The Myth of Liquidity

Central bank policies to combat the negative economic impact of a Global Pandemic and, previously, the Global Financial Crisis have caused the markets to be "flush with liquidity." These policies have driven equity valuations to historic highs, fixed income yields near all-time lows and credit and other spreads near historical lows. In this period of extremes, it is apt for us to take pause and review both the real meaning of liquidity and the underlying qualities of portfolio assets.

*The "go to" assets for liquidity in today's markets are **cash equivalents, fixed income, and equitiy securities**. **Cash equivalents** are expected to provide a safe harbor, shielding money from market risk. **Fixed income** is expected to provide liquidity, safety, and income. **Equities** are expected provide long-term growth, supplemented by dividend income. In this paper we pose the idea that these expectations may be flawed and susceptible to change due to ongoing, extraordinary central bank policy and the possibility that these efforts may ebb or even reverse in the coming years.*

"Liquidity":

Merriam-Webster:

> ***a:*** *consisting of or capable of ready conversion into cash (liquid assets)*
> ***b:*** *capable of covering current liabilities quickly with current assets*

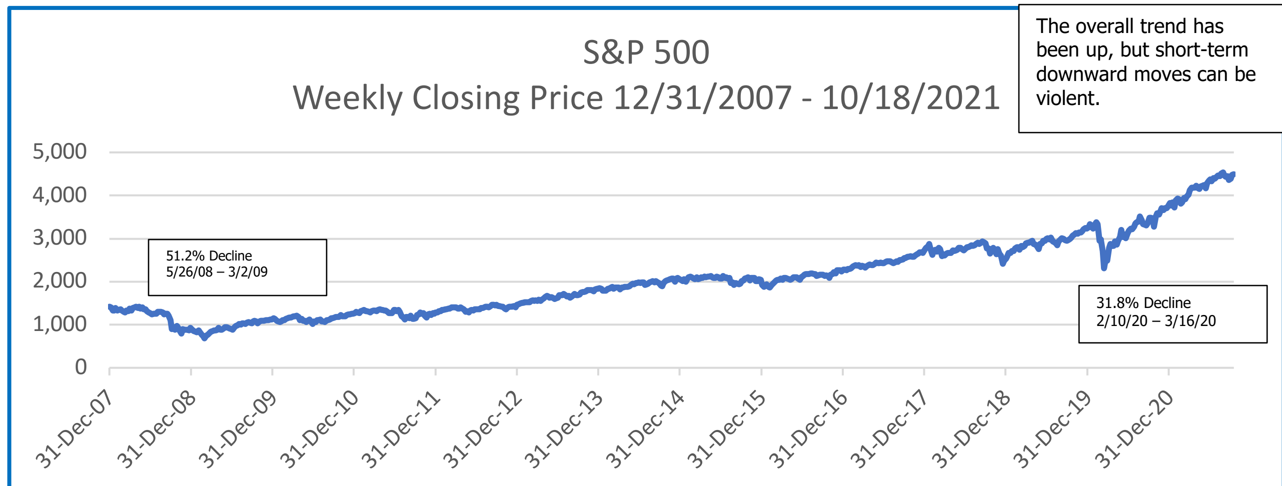
Investopedia.com:

> *Liquidity refers to the efficiency or ease with which an asset or security can be converted into ready cash without affecting its market price. The most liquid asset of all is cash itself.*

How do you Think of Liquidity?

The Investopedia.com definition seems most consistent with investors' expectations. The desire for liquidity has tilted investor appetite toward assets that can be "*converted into ready cash without affecting its market price*." While this may currently be true for equities as well as intermediate and long-term fixed-income securities, these assets can be volatile. While recent performance may support the idea that these assets are liquid,

bouts of volatility, the likes of which we witnessed in 2008 and again in 2020, can render these securities illiquid (certainly in the case of bonds) or can materially impact the market price (notably in the case of equities). This can result in proceeds that are significantly less than one would have anticipated, failing to satisfy the Investopedia definition.

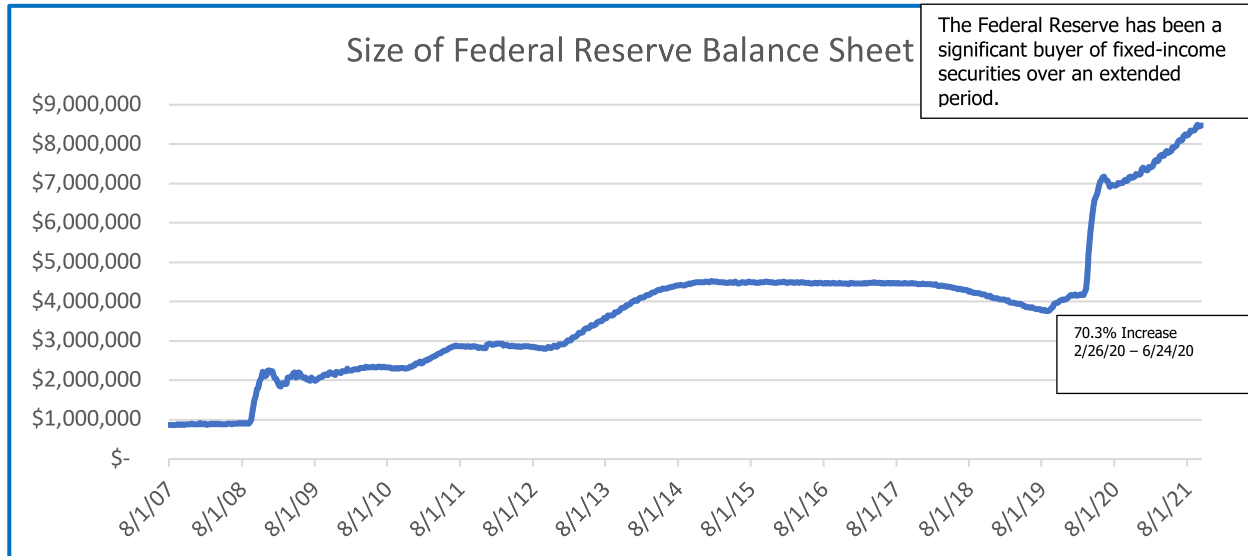


S&P 500 (^GSPC) SNP - SNP Real Time Price. Currency in USD – Source: Yahoo Finance

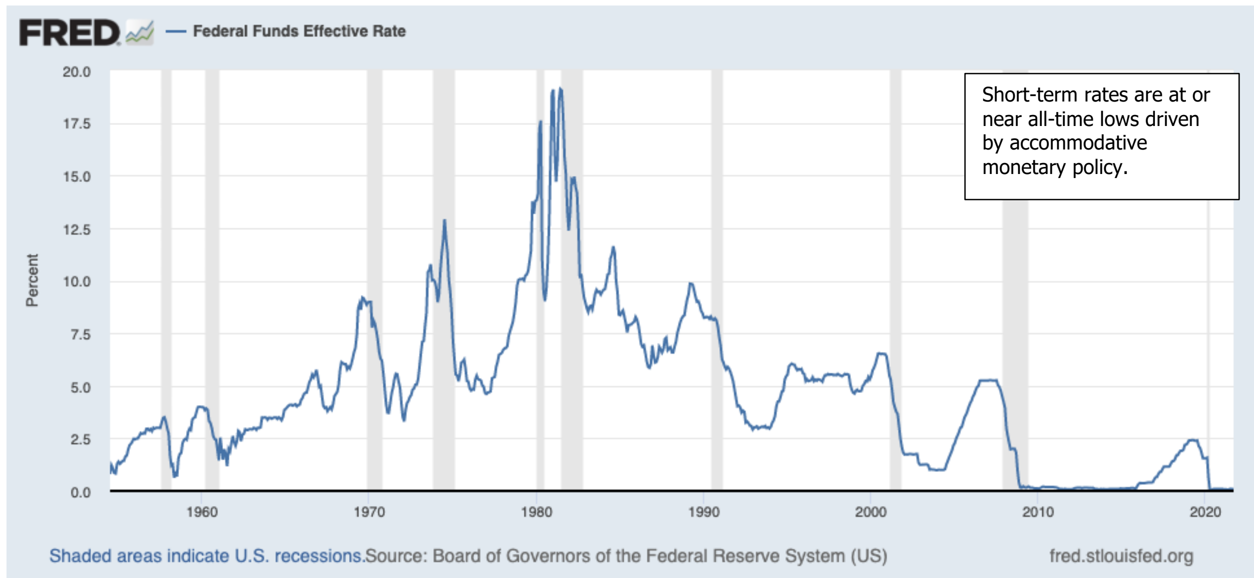
Why Is Liquidity a Myth?

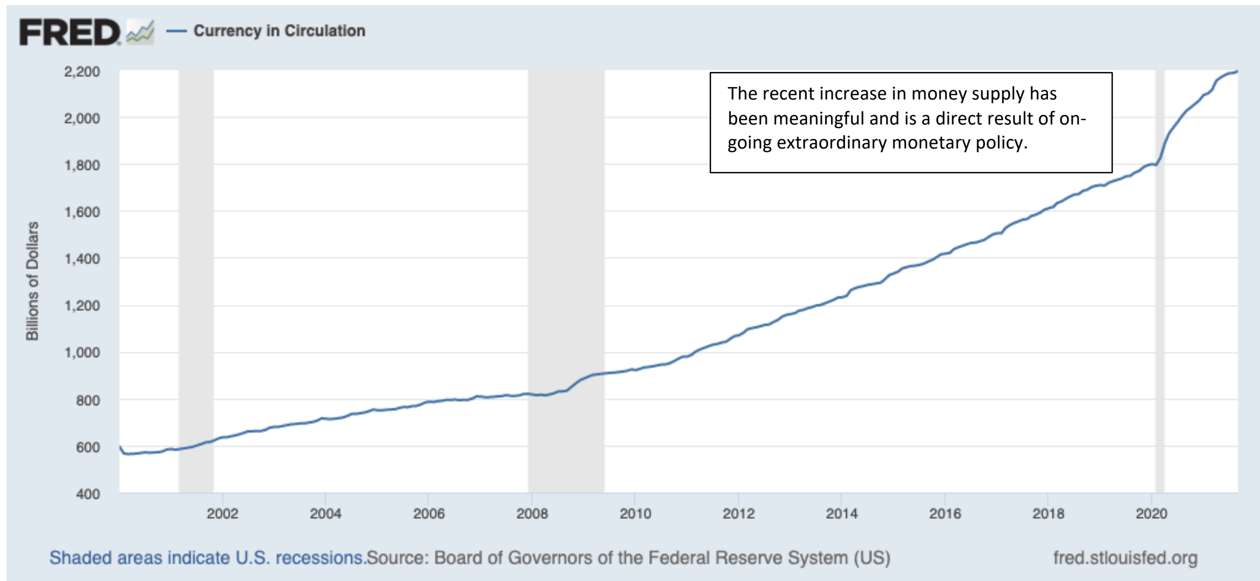
Liquidity itself is not a myth. Rather, the myth is that we can rely on longer-term assets such as fixed-income and equities to meet our liquidity needs. It is true that asset prices have been relatively stable and trending upwards since the end of the financial crisis. This has been influenced significantly by on-going monetary and fiscal support from the Federal Reserve and from Congress.

Fixed-income prices have been supported by the Fed's monetary policy since the on-set of the Global Financial Crisis in 2008. The combination of balance sheet expansion, bond buying, and low interest rates executed by the central bank has provided significant and substantial support to financial assets. Equities have been deemed "liquid" based on the resulting performance. Despite several episodic declines in equity prices, monetary policy has aided recovery, focused investors on the relative value of dividend yields, and propelled prices higher, further bolstering investor confidence in the liquidity characteristics of equities.



Source: FederalReserve.Gov





A key phrase in the definition of Liquidity, "*without affecting its market price*", is critical. Fixed income securities currently offer low yields and higher durations. Modified duration is a measure of price sensitivity and most fixed income securities with a maturity of 5-years or greater have modified duration that is greater than its yield. This means that a 1% change in interest rates will cause the price to move up or down by more than its annual yield.

In the case of equities, they are certainly liquid, in that they can be sold in an instant at or near quoted market prices at any time during market hours. But do equities meet the strict definition of liquidity? Can they be converted into ready cash without affecting market price? Certainly, any transaction that you or I initiate will not adversely affect market pricing as the markets are deep and broad, but when markets are under stress, can we transact at the prices that we saw yesterday, last week, or last month? Certainly not. That is why conventional wisdom dictates that as you age, you should 1) increase your allocation to fixed income, a less volatile asset class and 2) keep an increasing portion of assets in cash equivalents (a near zero volatility asset) so that these assets can reliably be converted to cash as or when needed with little or no price risk.

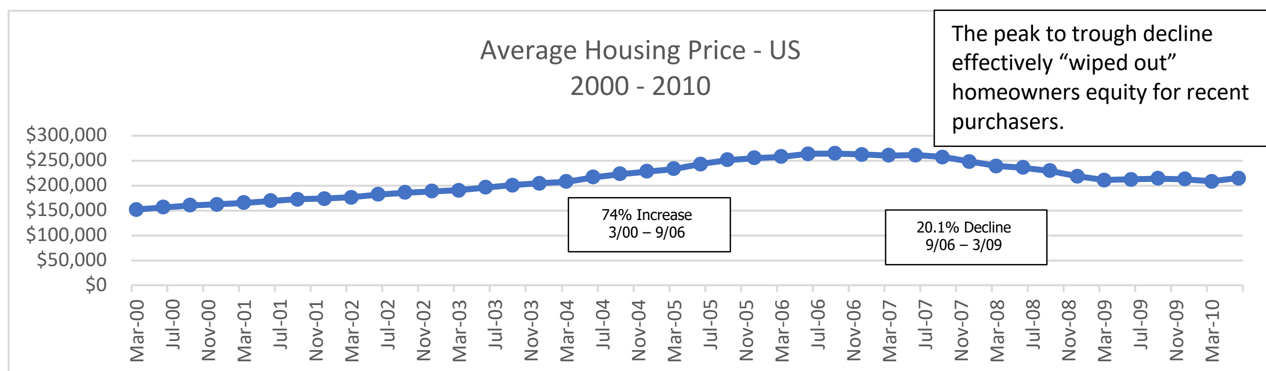
With the Fed suggesting that its accommodative policy will reverse in 2022 (as indicated by statements of Federal Reserve officials), we need to question the "Liquidity" and safety of fixed income. A potential rise in rates, arising from reduced Fed purchases and potential

increases in the Fed Funds Rate, will likely cause fixed income prices to decline and, in the case of intermediate and longer-term securities, possibly result in losses for investors.

Case Study: Housing

A lesson can be learned from the housing crash of 2007. In 1998 the Clinton administration passed legislation that benefited the liquidity of the housing market. They enacted legislation that excluded $250,000.00 of gains ($500,000.00 per couple) from the sale of a home after using that home as a primary residence for two years. Coupled with declining interest rates and greater availability of mortgage loans, this propelled housing prices and housing turnover upwards and caused many, including banks, to assign a higher liquidity score to housing. It also led to the perception of housing as a more liquid asset. The idea of "flipping" took root with homeowners/investors actively seeking to acquire, live in for two years, and then sell at a presumed profit. This was facilitated by and led to a rising tide in the market and virtually frictionless financing and refinancing.

Housing prices then peaked between 2005 and 2007 depending on the region. Following the peak, defaults began to increase, and banks pulled back. This led to a near catastrophic financial crisis and significantly changed/corrected the view of both banks and the larger public's view of the liquidity of housing and related securities. Housing went from very liquid to completely illiquid in a very short period resulting in, not just homeowner defaults, but the collapses of Bear Stearns and Lehman Brothers and the need to bolster the capital positions of virtually every major bank in the developed world. Note that the peak to trough decline, as illustrated in the chart below, was roughly 20%, an amount equal to the standard down payment (homeowner's equity).



Source: Federal Housing Finance Agency

The Role of Leverage

The decline in the liquidity of housing and related securities, notably all types of mortgage debt, led to a reduction in the amount of financing available for these assets. This was exacerbated as the risk weighting, effectively the amount of capital that banks had to hold against assets that they had financed, increased (in some cases from zero) and forced banks to either raise more capital to support these assets or to reduce the number of assets that they owned. Bank portfolios are significantly larger than yours or mine and their sales exacerbated the price declines in these markets necessitating even more capital and/or more sales. This created a meaningful (if not violent) negative feedback loop. Ultimately, markets seized, and the government had to provide additional capital to Banks and other financial institutions.

Bank portfolios, as well as those of insurance companies and other financial institutions, often make extensive use of leverage. So as leverage is reduced, prices generally decline, sometimes severely. Therefore, it is important to note that both fixed-income and equity markets utilize leverage. Fed tightening is a distinct possibility in the coming year(s). It will likely lead to a decline in leverage and will, at a minimum, cause headwinds for future price increases for both fixed-income and equities and could, potentially, cause price declines.

How Does This Impact Liquidity?

Less leverage means that there will be less capital available to support the current stock of financial assets. This is the exact opposite effect than what we have experienced over the last 12+ years, where we had an increasing amount of capital.

Should Cash be the Primary Source of Liquidity?

While cash and cash equivalents are less susceptible to these market events, there are concerns about relying on these assets for longer-term liquidity needs. Cash yields are low, by any measure. Money market yields are well below 1% in the US and below zero in the EuroZone. Inflation is currently elevated in the US with CPI (the Consumer Price Index for All Urban Consumers) coming in at an annualized rate of 5.2% for the trailing

twelve months as of August 2021. This means that holding cash has resulted in a loss of purchasing power over the last year, the equivalent of a nearly 1,800-point decline in the Dow or 225-point decline in the S&P 500 (the equivalent of a 5.2% decline). This indicates the implicit cost of liquidity and has provided the impetus for investors to pursue other opportunities in fixed income and equities.

What is "Safe Liquidity" and Where Can You Find It?

If liquidity is the goal, let's narrow the objective to be, "Safe Liquidity"; a reliable source of cash that offers stable value, meaning both little or no price risk ***and*** stable purchasing power.

If core assets such as equities and fixed income have price risk and cash loses purchasing power as inflation rises, how can someone reliably have access to liquidity with certainty of both value and purchasing power?

In our opinion, *income* is a reliable source of "Safe Liquidity." If you derive income from wages, then your income should rise as inflation rises (albeit with a lag). If income is sourced from financial assets, the value of those assets should tend to increase over time. If the yield stays constant, the income will rise. This is why *correlation* and, more importantly *non-correlation*, matters. If asset values decline as inflation increases, income will decline, at least on a purchasing power basis. Floating rate securities, whose coupon increases as rates rise can be a safer option. Another option is an asset whose value is uncorrelated to the broad markets, an asset that tends to increase in value over time driven by the underlying cashflows of the asset, rather than market performance.

Reliable, Safe Liquidity

The value of specialty finance and collateralized lending strategies is driven by cashflows. Specialty finance strategies provide capital to finance or buy assets when capital is not available from traditional banks. Lenders can receive rates that are significantly higher than both prevailing fixed-income rates and the current rate of inflation. In addition, specialty lenders can secure additional protections including collateralization, over-collateralization, senior priority on cashflows, and liens to secure their investments and substantially reduce the risk of loss.

Strategies that have identified underbanked pockets of the market provide investors with reliable cash distributions at a rate significantly higher than the prevailing rate of inflation. Reinvesting the excess will grow the capital base and result in increased distributions over time. Doing so will provide investors with reliable and *safe liquidity*. Investors can allocate a portion of their portfolio to these assets and utilize the distributions as a source, if not the primary source, of liquidity.

We believe that this approach is safer than relying on tradeable assets, which can be volatile, and better than cash or cash equivalents, due to the purchasing power/inflation risk inherent in cash and cash equivalents.

Conclusion: Look Beyond Liquidity… to Safe Liquidity to Derive Income from Capital

We all need liquidity in varying degrees. For those who are earning current compensation from working, liquidity is not as critical an issue. For those who rely on accumulated wealth for liquidity, take note; asset prices can be volatile. We have witnessed relative stability and rising asset prices for an extended period. We are not predicting an end to this. We are merely pointing out that these conditions can change both significantly and suddenly.

While the broader population has been financially challenged, those with financial assets have disproportionately benefitted from an extended period of easy monetary and fiscal policies. If you are relying on wealth for liquidity, we believe that it pays to dedicate a portion of your capital to income generating assets that can provide reliable and safe liquidity to meet your cashflow needs over both short and long-term timeframes.

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