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INSIGHT

VIEWPOINT

Investment Liquidity: “Eight Miles High and Falling Fast”

TAD RIVELLE & MITCH FLACK | JULY 20, 2015

Upon receiving a call from his stock broker advising him to buy 500 shares of a recently IPOed micro cap at $10, an investor agreed to make the purchase. The next day, the investor was pleased to see that his stock was opening much higher at $15, so he proceeded to buy another 500 shares and the price promptly rose to $25 on good volume. Notwithstanding the hype and lack of earnings, the customer told his broker to keep buying the stock until the price reached a towering $50. Satisfied with his “ride,” the customer called his broker, told him about the new yacht he wanted to buy, and instructed him to sell all his stock in the micro cap. The broker listened–paused–and then asked, “To whom?”

Our investor learned the hard way that liquidity can be difficult to assess and often has an ephemeral, “now you see it, now you don’t quality” to it. Liquidity can be judged in any number of ways: by the size of the bid/offer spread, by the depth of the market, or by the continuity of real time price action. Further, asset classes that are liquid today because they are in vogue might not be so liquid tomorrow, perhaps owing to a change in sentiment. Indeed, we have seen certain security types exhibit sizeable, even catastrophic shifts in their liquidity profiles over the course of a business cycle. Given such fluidity, what is the proper way to manage liquidity over the course of a cycle?

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Liquidity is commonly thought of as an absolute good to be maximized whenever possible. This is overly simplistic. Judging an asset as liquid is tantamount to saying that a ready market exists for the asset. As such, the asset can be either bought or sold, in size, with a clear expectation of the price to be paid. Investors in liquid assets develop an expectation that they can get in or out with no muss, no fuss. Yet, might an excess of liquidity also signal an excess of enthusiasm? After all, in their hey-days, tech stocks, suburban homes, and subprime mortgages were extraordinarily liquid investments. As it turned out, an ill-timed portfolio overweight in such "liquid" assets experienced returns which sank to the depths of Davy Jones' locker. What we often see is that investors conflate the concepts of liquidity and price volatility. When clients ask us what is the liquidity of certain asset classes, what they often are interested in is the potential price volatility of that sector during stressed periods, not whether they easily and quickly can exchange their assets for cash today at recently transacted levels.

Measuring the liquidity of an asset today may tell you little about its liquidity tomorrow. Indeed, for risk-based assets, heightened liquidity may actually be a contrary indicator. Liquidity for many assets tends to rise so long as prices are also rising. Bull markets tend to broaden and deepen market participation, both essential qualities of a liquid market. A market has depth because of the participation of the many. Bull markets also have a tendency to dull the senses to current valuations. Who needs to understand the fundamental value of an asset when prices are readily available, when you can always bail out of the asset if prices begin to go south, and when momentum and the hype of the promoters is carrying the day? Investors get swept up in the socially constructed reality of a bull market and come to expect high returns on capital.

Hence, building a portfolio that is chock full of seemingly liquid assets today may not maximize its prospects over time. Inevitably, booms turn to busts and no one will much appreciate clothes designed for a warm summer day in the depth of winter. Rather, investors come to rue that market participation falls off in a bear market as rapidly as attendance does for a losing sports team. Who really wants to "try and catch a falling knife" when each day, every day, brings a new low in prices? Without eager fans, market participation dips and the liquidity that had been a rushing river becomes a parched bed of rocks. Investors forget about return ***on*** their capital and worry only that they get some return ***of*** their capital.

Yet, for the value investor, the loss of liquidity can be a cry of "Tally-ho!" While subprime bonds in 2006 may have been horrific investments when they were liquid and trading at par, they turned out to be mighty powerful generators of wealth after prices collapsed to 30 or 40 cents on the dollar in 2009. The very lack of pricing information and loss of liquidity reflected deep fears on the part of investors as to whether the asset class had any future at all. Conversely, as home buyers/investors today scoop up million dollar condos effectively at low single-digit cap rates, comforted by a broad base of investors and excellent price information, a dearth of value becomes more evident.

In other words, what we are saying is that liquidity tends to be high when risk assets are in vogue, fundamental value theses play a secondary role, and after positive price momentum has occurred. Liquidity tends to be limited after market disruptions occur, leading to fundamental valuation reassessment that often results in sharp price drops. ***Ironically, it is during these more difficult market environments that investors should consider the purchase of illiquid assets where cash flows are discounted at much higher rates. Conversely, when markets trade with great liquidity, caution should be exercised in taking on risk assets at yields that may be too low for the risk.*** In short, the value investor should be continually aware of the market environment and recognize that as with so many

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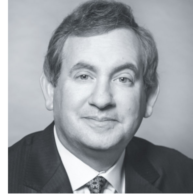
market variables, liquidity–especially the liquidity of risk assets–is very much a pro-cyclical occurrence. Importantly, when liquidity is relatively available, particularly late in the credit cycle, it is often a signal that risk assets are not being judged with sufficient skepticism. Changes in market climate can easily, and without warning, transform a "liquid" risk class to an "illiquid" (or less liquid) one. Often, liquidity is here today, but gone tomorrow. After the liquidity has evaporated, deep value is often exposed. That would be the right time to build a less liquid, higher returning portfolio. ■



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Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing $140 billion in U.S. fixed income assets, including over $85 billion of U.S. fixed income mutual fund assets under the TCW Funds and MetWest Funds brands. Prior to joining TCW, Tad served as Chief Investment Officer for MetWest, an independent institutional investment manager that he cofounded. The MetWest investment team has been recognized for a number of performance related awards, including Morningstar's Fixed Income Manager of the Year. Mr. Rivelle was also the co-director of fixed income at Hotchkis & Wiley and a portfolio manager at PIMCO. Tad holds a BS in Physics from Yale University, an MS in Applied Mathematics from University of Southern California, and an MBA from UCLA Anderson.

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