THE INVESTMENT ASSOCIATION

MACFARLANES

PRIVATE MARKETS
ILLIQUIDITY PREMIUM EXPLAINER

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About The Investment Association

The IA champions UK investment management, supporting British savers, investors and businesses. Our 250 members manage £11.1 trillion of assets. Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers. Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital.

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs. The UK is the second largest investment management centre in the world after the US, and manages £5.9 trillion in overseas client AUM.

About Macfarlanes

Macfarlanes is a pre-eminent law firm serving a global client base in Private Capital, Private Wealth, M&A and Disputes. Our work includes advising on the structuring of regulated and unregulated investment funds across all asset classes, and the legal and regulatory requirements governing them and their managers. We actively contribute to Investment Association initiatives and have been closely involved in the development of the regulatory framework for the Long-Term Asset Fund (LTAF) since its earliest stages.

Our Investor Intelligence team complements this legal expertise with market research and commercial insight to inform clients' fundraising and product development decisions. Through research reports, training and bespoke analysis, the team examines investor demand across jurisdictions and how regulation, fund structures and distribution channels shape investment opportunities.

Our collaboration with the Investment Association brings together these legal and commercial perspectives to support informed participation in private markets as access broadens, building understanding of private market strategies, their features and the considerations they present for retail investors.

WHAT IS THE ILLIQUIDITY PREMIUM?

The illiquidity premium is the additional return investors may expect for committing capital to assets that cannot be easily or quickly bought and sold. It compensates investors for accepting reduced liquidity, longer holding periods and greater uncertainty over when and how they can realise their investment.

OVERVIEW

- This explainer examines how liquidity works in private markets, focusing on evergreen funds and how managers balance long-term investment with periodic investor access.
- Investors accepting reduced liquidity may benefit from higher expected returns through an illiquidity premium which derives from investing in a broader range of long-term investment opportunities.
- Managers use a combination of liquidity levers and liquidity management tools to meet investor redemption requests while maintaining the fund's investment strategy. The fund's structure and the manager's ability to manage liquidity effectively can therefore be important drivers of investor outcomes.

ILLIQUIDITY PREMIUM: POTENTIAL BENEFITS AND TRADE-OFFS

Accepting reduced liquidity involves an investment trade-off: investors who commit capital for longer may expect compensation through a potential illiquidity premium, which can contribute to expected returns but must be weighed against more limited access to capital.

Benefits

Higher return potential:
Investors can receive additional expected returns for accepting reduced access to capital.

Broader opportunity set:
Exposure to companies, loans, infrastructure and assets not generally available through public markets.

Invest through market cycles:
Reduced redemption pressure can help avoid rapid sales during short-term volatility or selling at a discount.

Portfolio diversification:
Illiquid assets can have different return drivers from listed equities and bonds, potentially improving diversification and portfolio resilience.

Potential compensation for committing capital for longer

Trade-offs

Access to capital:
Investors cannot withdraw on demand, even where circumstances or financial needs change.

Uncertain timing and exit value:
Investments can take longer than expected to realise and an early sale may require the investment to be sold at a discount.

Vulnerability during periods of stress:
Liquidity can become more difficult and costly to obtain when markets are under pressure, increasing delays or discounts on asset sales.

Less transparent valuations:
Valuations are less frequent and market prices are not always readily observable.

LONG-TERM VALUE CREATION IN PRIVATE MARKETS

Private market strategies rely on a longer-term investment horizon to allow for value creation and investment returns to develop over time. If an investment must be realised earlier than intended simply to raise cash to meet redemption requests, this can interrupt the expected return profile and result in a less favourable outcome.

The table below illustrates this across private equity, private debt, infrastructure and real estate.

	 **Private equity**	 **Private debt**	 **Infrastructure**	 **Real estate**
Value creation	Growth in the underlying business and operational improvements that can increase company value over the period the investment is held for.	Interest income reflecting the complexity of directly sourcing, structuring and negotiating loans, alongside the credit risk taken, with principal repaid over the term.	Long-term contractual or operating cash flows, alongside potential capital appreciation as assets are developed and enhanced over time.	Rental income alongside potential capital appreciation through active asset management, improvements and repositioning.
Long-term rationale	The investment is typically held for several years to allow the value-creation strategy to develop before being sold.	Loans are typically held over their agreed term so that the expected interest and principal repayments can be received.	Projects often require time to develop, mature and generate their expected cash flows before value is fully realised.	Value-enhancing initiatives, such as refurbishment, redevelopment and improving occupancy, can take time to implement before value is fully realised.

LIQUIDITY ACROSS FUND STRUCTURES

The fund structure through which investments are made dictates the extent of the liquidity available to investors. Closed-ended, evergreen and daily-dealing funds provide different routes to investor access, even where the underlying exposures may be similar. Closed-ended funds generally lock capital in for the life of the fund; evergreen funds have no fixed end date and typically offer periodic redemptions; daily-dealing funds allow investors to redeem on each dealing day, subject in each case to the fund's terms.

	Closed-ended fund *A fund with a fixed life where investors commit capital for the long term and generally cannot redeem before the fund ends.*	**Evergreen fund** *A fund with no fixed end date that offers periodic opportunities for investors to subscribe and redeem, usually subject to notice periods and fund terms.*	**Daily-dealing fund** *A fund that allows investors to buy and sell units on a daily basis at the fund's Net Asset Value (NAV).*
Access	Commit at launch, with capital drawn over time. Capital is returned as investments are realised.	Ongoing or periodic subscriptions. Redemptions at the fund's net asset value (NAV) at set intervals, subject to fund terms.	Invest and redeem daily at the fund's NAV.
Liquidity terms	Fund term is typically 5-12+ years. No redemptions during the fund term; capital is typically returned towards the end of the fund life as investments are realised.	Redemptions are typically quarterly subject to caps, notice periods and other dealing terms. Where redemption activity is elevated, requests may also be limited, deferred or suspended.	Daily dealing; cut-off time applies.
Illiquidity premium exposure	**Higher** – long-term investment with no routine redemptions.	**Moderate** – balances exposure to illiquid assets with periodic liquidity.	**Limited** – daily access generally requires a more liquid portfolio.
Liquidity implications	Investor access depends on asset realisations or finding a buyer for your stake in the fund (a secondary sale).	Investors can typically redeem subject to caps, notice periods and other dealing terms. Where redemption activity is elevated, requests may also be limited, deferred or suspended.	Daily redemptions may create a mismatch where underlying investments cannot be sold quickly enough.

THE FIVE LEVERS OF LIQUIDITY

For evergreen funds, periodic investor access needs to be balanced with the longer-term nature of the underlying investments. As part of their ongoing portfolio and liquidity management, managers can draw on a combination of liquidity levers to meet redemption demand. The tools available will vary depending on the fund's terms, structure, investment strategy and applicable regulatory requirements.

1. **Netting subscriptions and redemptions –**
incoming subscriptions can offset redemption requests, reducing the amount of additional liquidity the manager needs to raise.

2. **Liquidity bucket or sleeve –**
a portion of the portfolio may be held in cash or more liquid investments that can be drawn on or sold to meet redemption requests. The size and parameters of the liquidity sleeve may also be informed by applicable regulatory requirements or guidance. However, holding too much cash or lower-returning assets can create cash drag.

3. **Income generated from underlying assets –**
interest, dividends, rental income and other portfolio cash flows can provide a recurring source of liquidity.

4. **Credit facility –**
where permitted, short-term borrowing can bridge timing differences between redemption payments and expected portfolio cash inflows.

5. **Asset sales –**
portfolio investments may be sold to generate additional liquidity. When managing redemption demand, managers will typically seek to use other available liquidity tools first, with asset sales considered where those sources are insufficient.

LIQUIDITY MANAGEMENT TOOLS

Liquidity management tools complement these levers by helping managers manage redemption activity, including when and how much capital can be redeemed and how associated costs are allocated.

Notice periods and dealing frequency

Notice periods for the submission of redemption requests and periodic redemption dates give managers advance visibility of redemption demand and time to plan how requests will be met. Quarterly redemptions mean redemption requests are processed at one of four points each year, usually following the giving of advance notice. Investors must provide the manager of an LTAF at least 90 days' notice of a redemption request, and some managers pay out the redemption proceeds several weeks after the redemption date itself.

Example LTAF redemption timeline: from request to payment



Redemption limits and deferrals

Where redemption requests exceed a threshold specified in the fund documents, the manager can limit the amount paid out to redeeming investors in respect of a redemption date. Depending on the fund's terms, where this threshold is exceeded, redemption requests are typically pro-rated so that all redeeming investors receive a proportion of the amount they wish to redeem, up to the fund-level limit (often set at 5% of NAV). Any outstanding balance may then be deferred to a future redemption date. This can reduce the incentive to redeem early simply to get ahead of others, limiting first-mover behaviour that might otherwise intensify liquidity pressure.

Dilution adjustments

Subscription or redemption prices may be adjusted to reflect the transaction costs associated with buying and selling investments to accommodate investors entering or leaving the fund, helping to protect remaining investors from bearing those costs. This is governed by the fund's terms and conditions.

Suspensions

In exceptional circumstances, such as periods of significant liquidity pressure or market disruption, redemptions may be suspended where continuing to meet requests would not be in investors' collective interests. A suspension temporarily prevents redemptions while those circumstances are addressed.

CONSIDERING LIQUIDITY IN PORTFOLIO CONSTRUCTION

The features described above lead to three practical questions when deciding whether exposure to an evergreen fund belongs in an investor's wider portfolio.

→ How much reduced liquidity can the portfolio accommodate?

The potential illiquidity premium should be weighed against more limited access to capital. Investors should have sufficient accessible assets elsewhere in the portfolio to meet foreseeable needs and changing circumstances. Pension portfolios can be well suited to evergreen funds given their typically long investment horizons, particularly for investors further from retirement who may be better placed to accept reduced liquidity.

→ How and when can capital be accessed?

The fund's notice period, dealing frequency and settlement timetable should be considered alongside the circumstances in which redemptions may be limited, deferred or suspended. These terms should inform expectations around access to capital, rather than the investment being treated as available on demand.

→ How well placed is the manager to manage liquidity?

Fund structure and the manager's ability to manage liquidity effectively can be important drivers of investor outcomes. The manager's investment approach, track record and valuation practices should therefore be considered alongside how the liquidity levers and liquidity management tools described above have been used across different market conditions.

COMMON MISCONCEPTIONS

"Illiquidity guarantees higher returns"

Illiquidity may be rewarded, but the illiquidity premium is not guaranteed.

"Monthly or quarterly dealing means cash is paid at the dealing date"

The dealing frequency describes when requests are considered. Notice periods, redemption limits, settlement arrangements and deferrals can significantly delay payment.

"Application of a redemption limit is a sign of fund failure"

Redemption limits are pre-defined liquidity management tools set out in fund documentation and may be used to manage periods of elevated redemption demand. Their use may signal liquidity pressure, but it is not a direct indication of a fund in distress.

"Evergreen and 'semi-liquid' mean the same thing"

"Semi-liquid" is sometimes used to describe funds offering periodic liquidity, but it is not synonymous with an evergreen fund. "Evergreen" describes a fund with no fixed end date, while the level of liquidity available depends on the specific fund terms.

GLOSSARY

Key terms

Liquidity	The ability to convert an investment into cash within a desired timeframe and without significant loss of value.
Illiquidity premium	The potential additional return associated with accepting reduced liquidity; it is uncertain and not guaranteed.
Evergreen fund	A fund with no fixed end date that typically offers periodic subscriptions and redemptions, subject to the fund's terms.
Redemption request	An investor's request to withdraw some or all of their investment from a fund in accordance with the fund's terms.
Redemption limit	A limit on the redemption requests that can be met on a particular redemption date. Sometimes referred to as a 'redemption gate' or 'redemption cap'.
Deferral	Where part or all of a redemption request is carried forward to a future redemption date, for example where redemption requests exceed the fund's redemption limit.
Cash drag	The potential reduction in returns from a fund holding cash or lower-returning liquid investments, either to provide liquidity to meet redemption requests or while new subscriptions are being deployed, rather than fully investing in target assets.

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