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The illiquidity puzzle: theory and evidence from private equity ☆

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Abstract

This paper presents the theory that managers can use the liquidity of securities as a choice variable to screen for deep-pocket investors, those that have a low likelihood of facing a liquidity shock. We assume an information asymmetry about the quality of the manager between the existing investors and the market. The manager then faces a lemons problem when he has to raise funds for a subsequent fund from outside investors, because the outsiders cannot determine whether the manager is of poor quality or the existing investors were hit by a liquidity shock. Thus, liquid investors can reduce the manager's cost of capital in future fundraising. We test the assumptions and predictions of our model in the context of the private equity industry. Consistent with the theory, we find that transfer restrictions on investors are less common in later funds organized by the same private equity firm, where information problems are presumably less severe. Also, partnerships whose investment focus is in industries with longer investment cycles display more transfer constraints. Finally, we present evidence consistent with the assumptions of our model, including the high degree of continuity in the investors of successive funds and the ability of sophisticated investors to anticipate funds that will have poor subsequent performance.
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1. Introduction

Economists have long argued that liquidity is a mixed blessing. On the one hand, liquidity provides a number of benefits for investors. For example, more liquid assets can provide positive incentive effects through improved performance measurement and more informative stock prices (see, for example, Holmström and Tirole, 1993; Faure-Grimaud and Gromb, 1999; Scharfstein and Stein, 2000). Greater liquidity also allows investors to easily redirect funds toward more efficient uses (as highlighted in the literature on liquidity shocks in the tradition of Diamond and Dybvig, 1983; Shleifer and Vishny, 1997). On the other hand, the literature has identified costs of investor liquidity. Most of these papers rely on the intuition that increased liquidity reduces the incentives for large shareholders to fulfill their monitoring role (as in Bhide, 1993; Aghion et al., 2000).

This paper examines a rationale for liquidity that is distinct from the governance-based stories that have dominated the earlier literature. We present a model in which a manager of a private equity firm explicitly chooses the degree of illiquidity of shares to screen for investors with long horizons. Investors who expect to face many liquidity shocks in the future would find these restrictions especially onerous and therefore would avoid investing. The benefits of having liquid investors become apparent once the firm has to go back to the market to raise new capital. If the original investors do not reinvest because of a liquidity shock, the outside investors cannot distinguish whether the initial investors truly faced a liquidity shock or whether they have learned that the fund is a lemon. Transfer constraints de facto allow the manager to trade off increased cost of capital in early fundraising against lower cost in future fundraising by minimizing the lemons problem with respect to the outside market.

The novel contribution of our model is that we analyze illiquidity as a choice variable, which can be influenced by the manager of the fund and allows him to screen for deep-pocket investors. Thus, illiquidity here is not the symptom of an underlying asymmetric information problem as it is in most of the asset pricing literature on liquidity. Instead, we model illiquidity as an outcome of the optimization problem that the general partners (GPs) have. The intuition of our model is driven by the information asymmetry between inside and outside investors and not by the fact that a private equity fund could face large transaction costs if it was forced to liquidate prematurely. The transfer of equity stakes is independent of the capital commitment to the fund.

We motivate the analysis by considering a setting where the monitoring role of large investors is much less important, but severe restrictions on liquidity are commonplace: private equity limited partnerships. Three observations inspire our analysis. First, limited partners (LPs) in U.S. private equity funds typically have very

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