



An Illiquidity Trap: Risks of Alternative Investments

As the age-old saying goes: “always know your exit before you enter”

The allure of alternative investments – bundles of real estate, private equity, buyout deals, and private debt – can be irresistible. These assets, often unlisted on traditional stock exchanges, promise unique opportunities and the potential for significant returns. However, while getting into these investments is easier than ever, a crucial question often goes unasked: How will you get out?

The Growing Obsession with Alternatives

Wall Street’s fascination with alternative assets is undeniable. In 2023 alone, three categories of alternatives – nontraded real estate investment trusts (REITs), business development companies (BDCs), and interval funds – raised a staggering \$55.8 billion. That’s more than double the \$26 billion raised just a decade earlier. The surge in popularity is partly due to the perception that these investments offer a buffer against market volatility. By locking up your money for months or even years, you’re theoretically insulated from the temptation to sell during downturns, allowing portfolio managers to build a portfolio that may yield substantial long-term returns.

The Illusion of Safety

The premise behind these investments seems sound: By removing the ability to trade frequently, you reduce the risk of making impulsive decisions during market fluctuations. But this perceived safety comes with a trade-off. The very act of eliminating liquidity – a key characteristic of most alternative investments – introduces a new and often underestimated risk: the challenge of exiting the investment.

The Illiquidity Dilemma

Investments that don’t trade on public markets may offer benefits such as reduced volatility and potentially higher returns, but these come at a cost. Once you’ve purchased a nontraded REIT, private debt, or other similar assets, selling it can be a complex and often costly endeavor. The illiquidity of these assets means that there isn’t always a ready market of buyers, which can force you to sell at a significant discount from the reported price – a deep haircut that can erode your returns.

How Deep is the Haircut?

When you decide it’s time to exit an alternative investment, you may find that the reported value of your asset doesn’t align with what the market is willing to pay. The discrepancy can be stark, with discounts sometimes reaching 20% or more. This illiquidity risk is further compounded by market conditions, as the demand for these assets can dry up quickly in a downturn, making it even harder to sell without taking a substantial loss.

Know Your Exit Before You Enter

Given these challenges, it’s critical to have a clear exit strategy before you commit to any alternative investment. Here are a few considerations to keep in mind:

1. **Understand the Liquidity Terms:** Before investing, ensure you fully understand the liquidity terms. How often can you withdraw your money? Are there penalties for early

withdrawal? Knowing the answers to these questions will help you gauge how easily you can access your funds if needed.

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- 2. Consider the Secondary Market:** Some alternative investments may offer access to a secondary market where you can sell your shares. However, these markets are often thinly traded, and prices can vary widely from the asset's reported value. Investigate the availability and viability of a secondary market before committing your funds.
- 3. Diversify Within Alternatives:** Just as you would diversify a traditional portfolio, consider diversifying within your alternative investments. This might mean spreading your investments across different types of real estate, private equity, and private debt to reduce the risk associated with any one asset class.
- 4. Be Prepared for a Long-Term Commitment:** Many alternative investments are designed for long-term holding periods. If you're not prepared to lock your money away for an extended period, these assets may not be suitable for your financial goals.
- 5. Consult with a Financial Advisor:** Given the complexity and risks associated with alternative investments, it's wise to consult with a financial advisor who can help you evaluate whether these assets align with your overall financial strategy. An advisor can also assist in developing an exit plan that minimizes potential losses.

Understand Clearly

Alternative investments can be an attractive addition to a well-diversified portfolio, offering potential for higher returns and reduced volatility. However, the illiquidity of these assets presents a significant risk that must be carefully considered.

Before you invest, make sure you have a clear understanding of how and when you'll be able to sell, and what kind of discount you might face in doing so. In the world of alternative investments, the ease of entry often belies the difficulty of exit.