on to explain, liquid REITs are inferior because "...the share price can drop below the value of the underlying real estate". By contrast, because you can't sell an NTR you benefit from, "...the inability of investors to "panic sell" their securities."

Jain further notes that conventional, publicly traded REITs are subject to more market volatility than NTRs which, he asserts, makes them *more* risky. This is because NTRs don't trade, and they update their asset values infrequently. Of course, publicly traded REITs aren't inherently more risky, their prices are simply more current. Yet Mr. Jain argues that, because your brokerage statement will show fewer fluctuations in NTRs (because there are no new prices), rational investors (as oddly defined by Jain) should demand a higher return for publicly traded REITs versus the NTRs he prefers. He wants you to choose the illiquid security over the liquid one. This is in spite of the fact that the Financial Industry Regulatory Authority (FINRA), which regulates American Realty Capital, has a [warning](#) on its website that the, "Lack of a public trading market creates illiquidity and valuation complexities for NTRs."

What's wrong with this is that Sameer Jain's educational background leads the casual reader to assume he's intelligent. Evidently, the presumption of a high IQ should not be confused with a genuine desire to offer investors good advice. It's hard to comprehend why he holds such a view, and causes one to consider an alternative plausible explanation, that he's disingenuously offering "advice" that benefits his business while believing something different. When Wall Street analysts were caught doing this during the dot.com bubble it resulted in large fines and the subsequent inclusion of an Analyst Certification on every report saying that the writer believed what he wrote. Of course it shouldn't have been necessary, and yet you can still find examples of people writing what they surely know cannot be right.

It's what gives Finance a bad name. Daylight is often the best disinfectant.