Viewpoint

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Don't Know What You've Got 'Til It's Gone: The Sources and Uses of Liquidity

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The financial turmoil of the last several years has debunked some common myths about liquidity. The first myth is that long-term investors don't need short-term liquidity; the second myth is that short-term investors are a reliable source of short-term liquidity.

Executive Summary

Bob Jaeger discusses the lessons the global financial crisis taught us about the precious but fragile liquidity of capital markets.[2] Debunking myths about long-term investors' liquidity needs and the role of hedge funds and high-frequency traders in supplying liquidity, Bob argues that the most important source of liquidity is unleveraged contrarian investors who are willing to take the other side of an overcrowded trade. He warns that the growing homogenization of the universe of market participants is endangering the kind of investor diversity that is a critical key to preserving reliable sources of liquidity.

The financial turmoil of the last several years has debunked some common myths about liquidity. The first myth is that long-term investors don't need short-term liquidity; the second myth is that short-term investors are a reliable source of short-term liquidity. The reality is that genuine liquidity (as opposed to "fool's liquidity") requires deep pockets (no leverage), a highly diverse investor group, and an ample supply of contrarian DNA.

Liquidity and the Long-Term Investor

The first myth, that long-term investors don't need short-term liquidity, was especially prevalent within the U.S. endowment community. During the multi-decade bull market that began in the early 1980s, many endowments had augmented their exposure to marketable equities with large positions in various illiquid assets, such as private equity, hedge funds, farmland, timberland, and so on. The reasoning was simple: We are long-term investors, therefore we don't need short-term liquidity, therefore we should focus our efforts on earning "the illiquidity premium," i.e., the return premium available to those who are willing to take on the distinctive risks of owning an illiquid asset.

1 Please see disclosures at end.

2 A version of this article will appear in *Institutional Investors'* upcoming Liquidity Guide. Bob is Senior Investment Strategist with the Investment Strategy and Solutions Group.

The trouble with this line of thought is that endowments have short-term spending requirements. Even if the spending policy is based on a "percent of market value" formula, there are institutional forces that make it difficult to inflict sharp year-over-year declines in endowment spending. The bottom line is that the endowments needed spending money, so a painful number of endowments became forced sellers in distressed markets. The moral to this story is that you can't be an effective long-term investor unless you have enough short-term liquidity to get you over the rough spots. Strong hands require dry powder.[3]

The recent financial upheavals also remind us that "the illiquidity premium" is like every other risk premium: sometimes you get paid for taking the risk, sometimes you don't. Investors talk loosely about "getting paid for taking risk," but you never know in advance whether you'll get paid. That's why they call it risk.

The broad category of "long-term investors" can be divided into three main subcategories: investors with no specific spending requirements (e.g., sovereign wealth funds); investors with spending requirements but no "liabilities," i.e., no need to calculate the net present value of their required spending (e.g., endowments and foundations); and investors who have both spending requirements and precisely defined liabilities (e.g., corporate and public defined benefit plans). The endowments have no "liabilities" in the strict sense, but they do have spending requirements, and that means that they need some sort of liquidity cushion.

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Liquidity and the Short-Term Investor: High-Frequency Trading

The second myth is that the short-term trading community is a reliable source of liquidity. This community generally can be divided into two main sub-components: high frequency traders and hedge funds (that is, some hedge funds, but not all. Many hedge funds work hard to defy the "short-term trader" stereotype). The problem here is that many of these market participants are either momentum-based traders, or they are operating on leverage, or both. And, as we shall see, momentum and leverage are the enemies of liquidity. Moreover, momentum and leverage are closely connected, since leverage ultimately forces investors into a momentum mode of behavior.

Do high-frequency traders add liquidity to markets? It all depends on what you mean by "liquidity." High-frequency traders can boost trading volume, improve speed of execution, and reduce bid/ask spreads. These functions can help lubricate the market engine when it is running "normally," but good lubrication is not a panacea for all engine problems. And, as we saw clearly during the "flash crash" of May 2010, this kind of lubrication can disappear suddenly. "High frequency liquidity" may be viewed as a form of "fool's liquidity," unlike "the real thing," which is provided by deep-pocketed investors who are willing to "step up to the plate" and buy what everybody is desperate to sell. The high-frequency trading community is not a deep reservoir of contrarian buying power.

3 Robert A. Jaeger, Michael A. Rausch, Margaret Foley, "Multi-Horizon Investing: A New Paradigm for Endowments and Other Long-Term Investors," *The Journal of Wealth Management*, Summer 2010, Vol. 13, No. 1: pp. 32-42.

High-frequency traders operate on leverage, and leverage does not mix well with liquidity. Leveraged investors (hedge funds, proprietary trading desks, and so forth) have to be focused on maintaining sustainable equity/debt ratios. If falling prices push those ratios into danger territory, then the leveraged investor is forced to sell. In other words, the leveraged investor is forced to sell what everybody else is already selling, thus creating a positive feedback loop that can destabilize markets. The contrarian investor is part of a negative feedback loop that can offer stability and liquidity to markets.

Many hedge fund strategies have a definite contrarian flavor, which improves liquidity. For example, many market neutral equity hedge funds pursue a mean-reversion strategy (buying the losers and selling the winners) and many global macro funds ("global tactical asset allocators") follow a similar "value-oriented" approach.

Liquidity and the Short-Term Investor: Hedge Funds

Hedge fund aficionados often claim that the hedge fund community (broadly defined to include both the short-term traders and more patient practitioners) provides liquidity to markets, and even offer this fact as one of the reasons why hedge funds make money over the long term. Is this true? The answer, not surprisingly, is *Yes* and *No*. The Yes part of the answer divides into four parts:

- Hedge funds can sell short, which definitely provides an additional source of liquidity for long-oriented investors. Market bubbles develop when greed dominates fear and buyers dominate sellers. Hedge funds add to the supply of sellers, which is a good thing. Indeed, I believe it is very useful that many institutional fiduciaries are enlarging the short-selling pool by allowing their long-biased managers to engage in selective short selling (*via* 130/30 strategies or related programs). This is a sensible move, since most equity benchmarks are conspicuously skewed: a small number of very large positions is combined with a large number of very small positions. For example, in the S&P 500, 10 names make up roughly 20% of the index while 490 names account for the remaining 80%. This means that 490 names have an average position size of 0.16%. The long-only manager who wants to be underweight one of those smaller companies doesn't have much room for maneuvering.

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- There are some specialist hedge fund strategies that channel money into areas where others prefer not to play. The notable examples here are risk arbitrage, which offers liquidity to equity investors who don't want to take on the unique short-term risks of owning a company that's involved in a merger or acquisition, and distressed debt investing, which offers liquidity to fixed income investors whose portfolio guidelines may force them to sell after a downgrade or default.

- Hedge funds, like university endowments, are often focused on "capturing the illiquidity premium. Endowments seek to earn the illiquidity premium through a variety of long-only strategies, while hedge funds often prefer a hedged illiquidity capture trade, in which a long position in a less liquid asset is hedged with a short position in a more liquid asset. The classic example here is a trade made famous by Long Term Capital Management: buy the off-the-run Treasury bond, short the on-the-run bond. (The yield premium of the off-the-run bond is due almost entirely to an illiquidity premium.) Many other fixed income hedges, in which a long position in spread product is paired with a short Treasury hedge, have the same liquidity profile. In the equity arena, a hedge fund manager might own a portfolio of small under-researched equities and hedge the portfolio with a short position in S&P 500 futures. Needless to say, all these illiquidity-capture trades come under excruciating pressure whenever the markets go into "flight to liquidity" mode. If the trades are implemented with high leverage, the results can be catastrophic.

To the extent that markets become dominated by a small number of players who tend to act alike (especially in extreme circumstances, which tend to happen more often than we would like), liquidity will suffer. Herds are not a reliable source of liquidity.

Despite these pro-liquidity considerations, there are two major factors that limit the ability of the hedge fund community to serve as a reliable source of market liquidity:

- Many hedge funds act as short-term momentum traders, which are consumers of liquidity, not providers.

- Even the contrarian hedge funds are often operating on leverage, which means that when their portfolios are under pressure they will go into loss-control mode, which is a form of momentum investing. This point emerged with painful irony during the tech bubble, when many short sellers bet against overvalued tech stocks that had been driven to irrational prices by momentum-driven investors. Many of the short sellers were early, so they were forced to buy back their shorts as the bubble kept expanding. In other words, the short sellers were ultimately forced to adopt the momentum strategy that they were betting against.

Liquidity and Investor Diversity

True liquidity requires deep pockets and genuine diversity of investor behavior. The point about deep pockets has already been beaten into the ground: leverage is the enemy of liquidity. The diversity point follows from the notion that, in a highly liquid market, buyers and sellers can find each other easily. This means that the investor group needs to be as heterogeneous as possible. To the extent that markets become dominated by a small number of players who tend to act alike (especially in extreme circumstances, which tend to happen more often than we would like), liquidity will suffer. Herds are not a reliable source of liquidity.

Investor diversity has at least three dimensions: diversity of belief, diversity of situation, and diversity of psychological type.

- Diversity of *belief* means good old-fashioned disagreement about the facts and about valuations. If we want liquid markets, then we want more disagreement, not less.

Once we appreciate the linkages among liquidity, contrarian investing, and diversity of investor behavior, the Federal Reserve appears in a new light as "the contrarian of last resort."

- Diversity of *situation* means different categories of investors with different investment objectives, different investment horizons, different risk tolerances, different spending requirements, and so forth. Consider, for example, the plight of a typical underfunded U.S. corporate defined benefit pension plan. Because the plan is underfunded, it maintains a substantial exposure to the equity markets: avoiding equity risk would merely lock in the underfunding. If equity markets behave generously, then the funding ratio will improve and the plan will switch from equities to bonds in order to hedge out the pension liabilities. In other words, the plan is a temporary owner (weak hands) of equities and hopes to become a long-term owner of bonds. Hundreds of billions of dollars of U.S. pension assets are in this position: at some point down the road, they hope to be a seller of equities and a buyer of bonds. Those investors need someone to take the other side of the trade, and that someone has to come from outside the U.S. defined benefit plan community.

- Diversity of *psychological* type means investors with very different investment DNA. Two dimensions of analysis are especially important: the contrast between optimists and pessimists, and the contrast between contrarian and momentum investors. The contrasts themselves are obvious. The important point is that these contrasts are totally independent of one another, which provides a frequently overlooked source of market unpredictability. To illustrate, consider the market upheavals of late 2008 and early 2009. Pessimists thought that the world was ending; optimists thought that we'd muddle through. Contrarians wanted to buy when there was blood in the streets; momentum investors were in heavy-duty loss-control mode. But what if you were a pessimistic contrarian? Your pessimism made you want to sell, but your contrarianism made you want to buy. If you were an optimistic momentum investor, then you were in the opposite situation. In other words, deeply rooted psychological traits and tendencies sometimes point in opposite directions, so the result is either a very tough decision or total paralysis. In situations like this, the person making the decision has no idea what he's going to do, so it's unrealistic to expect a mere outsider (even one armed with all the latest insights of behavioral economics) to predict the outcome.

Once we appreciate the linkages among liquidity, contrarian investing, and diversity of investor behavior, the Federal Reserve appears in a new light as "the contrarian of last resort." The Fed is far from perfect, but it is nonetheless an essential piece in a fragile ecosystem that depends critically on checks and balances. As we observed earlier, the herd is not a reliable source of liquidity. In a healthy market there is a reasonably fair battle between optimists and pessimists, contrarians and momentum investors. During bubbles and panics, all balance disappears and the herd moves in lockstep. What's needed then is a force from outside the herd.

In short, we need to reject the idea that some assets are intrinsically more liquid than others. Liquidity depends ultimately on easily overlooked questions of market infrastructure and on the willingness of investors to buy and sell in specific circumstances, and those circumstances are constantly shifting.

Liquidity Comes and Goes

During the recent financial crisis liquidity essentially disappeared throughout the credit markets while the U.S. Treasury market and the stock market remained liquid for the most part. In the Treasury market prices rose sharply on a stampede to quality; in the stock market prices fell, but at least markets cleared: buyers and sellers found prices at which they were able to transact. Forced sellers found willing buyers as equities moved from weaker hands to stronger hands. (Old Wall Street saying: "During a bear market, stocks return to their rightful owners.")

The continuing liquidity of the Treasury market and the equity market are not constitutionally guaranteed rights. If the next financial crisis involves a run on the U.S. dollar, even the U.S. Treasury market could get illiquid, as it has done in the past.

As for the continuing liquidity of the equity market, it's important to ask why the equity market remained so much more liquid than the credit market during the recent crisis. Part of the answer turns on the difference between a dealer market and an exchange market. The dealer market became paralyzed by paranoia about counterparty risk, but that issue did not arise within the equity market. Moreover, the equity market is vastly more transparent than the credit market: buyers and sellers had open access to prices, volume, and other relevant information. Finally, the equity market is considerably more granular than the credit market: there is much more room for small trades to be executed by small investors.[4]

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Conclusion

Liquidity is like other things we value: we don't fully appreciate them until they're gone. Even very long-term investors need some amount of short-term liquidity, and we can't blindly rely on short-term traders to provide the liquidity that we all need. Ultimately, the most important source of liquidity is deep-pocketed (i.e., unleveraged) contrarian investors who are willing to "take the other side of the trade." That source of liquidity has become an endangered species as the universe of market participants has become more homogeneous and more concentrated. We must actively cultivate investor diversity, a robust market infrastructure, and other key sources of liquidity. Liquidity is fragile: when we take it for granted, it disappears.

4 For more on these themes, see Cameron, Challenger, Jaeger, Leduc and Jacklin, "Structural Drivers of Liquidity Shocks," *BNY Mellon Asset Management Market Insights,* June 2010.

Disclosures

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