



Liquidity and the Long-Term Investor:



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How the Fish Realized That They Need Water

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Investors need liquidity just as fish need water, but you don't realize how much you need it until you don't have it. Even long-term investors need short-term liquidity. As we saw clearly during the recent market meltdown, without liquidity you can't buy during stress periods and you may even become a forced seller. Strong hands require deep pockets.

The university endowment community provides an excellent case study. Endowments have a time horizon of perpetuity and, unlike defined benefit pension plans, they don't have contractual liabilities. Endowments thus seem uniquely qualified to capture the equity risk premium, the illiquidity premium, and other risk premia available only to long-term investors. Many endowments therefore eliminated their allocations to cash, reduced their allocations to bonds, and increased their allocations to equities (both public and private) and to alternative strategies. The typical endowment portfolio became increasingly illiquid.

This strategy created perfect targets for the recent financial storms. After suffering big losses in their equity portfolios (both public and private), endowments still had to make distributions to fund operating budgets and they faced capital calls from their private equity partnerships. Many of them became forced sellers exactly when they might have preferred to be buyers.

You need cash to buy during a panic. You even need cash to hold onto what you've got. The recent market meltdown was driven to a large degree by forced selling, much of which came from leveraged investors who faced margin calls. But a good deal of forced selling also came from non-leveraged investors who didn't have enough liquidity. Many unleveraged investors were flying too close to the sun.

Staying power requires dry powder: a pool of cash (or near cash) big enough to fund spending during emergencies. The liquidity cushion has to be simple, high quality, and "real": it can't be a "contingent claim" or contain counterparty risk. This point rules out lines of credit and various over-the-counter option transactions (such as puts on equities or calls on bonds.)

Cash will be seen as a "drag on performance," since the *expected* return on cash is lower than that of many "risky assets." That may be, but the *actual* return on cash may be much higher. Sometimes you get paid for taking risk, sometimes you don't.

Building the entire liquidity cushion *now* isn't practical, since many highly liquid "safety assets" (e.g. U.S. Treasuries) are prohibitively expensive. But the liquidity cushion may also contain risky assets, such as stocks, some of which look very cheap. For example, large capitalization stocks continued to trade even when the corporate credit markets were totally frozen.

The lesson of recent history is that liquidity has to be built into the foundation of the portfolio. If you don't have enough short-term liquidity then you can't be an effective long-term investor: you can't buy during panics and you may even become just another forced seller.

These highly liquid risky assets are arguably “oversold” relative to the less liquid opportunities hidden under the investment rocks. Forced sellers dump what they can sell, not what they want to sell, so the best bargains may now be hidden in plain sight.

Highly liquid equities (unencumbered by securities lending or other “enhancements”) may also sound like a drag on performance, given the widespread belief that “the real opportunities are in illiquid/inefficient markets.” But, once you own a portfolio of liquid equities you can be more adventurous elsewhere. And, as noted above, it’s an oversimplification to assume that “less liquidity” is always linked to “more opportunity.”

One final thought about simplicity. Many of the recent disasters were created by conservative investors who were reaching too hard for yield or for low volatility returns. AAA bonds evaporated, money market funds threatened to break the buck, and Bernie Madoff has confessed to being a fraud. These cases illustrate the dangers of negatively skewed investing, where the high probability of a modest incremental return is balanced against the low probability of a disproportionately large negative surprise.

Post-meltdown investors are likely to be more interested in strategies that offer meaningful upside rather than those that deliver smaller returns with so-called “negligible risk.” These strategies have been pursued by long-term investors (both university endowments and others) for some time. The lesson of recent history is that liquidity has to be built into the foundation of the portfolio. If you don’t have enough short-term liquidity then you can’t be an effective long-term investor: you can’t buy during panics and you may even become just another forced seller. You can give up liquidity in a portion of your portfolio, but only if you have plenty of liquidity elsewhere.



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