

# understanding the importance of liquidity

## WHAT DOES LIQUIDITY MEAN?

The liquidity of a particular asset indicates how quickly it can be sold and converted into cash. For many investors, liquidity means how quickly they can exit an investment and access their money.

## LESSONS FROM THE GLOBAL FINANCIAL CRISIS

The global financial crisis was, among other things, a crisis of liquidity. As liquidity in the markets dried up, investors were caught out. Several local and global funds froze redemptions; that is they restricted or prohibited the withdrawal of money by investors. Even some funds that previously were considered highly liquid, for example mortgage funds, suffered liquidity problems. Many fund managers could not sell their assets quickly enough to meet demands from their investors to repay their money. This problem is known as a "liquidity mismatch".

This lack of liquidity had flow-on effect. Those funds that remained liquid and could sell their assets suddenly found themselves swamped with redemption requests, as panicked investors retrieved their money from wherever they could. This forced these funds to sell assets into a very poor market to meet this extra demand. In particular, some of the emerging market funds and the more conservative hedge funds were hit and experienced massive withdrawal of funds. As a result, their performance suffered too, despite being invested in high quality assets.

The GFC also highlighted that certain asset types are inherently illiquid, something that had been forgotten during the long bull market that preceded the GFC. The most obvious is unlisted property. Unlike listed real estate investment trusts (REITs), unlisted property comprises discrete holdings in large buildings. These buildings cannot be sold off piecemeal, but require a single large transaction if the asset is to be converted to cash. During the GFC, the market for commercial and industrial buildings

dwindled as buyers could not get access to debt funding and there were more buildings on the market than there were buyers. Consequently, most unlisted property funds were forced to suspend redemptions and investors were unable to access their money.

The same happened to mortgage funds. When the introduction of the Government Guarantee on deposits changed the dynamics of the mortgage fund business, the funds could not realize sufficient money from expiring longer

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dated mortgages to meet current investor demand for cash. In a classic liquidity mismatch, the mortgage funds had borrowed short but had lent long. They were forced to suspend redemptions despite their loan books being essentially sound.

Property syndicates too are illiquid investments, where the investment is locked in for a period of time, sometimes as long as seven years or more. When the syndicate term expires, the building is usually sold. Unfortunately, there is no assurance that the sale will occur during a strong property market. Many

syndicates launched in 2000-2002 expired during the GFC when the capital value of the underlying assets had fallen substantially. The illiquidity of the syndicate structure prevented the assets from being sold at the peak of the market cycle in 2007, reducing the overall return on the investment.

## A NEW PERSPECTIVE

The GFC has perhaps changed the way many investors regard liquidity. Before investing, it is worth asking the following questions:

### ■ How liquid are the investments made by the fund manager?

If the fund manager is investing in assets that cannot be easily valued or sold, this increases the possibility of a future liquidity mismatch – especially during times of market stress like the GFC. If the assets are illiquid because they comprise direct property, or are hard to price due to their complexity, or are only traded 'over the counter' or on a best endeavours basis



This article by Patrick Bennett (above), Head of Research.

rather than openly on an exchange, then great care is warranted before investing. On the other hand, if the fund's assets are liquid, for example because they can be traded in large volumes on regulated exchanges, then the possibility of liquidity problems should be minimised.

■ **Did the fund manager have liquidity issues during the GFC?**

Investors should be wary of those fund managers that were forced to freeze redemptions during the GFC and should question whether this could happen again in the future. This action may have been due to misrepresentation of the liquidity of the assets in the fund, or due to a poor capital management strategy which wrongly relied on an ongoing ability to sell assets to meet debt repayment schedules.

## A WORD OF CAUTION

In theory, it is perfectly fine to hold illiquid assets if the investor understands that they are illiquid and may not be redeemable on demand. In addition, some investment strategies take longer to develop, and in these cases some illiquidity may benefit both the fund manager and the investor. Research by Ibbotson shows there is a premium to be had for accepting some investment illiquidity.

Mentally, an investor can put these illiquid investments into the 'bottom drawer' as long term investments. However, crises like the GFC tend to overwhelm logic and investors become understandably nervous about their investments. Issues like the ongoing solvency of the fund manager and the actual value of the asset loom larger than they would when markets are travelling well. This concern is exacerbated when the media is full of stories of dramatically falling asset values and failing financial institutions. It is at these times that investors want assurance they will get their money back and return of capital becomes far more important than return on capital.

Another problem arises when it is time to rebalance a portfolio. An illiquid asset cannot be rebalanced and may become a larger-than-desired holding and hence a significant risk in the portfolio. It is worth noting that some funds froze liquidity for extended periods – some for over two years. This is a long time for a portfolio to have a higher risk exposure than the investor feels comfortable holding.

## OUR VIEW

SFG believes that liquidity is an important investment characteristic and it is desirable to hold liquid investments in portfolios. Our Strategic Trusts invest in highly liquid markets on regulated exchanges. It is our view that the peace of mind that comes from the assurance that capital can be accessed when needed outweighs any marginal return benefits that may come from an illiquid investment.



# Shadforth Financial Group

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