The Importance of Liquidity

Stockholm (HedgeNordic) – Locking up money in illiquid alternative asset classes can be a risk even for long-term-oriented investors such as pension funds, particularly in times of market stress. “One of the key lessons” learned from the turmoil caused by COVID-19 is “the importance of liquidity,” Mikko Mursula *(pictured)*, the CIO of Finnish pension insurance firm Ilmarinen Mutual Pension Insurance, tells Bloomberg.

The combination of higher yields, lower volatility and limited correlations to traditional asset classes have lured institutional investors to alternative asset classes over the past decade. Longer-term-oriented investors with fewer liquidity requirements than shorter-term investors have the ability to invest in longer-term, illiquid assets. The coronavirus-triggered market meltdown in March created liquidity shortages for some institutional investors that had significantly increased allocations to illiquid alternative asset classes such as real estate and infrastructure.

Although long-term investors such as Ilmarinen can stomach illiquidity, certain alternative asset classes did not compensate enough for the illiquidity risk, according to the CIO of the Finnish pension insurance firm. “In some sub asset classes, you didn’t earn enough of an illiquidity premium anymore,” Mursula tells Bloomberg. The pressure on liquidity started to intensify in March and “there is not much you can do in the middle of a crisis like this,” he continues. Even “as a long-term investor, you need to make sure that you will be able to survive.”

Ilmarinen’s investment portfolio lost 7.5 percent in the first quarter of 2020, bringing the market value of its investments to €46.4 billion at the end of March from €50.5 billion at the end of last year. Due to the negative return, Ilmarinen’s solvency capital declined to €8.1 billion from €10.8 billion quarter-over-quarter, and the solvency ratio decreased from 120.7 percent to 126.6 percent. “At the onset of the crisis, Ilmarinen’s solvency was strong, and the buffers that have accumulated over a long period of time secure pension assets also in tough times,” Jouko Pölönen, President and CEO of Ilmarinen, wrote in an interim report. “The solvency ratio declined to 120.7 per cent, but is still clearly higher than the regulatory requirements,” he emphasized.

After the liquidity shock experienced by some investors during the first quarter, the focus has quickly shifted to regulatory solvency requirements, according to Mursula. Institutional investors will now “be going through their liquidity (or illiquidity) levels more thoroughly after the crisis” after experiencing how quickly things can change, Mursula tells Bloomberg. The CIO of Ilmarinen still reckons that alternative assets are a sound bet if managed properly.

Ilmarinen’s real estate investments at the end of March stood at €6.5 billion, accounting for 14.1 percent of all investments. The total return on real estate investments during the first quarter was 1.7 percent. The pension insurance firm’s investments in hedge funds, commodities and other investments made up 8.8 percent of all investments at the end of March, with this group returning a negative 8.1 percent in the first quarter. Fixed-income investments accounted for a total of 33.5 percent of Ilmarinen’s investment portfolio, while listed and non-listed equities and private equity investments made up 43.7 percent of all investments at the end of March, down from 47 percent at the end of last year.

Ilmarinen still needs “to have enough equity type of risk on board” to meet its return targets, Mursula tells Bloomberg. “Some areas of the equity markets are looking a bit rich when compared to historical average valuation levels,” he points out. “Also, in those markets there are many investors who wouldn’t be there if interest rate levels were a bit higher. That is because of the lack of alternatives.” Mursula is preparing Ilmarinen’s portfolio for a potential “second wave” scenario both in terms of infections and investor panic, which the market is “definitely not pricing in.” This scenario, however, represents “a high enough probability” to be a concern.