Spotlight on Liquidity Risk

Just as market prices can change, so too can the level of interest in buying or selling any asset. The ease with which an investor can enter or exit a market is referred to as *liquidity*. Think about what can happen with buying or selling a house. In 2006, open houses attracted hundreds of prospects, sellers could expect multiple offers, and buyers often missed out. In 2008, an open house might have attracted no one, sellers could not afford to be picky, and buyers with access to funds had plenty of houses to choose from. In 2006, houses would often sell in a matter of days and house prices skyrocketed. In 2008, houses took many months to sell and often traded at greatly reduced prices.

Investments also have liquidity and, like houses, can see their liquidity increase or decrease as market conditions change. The greater the number of buyers and sellers, and the more evenly balanced their needs are, the greater the chances that market participants will be able to close a deal quickly and efficiently. Problems with liquidity crop up when there is a mismatch between the numbers or needs of buyers and sellers. This can affect both the length of time needed to buy or sell a position and the premium or discount at which the asset trades.

In times of market stress, liquidity "dries up" and market participants find it difficult, costly, or impossible to complete a transaction. How can we mitigate liquidity risk in portfolios? Two ways: focus on estimating the liquidity of each of our investments, and diversify.

How do we predict liquidity levels for financial assets? One way is to understand supply and demand. We keep track of who is likely to buy and sell the asset. To gauge this, we look at both the structure of the markets and the level of investor sentiment.

Some market participants are "natural" buyers and sellers – individuals or institutions that need to purchase or sell certain assets. Young couples with a baby on the way are natural buyers for a house; empty-nesters are natural sellers. Likewise, pension funds need to be ready to pay workers when they retire, so they predict the timing and amount of their cash flows. Until pension funds need the cash, they must invest it profitably, in something stable. Corporations need to be able to count on stable financing in order to invest in projects. Therefore, corporations that need to borrow money will issue bonds that match the timing and cash flow needs of the pension funds that will be lenders. This matching creates "natural" sellers and buyers.

What can go wrong with this arrangement? If a pension like General Motors' runs out of cash to buy bonds, they will stop making purchases. There will be fewer buyers of corporate bonds, and corporate issuers will compete harder to sell their bonds. Fewer bond trades will take place, and bond prices will fall. If a natural buyer disappears, the natural seller may be in for hard times.

Sometimes the way markets are structured means there are no natural buyers for an asset. An example is a single municipal bond. It is easy to buy a municipal bond at the initial offering but difficult to sell it later in the secondary market. The bond market is not like the stock market. There are thousands of bond issues, and most of them are held by investors who expect to keep them until they mature. An investor who wants to sell a bond before it matures must go to the dealers in the secondary market. The dealers make money by re-selling the bonds at a profit. The bond dealers have a good sense of who their clients are and what they would like to buy. Without a specific, known buyer, a bond dealer may not want to hold a bond in inventory, and so may be hesitant to buy it. Another way of saying this is that the dealers provide liquidity, at their discretion. If the dealer doesn't want your bond, you have run out of buyers.

Some assets do not have a natural buyers or sellers, but might have liquidity primarily because of market participants' expectations about the asset's future value. This expectation is based on confidence in the asset's value as a stake in a going concern. Because large, established firms with multiple lines of business seem to have durability, their stocks often have excellent liquidity. The stock of a company like Procter & Gamble, makers of thousands of personal-care products, will likely be more liquid than the stock of a small business like Steinway Musical Instruments, which makes pianos and band instruments. Indeed, the daily stock volume for Procter & Gamble is more than 14 million shares per day, but for Steinway, it is only 50,000.

Investor confidence can be fickle. During the dot.com boom, many investors believed that prices for tech stocks would keep rising. There was an abundance of buyers. Following the bursting of the tech bubble, investors grew to expect falling prices, and so they stopped buying tech stocks. After all, why buy something today if you think you can get it cheaper tomorrow? This is called a buyer's strike.

If nobody wants to buy an asset, sellers will have nowhere to turn. They may not find a buyer at any price, or may not be willing to sell at the reduced price that the remaining buyers are willing to pay. Overall, prices will plummet.

Eventually, prices will be so low that new buyers will emerge, attracted by the hefty returns implied by the low prices. These are called crossover buyers. Someone who scrupulously put away savings and lived frugally from 2001 to 2008 might decide to buy a house in 2009 because she saw real future value in becoming a homeowner in the prevailing real estate market. Therefore, we see how supply and demand based liquidity can establish itself, fail, and recover over time.

We manage liquidity risk by trying to predict the behavior of investors. When an asset becomes illiquid, we must decide whether we think the change is temporary or permanent. We look at changes in the market structure and in sentiment. Then we re-evaluate the risk/reward profile of the investment, and we attempt to sell it if we think it prudent.

Some assets have legal restrictions on their liquidity because they require a long time to produce value. We call them transformational assets. As we saw, claims on a going concern are tradable, and their liquidity depends on supply and demand. Transformational assets are designed to be illiquid because of the long time horizon needed to invest the capital and produce results. Think of the difference between a house that has been completely built and a house under construction. The completed house is move-in ready and can be used by its occupants immediately. A house under construction is not ready for occupancy and will require time, effort and patience to transform it into something useable. The developer and contractor transform land and building materials into shelter. Transformational assets have what we call lock-up terms, which means a period of time during which investors may not redeem their investment.

Private equity is a transformational asset, in which entrepreneurs make investments of time, money and skill into businesses they expect to be able to sell for a significant profit in the future. The private equity firm is not legally bound to return cash to its investors before a specific date because it has put its capital to work developing businesses. What if a holder of a stake in a private equity firm unexpectedly needs to sell? He must try to unload his stake in the secondary markets, where brokers and buyers are few, subjecting himself to the punitive terms that a non-forced buyer can impose.

Of course, nobody enters into an investment with a lock-up if he knows he will soon need access to his capital. Because people's circumstances change, we limit the size of any illiquid positions in a portfolio. In addition, it is crucial that we all be aware of the contractual terms for each investment we make. We will notify you which of your proposed investments are subject to contractual illiquidity.

Because of the perils of illiquidity, investors will not purchase illiquid assets without some incentive. In general, investors expect that, over the long term, they will achieve a higher return from investing in an illiquid asset than in a liquid one. Because the long term is composed of a string of short terms, the investor bears the risk that illiquidity will create a loss.

To mitigate these types of liquidity risks, we diversify our portfolio, just as we diversify to manage volatility. This generally works because it is rare for all assets to become illiquid at the same time. Diversification allows us to limit the damage of liquidity events. It also helps assure us that if you have a sudden need for cash, there will most likely be some readily marketable assets in your portfolio.