

For professional investors only

# The illiquidity advantage of Infrastructure Debt

December 2016



**Allianz**   
Global Investors

Understand. Act.



**Philip Dawes**  
Head of Institutional Sales UK

In the current environment of historically low yields, pension funds and life insurance companies with longer term known liabilities are likely to be considering asset classes with a higher return than long-dated gilts. This can encompass liquid and illiquid alternatives from high yield bonds to commercial real estate – though clearly the tenors of these can also differ markedly.

# The illiquidity advantage of Infrastructure Debt

Starting with the classical construction of a well-diversified long term portfolio, we observe different longer term risk premiums. While attractive and desirable together, they also come with varying degrees of inherent downside protection.

Unfortunately, portfolio diversification benefits are not constant. Thus different risk premia such as equity, term, credit, funding, FX, emerging market (sovereign and corporates) and liquidity premium will be inter-related to varying degrees across different asset classes, at different times. Take for example private real estate and investment grade bonds, both will contain very different degrees of exposure to funding premium while their equity premium contribution might actually be expected to be small and similar. One risk premium that can be easily overlooked is liquidity or the reward to investors for being exposed to illiquidity.

## What is liquidity risk?

Liquidity risk is the possibility that when you try and sell an asset there are not enough buyers in the market to offer a reasonable price. Notably it is when you need liquidity the most, i.e. during a financial crisis, that the problem of liquidity risk rears its head. Thus there are several components to liquidity linked to trading volume, transaction costs and price impact.

Central banks, through quantitative easing (QE), have created an era of financial repression, with negative real interest rates on many sovereign bonds leading investors to seek riskier, higher yielding areas of the debt markets. With concerns rising surrounding the possibility of near to medium-term rate normalisation driven by the US Federal Reserve, there is an increased risk of sell-offs in areas of the debt markets and an increased need for active management to navigate the resultant volatility.

Concerns regarding liquidity in fixed income markets have heightened in recent years due in part to structural changes to the way markets operate (e.g. the consolidation of market-makers) and regulatory driven changes. Unlike equity transactions that trade on exchanges, most bonds trade in an over the counter market that relies on banks and dealers to find a buyer. Historically if a buyer could not be found the dealer would hold the bond on its books. Regulatory changes to capital provisions however, whilst well intentioned, have lessened the appetite for banks to hold these inventories meaning a decrease in secondary trading activities.

Therefore whilst we have seen corporate issuance continue to reach record levels since the financial crisis the depth of the market has lessened. Estimates suggest investment bank assets as a proportion of the world's outstanding credit stock (comprising government debt, corporate debt and securitised lending instruments) has fallen with further de-leveraging expected.

The fear therefore is that with US-led interest rate increases investors will attempt to unwind their bond positions and that a liquidity crunch will seriously impair prices. This is less of a concern for sovereign bonds but a real possibility in the instance of emerging market debt or corporate bonds, precisely those asset classes that investors have turned to in the search for yield. The market underestimates how constrained market making may become in such a scenario.



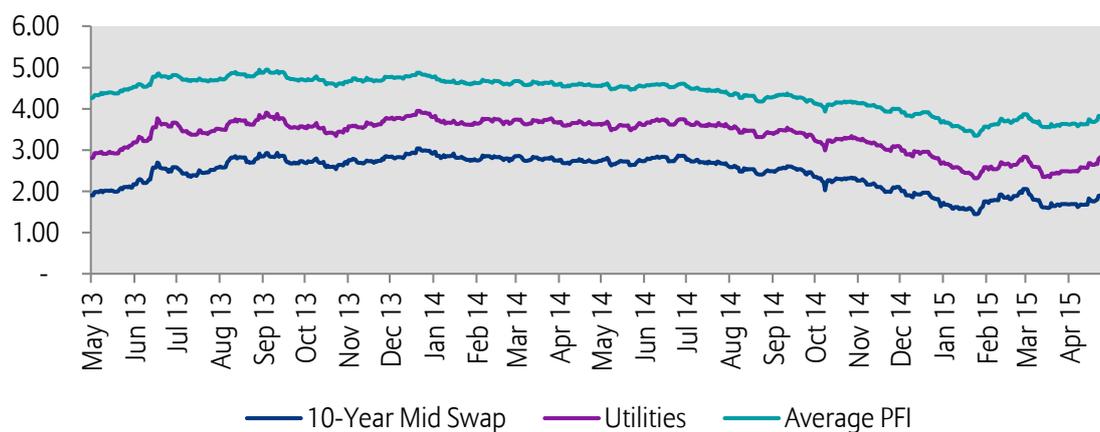
Academic and empirical evidence indicates that liquidity is an important determinant of corporate and emerging market bond yield spreads and returns. In fact liquidity risk appears to dominate credit risk in explaining yield spreads for both corporate and sovereign debt in emerging markets during times of market stress. Thus investors that have exposure to these assets classes are exposing themselves to an illiquidity premia indirectly, whilst assuming that under normal trading environments they have a liquid portfolio that can be traded frequently with minimal price impact. Given this indirect implicit exposure to illiquidity and the search for yield should investors consider more efficient and explicit means of exploiting this risk premia to their advantage?

### The illiquidity premium and infrastructure debt

An assessment of liquidity risk within investment portfolios needs to be conducted on an asset class by asset class basis. It is clear that the illiquidity premia exist within liquid and illiquid segments of the market and that it both varies by asset class and through time dependent on the prevailing economic and market environment. All things being equal however, the illiquidity premia can most efficiently be harvested by long-term investors from less liquid private markets, such as senior infrastructure debt. Quantifying the illiquidity premia for any given asset class is difficult however as directly comparable liquid assets may not be available or simply that as these are private markets accurate long-term price and default data are not available.

In the instance of infrastructure debt it is possible to infer the illiquidity premia by plotting a basket of known securities with similar ratings and duration. Figure 1 highlights listed Private Finance Initiative (PFI) bonds versus a listed A-rated utility and versus the 10-year swap rate. This indicates that over a 5-year period investors would have received a premia of c.100bps for purchasing an A-rated utility and a spread of 150-200 bps for private PFI placements. In terms of portfolio construction therefore, assuming the illiquidity premia could be viewed as an expression of manager skill in private markets, it follows that by harvesting the risk associated with illiquidity in the context of infrastructure debt one might reasonably expect >150bps p.a. as a consequence of this form of active management.

Figure 1



Source: AllianzGI, Bloomberg, April 2015. Past performance is not a reliable indicator of future results.

Notes: Index is the GBP A utilities: BVGBUA10 Index. Listed PFI bonds used are: Derby Healthcare plc - ED136226 Corp, Annes Gate Property Plc Fixed - EC5415087 Corp, Aspire Defence Finance plc [MBIA] - EF348243 Corp, Integrated Accommodation Services Plc - EC265904 Corp, RMPA Services PLC (Colchester) - ED318248 Corp.

## Portfolio construction and what should be considered?

In setting a tolerance for illiquidity institutional investors should focus first and foremost on the cash-flow and liquidity requirements of the underlying fund and associated liabilities. Thus liquidity risk should be considered across the entire scheme in a holistic manner. This is critical since during times of financial stress when liquidity can become scarce there is often high correlation across asset classes. Introducing asset classes that are lowly correlated can therefore help in part to mitigate this risk. It also implies that liquidity risk should be taken into account within fixed income portfolios as part of setting a strategic asset allocation and monitored on an ongoing basis.

Investors with a buy-and-hold mentality or a long-term focus may be more willing to ride out the potential volatility in markets and as most bonds are marked to market this volatility can be substantive. For private, illiquid asset classes, such as infrastructure debt where prices are marked to model (e.g. on a monthly basis) introducing the asset class into portfolios can help dampen overall portfolio volatility.

The extent of tolerance for illiquidity should also consider the prima facie risk attached to Defined Benefit pension schemes, namely covenant risk. Sponsor insolvency is paramount since ultimately it is an expression of the sustainability of a pension scheme for underlying members. Thus for pension schemes with a strong covenant and one that is committed to a medium to long-term deficit recovery plan one might argue that these cash-flows should increase the scheme's tolerance for illiquidity within the investment portfolio.

## Infrastructure Debt and illiquidity

Senior infrastructure debt as an illiquid alternative to other more traditional fixed income instruments has both diversification and yield benefits but is illiquid and requires a buy-and-hold mentality. That said the emergence of infrastructure equity funds and the subsequent development of secondary liquidity for these assets (both in pooled and segregated format) suggests that post construction LP interests in closed ended funds will become attractive and that as the asset class matures secondary liquidity mechanisms will emerge. Current market activity levels and appetite for infrastructure debt assets from a



proliferation of buyers (pension funds, insurance companies and pensions buy-out specialists) confirms the marketability of these assets when used as matching assets. The existence of specialist secondary advisory firms also confirms that there are routes to provide 'liquidity' even where the underlying assets themselves are not.

As with infrastructure equity interests the development of secondary activity (notably from insurance companies or pensions buy-out firms) will focus on the quality of underlying credits. Many participants will require external ratings of underlying projects and will require investment grade assets. Not all infrastructure debt portfolios will conform to these requirements so a clear understanding of the underlying transactions and inherent associated credit quality will be essential.

## Conclusion

A conservative approach to liquidity management in a period of uncertainty linked to QE tapering may make sense, but it can come at the expense of real return if illiquid assets are excluded. A systemic contraction in trading volumes have seen liquidity concerns re-surface in recent quarters but ironically long-term investors that can afford to efficiently exploit illiquidity can enhance portfolio returns, maintain credit quality and dampen portfolio volatility. Illiquidity should be viewed as a risk premia to be exploited (and not feared) be that through distressed debt, senior infrastructure debt, commercial real estate or other means. Whilst it must be conceded that the illiquidity of such assets is more pronounced and that secondary liquidity cannot be guaranteed this should not detract from the potential marketability of such assets in the future.



## Disclaimer

Investing involves risk. The value of an investment and the income from it may fall as well as rise and investors might not get back the full amount invested.

The views and opinions expressed herein, which are subject to change without notice, are those of the issuer companies at the time of publication. The data used is derived from various sources, and assumed to be correct and reliable, but it has not been independently verified; its accuracy or completeness is not guaranteed and no liability is assumed for any direct or consequential losses arising from its use, unless caused by gross negligence or wilful misconduct. The conditions of any underlying offer or contract that may have been, or will be, made or concluded, shall prevail.

This is a marketing communication issued by Allianz Global Investors GmbH, [www.allianzgi.com](http://www.allianzgi.com), an investment company with limited liability, incorporated in Germany, with its registered office at Bockenheimer Landstrasse 42-44, 60323 Frankfurt/M, registered with the local court Frankfurt/M under HRB 9340, authorised by Bundesanstalt für Finanzdienstleistungsaufsicht ([www.bafin.de](http://www.bafin.de)). Allianz Global Investors GmbH has established a branch in the United Kingdom, Allianz Global Investors GmbH, UK branch, 199 Bishopsgate, London, EC2M 3TY, [www.allianzglobalinvestors.co.uk](http://www.allianzglobalinvestors.co.uk), which is subject to limited regulation by the Financial Conduct Authority ([www.fca.org.uk](http://www.fca.org.uk)). Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.

Allianz Global Investors GmbH, UK Branch  
199 Bishopsgate  
London EC2M 3TY  
[www.allianzgi.co.uk](http://www.allianzgi.co.uk)

Telephone: 020 7859 9000

