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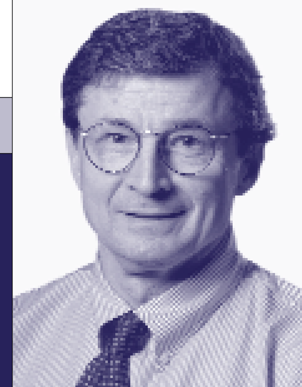
The Problem with Liquidity



This strategy has propelled public equities and put corporate governance in jeopardy.

One of the most significant developments of the last 50 years is the drive for liquidity, particularly among large institutional investors. This is the result of many factors, notably a proliferation of investment strategies such as index investing.

The quest for liquidity has had several important outcomes. The price of public companies climbed higher than private ones. Many more companies went public because the cost of capital was lower and there has been a lot more trading among public entities.

As well, investors were not interested in obtaining inside information because it was seen to hinder their ability to trade freely. Investors didn't want control over management or the board of directors. They simply voted with their feet by selling stock rather than making changes in how a company was run.

As a result, public companies began to issue poor-quality information to investors who did not want to play an active role in management. At the same time, the average portfolio contained a greater number of companies and investors adopted shorter and shorter time frames for investing (in some cases days, even hours). Consequently, the performance of public equity portfolios reflected the stock averages. This, in turn, made lower cost index investing attractive. Indeed, it is now widely practised, to say the least.

With index investing, investors completely abdicate control of management and the board of the company that they hold shares in. This leads to a breakdown in corporate governance. The management of many publicly traded companies, notably Enron and WorldCom, have exploited this situation, stepping into the void to enrich themselves at the expense of shareholders.

Rejecting liquidity

In contrast, private equity investors—those who invest in private companies that could potentially qualify for a listing on a stock exchange as opposed to venture capital—have rejected liquidity for hundreds of years. By doing so, they demand the best quality information available, including business plans, divisional data, legal structures, etc. These investors work with management and the board to execute a business plan, investing for a longer period, typically three to five years.

The greater confidence in the process means that the portfolios of private equity investors comprise 10 to 20 companies, not 50 to 200. The net result is significantly higher returns with much lower risk per investment. Higher returns occur because trading costs are reduced, the price, management control, information and business plan are better and the structure of the investment is far superior.

Over the last 15 years, allocations to private equity among pension funds have been growing steadily. Returns have been consistently better than those of the public markets for almost all time periods. Most statistics for private equity include venture capital, which in the last four to five years has become as big, if not bigger, than the true private equity market because of the mania for high technology venture capital. This distorts the returns for private equity.

Venture capital, particularly high technology investments, should be deleted from all data in order to show the true performance of the private equity market. It is exhibiting steady, but not spectacular, growth and returns that continue to exceed public equities by a significant margin.

Overall, ignoring the drive for liquidity is beneficial. Good governance is an integral part of private equity management. This investment approach has worked for hundreds of years, producing superior returns. ■