What's an 'illiquid' investment — and what do I need to know about the associated risks?

NEWS

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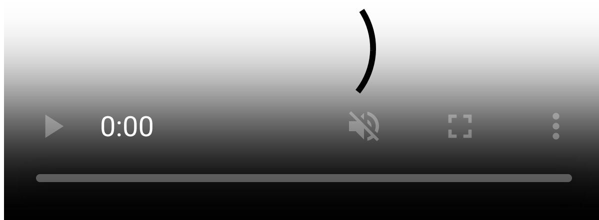
For FLORIDA TODAY



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Q: I've been pitched an investment that will tie up my money for at least seven years. Any thoughts?

A: You are referring to the concept of illiquidity. Not being able to access your funds for so long (when they might be needed) should carry a correspondingly higher return than investments that can be made into cash on short notice. During the time that your money is locked up, you must suffer the risks of inflation and even a failure to earn what you think you will.

In an interesting conversation with a client family this week, they remarked that their portfolio (like most) had dropped in price about 40% during the 2008-'09 stock market/economic troubles. The interesting comment

was that they were glad that they had a lot of equity in their home during that time and the value was therefore “preserved.”

I asked, “What do you think your house would have sold for in 2009 as compared to say 2006?” After some silence, I told them that it was entirely possible that they would have had to discount the price of their house much more than 40% in 2009 in order to sell it. Indeed, in our area of Florida, real estate prices commonly dropped 50% or more in the few years following 2008, and some have still not reached their pre-2008 highs.

Real estate is illiquid — we cannot make it into cash on short notice in most cases without potential losses. Also, we don’t see or know its price until it sells to someone else. If we are viewing real estate as an investment (and not a lifestyle expense like living in a nice home), there should be a higher return than on liquid investments to compensate for the “lockup” and invisibility of pricing while we hold the real estate.

Surprisingly, this is commonly not the case: We frequently see families who own investment real estate that has a return well below that of highly public liquid investments such as stocks. I think this would change if every property had a flashing neon sign out front that relayed its current market price daily (like stocks).

There are many other types of illiquid investments such as hedge funds and venture capital. Theoretically, they should all likely yield higher returns than liquid market investments to compensate for your inability to get your money back quickly and to compensate for not knowing the value of your investment until the end.

We see “investments” in non-publicly traded real estate and energy limited partnerships that pay huge commissions to salespeople and regularly do just terrible things to the investment portfolio. People buy

annuities hand over fist, paying large commissions and thinking that the guaranteed stream of income 10 years or more later is a ‘good deal.” It is not a good deal — it is a trade of some safety for a low return.

Typically, you give an insurance company some money and 10 years later they promise to pay you 4-5% of double your original investment annually for life. But you must remember several facts.

First, the investment is illiquid — there are large surrender charges and usually tax costs to recover your money early (if even possible). Second, the insurance company keeps your money with no return to you for 10 years. Finally, after you start to get your 5% return on double your original investment (let’s call it 10% of your original deposit), you are just getting back your own money for the next 10 years. Since you waited for 10 years, the insurance company doesn’t pay you with “their” money for 20 years. And the dollars you get in the future are worth less than they are today.

So, think about your investments and whether they are illiquid. If so, make sure you are well paid to take that burden.

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