The Importance of Illiquidity Budgeting for Families

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Introduction to Illiquidity Budgeting

Family offices face a unique set of challenges in the world of investing. Unlike endowments or pension funds, which have well defined, actuarily determined liabilities to meet in the future, a family office serves the needs of a specific family with different generations and spending patterns that make future cash demands difficult to forecast. A family office can plan for future liabilities and then suddenly face a major real estate purchase, a new philanthropic pledge, a new business opportunity, or just an unexpected life event within the family. This unpredictability arises from the unique and multifaceted considerations of the family and makes focusing on liquidity a vital part of the family's wealth management. Specifically, in the modern world of investing, it is a question of how *the illiquidity* within the family office's alternative investment portfolio is thoughtfully sized considering the broader portfolio and cash flow needs over the short and long term. Importantly, there are lessons in illiquidity budgeting that can be applied to individual investors as well.

Illiquidity budgeting is the disciplined process of determining how much of a portfolio can be prudently committed to assets that cannot quickly be converted to cash without facing substantial losses. This has become an important and misunderstood tool in family office portfolio construction. When done poorly, a family office can become hamstrung by the illiquidity of past investments. When it is done well, it allows the family to capture the return premium of illiquid assets to generate better long-term returns for the family while still preserving the flexibility necessary to meet the unpredictable needs of the family.

The Importance of Illiquidity Budgeting for Families

Illiquidity budgeting is a key part of planning for pension funds and endowments, and it is just as important for families. The difference is, as we said, the unpredictability of family liabilities. This creates positive and negative aspects for the family office when compared to institutional investors. The key advantage is timeframe. A family office can plan for multi-generational growth and can consider locking up assets for longer timeframes than many institutional investors can consider. Families can absorb longer lock-ups or investment horizons than an institutional investor with significant near-term obligations. This translates into a smaller universe of potential investors and thus less competition for such long-duration investments, increasing the potential for greater returns over time. Another key advantage for most family offices is flexibility, as they often do not have the same kinds of direct obligations that a pension or endowment must meet. This gives them more flexibility with their illiquidity budgeting over time.

However, illiquidity introduces several risks. First, family offices often underestimate the liquidity needs because the wealth feels "permanent" and always there. The wealth is there, but illiquidity means that the family doesn't have access to the capital. This seems like an obvious observation, but multiple investments over time can allow "illiquidity creep" in the portfolio and limit overall access to the family capital. Additionally, because the wealth feels permanent, there is a real temptation to over allocate to illiquid assets from the start. The problem is often exacerbated by over-allocating to illiquid, high-return alternatives such as Venture Capital or Private Equity assets which may introduce additional risks to the portfolio. Finally, many family offices have concentrated, single-family business exposure that is viewed as something different than an illiquid asset when it is exactly the kind of illiquid asset that we are highlighting here. Just because the family has owned a business for years, this does not make it special for the purposes of this exercise.

Building an Illiquidity Budget

Constructing a disciplined illiquidity budget for a family portfolio requires several interlocking steps, with each building on the last.

1. *Liability & Spending Mapping* – A realistic budgeting of expectations to create a catalog of probable cash needs including annual cash expenses, taxes, philanthropic commitments, and major purchases all organized by time frames of near, medium and long. This gives a "best assessment" of when cash will be needed rather than just guessing.
2. *Liquidity Tiering* – managers can then segment assets into categories with an understanding of the cash needs of the family. Major categories would be:
    - *Cash & Near Cash* – money market funds, treasuries, and short-duration bonds that can be converted to cash easily within days with minimal price impact.
    - *Semi-Liquid Holdings* – A broad category with many styles of assets. Publicly traded equities fall into this category despite their liquidity for several reasons – tax consequences as well as large positions that can make unwinding public equities more complicated. Hedge Funds, Interval Funds, and Evergreen funds offer liquidity windows after a lockup period with gating considerations when the fund manager can restrict or stop redemptions. Structured products with defined liquidity windows would also fall into this category. This category can be subdivided to reflect the liquidity considerations of these various products.
    - *Long-Locked Illiquid Holdings* – These assets cannot be sold on demand at all. This is capital that is often committed for years and exits often depend on things that are outside the manager or family's control. This category has private equity funds, direct investments, real estate, etc. including any family

operating businesses. Collectables and other passion assets such as art, wine or classic cars would be included here as well even though they can be sold as the market for these items is often quite thin.

3. *Illiquidity Ceiling* – with an understanding of the cash needs of the family and the liquidity tiering of assets, a family can reasonably set an illiquidity allocation ceiling, a maximum percentage of assets that are committed to the long-locked category of liquidity. This percentage will vary widely based on the family's circumstances and needs, but many offices fall in the 20-40% range. In practice, this number can be adjusted up or down significantly based on family cash needs or risk tolerance.
4. *Stress Testing* – allocation to these categories must be tested against historical downturns to understand how the portfolio reacts. Long-Lock assets tend to have better pricing through downturns. There are lots of reasons for this relative price stability (volatility laundering, delayed pricing, limited pricing), but the consequence to illiquidity budgeting is that when the market draws down, the long-lock assets become a much larger percentage of the portfolio. Often, private equity funds can become more aggressive deploying capital in market downturns, calling capital from investors quickly when managers see new opportunities. How does such a situation impact the cash flow of the portfolio and the needs of the family? This question must be answered in stress testing.
5. *Liquidity Reserve* – We all know things rarely turn out as expected. At this point in the process, a liquidity reserve should be put in place. A deliberate liquid asset buffer to cover several years of spending and capital calls should it become necessary.
6. *Pacing Model* – in this final step, the pacing of allocation to illiquid assets should be considered and mapped out so that commitments are made across vintage years and reducing exposure to a single market cycle. This is important both for diversification of the opportunities that come to market over time and smoothing cash flows over investment cycles.

Taking these six steps together creates a plan to manage illiquidity and cash needs over time. By repeating this process at a regular interval, the family can be prepared for cash needs at different time frames and thoughtfully allocate to illiquid assets.

Common Mistakes in Illiquidity Budgeting

Even with a process in place for an illiquidity budget, the process can fail in practice for several reasons. One of the most common mistakes is simply overallocation, i.e., chasing the illiquidity premium these investments offer investors. These assets offer a premium for a reason, and many investors do not sufficiently assess the cost or likelihood of being a forced seller, or being unable to exit outright. Evergreen fund managers can gate (i.e., close the exit) as they see fit to avoid fire sales, and drawdown fund managers can generally extend fund lives several years based on the assertion that holding out for a better exit environment will result in better overall returns to investors. These funds offer higher returns specifically because of that illiquidity risk.

Additionally, allocations to illiquid assets are often made without considering correlation between assets. How economically linked are these assets to other illiquid and liquid assets in the portfolio? Often, this kind of correlation is not fully considered when making allocations and when a downturn occurs, it can undermine the intended diversification from illiquid assets.

Furthermore, private funds can also add cash flow hazards to the portfolio just from unexpected capital calls. These funds often increase capital calls when the markets turn down, exacerbating the cash flow problem.

Finally, a family may set an illiquidity budget once and not revisit it. Circumstances change and life happens to a family. This illiquidity budgeting process is ongoing and must be revisited regularly to make sure it is still appropriate for the needs of the family. An ideal way to keep such considerations top of mind is by regular circulation of a liquidity dashboard that tells a clear story from multiple angles of how much adversity the liquidity situation could absorb over various timeframes without straying into potential hazard.

Best Practices

There are few best practices to keep in mind when doing this exercise.

1. *Repeat, Repeat, Repeat* – this is not a one-time exercise. Illiquidity budgeting is an ongoing exercise for the family. A living document guiding the allocations to ensure cash needs are met in the near and long term. This process should be executed at least annually alongside the broader investment policy statement guiding the investment approach of the family
2. *Governance Matters* – risk tolerances, time horizons, and goals can vary significantly between generations and individuals in the family. Ideally, the illiquidity budget should be built with buy-in from multiple generations and not set unilaterally by a single decision maker or outside advisor.
3. *Communication* – liquidity mapping and tiering can serve a purpose beyond portfolio construction. This can create a great tool for families to have honest conversations to facilitate understanding of wealth accessibility, cash flow needs/wants, and timelines across generations.
4. *Changing Times* – the illiquid market has been growing for years and is changing dramatically. There is a growing secondary market for private funds. This does not

make these assets liquid, but it does make their sale more efficient. Families need to understand and assess how liquidity assumptions can change over time.

Conclusion

Over the past 30 years, the use of alternative assets as a tool to achieve better returns for family offices has become common and expected. The illiquid aspect of these investments has often been viewed as an additional risk that should be minimized to protect access to capital. However, when looking at it through a more academic lens, illiquidity is the primary justification premium returns; thus, illiquidity is better thought of as a resource to be used and managed deliberately. The multigenerational aspect of a family office allows them to fully realize this illiquidity premium over time. Realizing that advantage requires disciplined process and deployment. There is no industry benchmark for illiquidity budgeting. It is a process that depends solely on the unique situation of the family. Families that treat illiquidity budgeting as a rigorous, recurring process will position themselves to capture the benefits of long-term, illiquid investing without being caught short when liquidity matters most.