Viewpoint

BNY MELLON
ASSET MANAGEMENT

Zen and the Art of Liquidity Maintenance

Robert A. Jaeger, Ph.D., Senior Investment Strategist
BNY Mellon Investment Strategy and Solutions Group (ISSG)[1]

February 2012

Today's stock market is a high-revving engine machined to very tight tolerances with a highly sophisticated lubrication system.

Executive Summary

Comparing the stock market to a high-performance engine, ISSG Senior Investment Strategist Bob Jaeger warns against confusing speed with liquidity in today's changing markets. Reliable liquidity, he argues, comes from long-term investors with strong enough nerves to withstand price volatility; not high-frequency traders with microsecond investment horizons. Moreover, leverage is the enemy of liquidity, since it forces investors into short-term thinking and momentum-driven behavior.

Everything you need to know about market liquidity you can learn from the engine of your car. The first big lesson is that lubrication isn't everything. You also need fuel, air, electricity, and strong engine parts, to name just a few essential elements. The second big lesson is that speed isn't everything. We all want high horsepower, but horsepower has two dimensions: it's torque (force × distance, as when a force is applied at the end of a lever) times revolutions per minute (RPMs). Automobile racing engines are high-revving engines that often have relatively little torque at low RPMs; tractor trailers and tugboats have slow-turning engines that deliver enormous amounts of torque with each revolution.

Today's stock market is a high-revving engine machined to very tight tolerances with a highly sophisticated lubrication system. And it's very temperamental. The lubrication system is prone to failure, so the engine sometimes seizes up dramatically, as in the "flash crash" of May 2010. And sometimes the engine just runs out of gas, as when all the buyers disappear at once. And even when it's running normally, it doesn't have as much torque as we'd like.

1 The ISSG is part of The Bank of New York Mellon, a principal banking subsidiary of BNY Mellon.

The most important form of liquidity comes from long-term investors who have strong nerves, i.e., they can withstand price volatility. The high-frequency trader with a microsecond investment horizon isn't really willing to "take the other side of the trade."

Torque relates to size, not speed. On a "normal" day, bid/offer spreads are tight and you can do small trades at a price pretty close to the last trade. To improve liquidity, you can try to get the smaller trades done faster, or you can try to get larger trades done without incurring a painful price penalty. In automotive terms, you can boost horsepower by making the engine turn faster or by increasing the torque. When market engineers focus exclusively on executing small orders at faster and faster speeds, the result is a high-revving engine with not nearly enough torque.

We think of liquidity as a short-term phenomenon: "short-term liquidity" sounds redundant, and "long-term liquidity" sounds like a contradiction in terms. However, short-term traders are an unreliable source of liquidity. The most important form of liquidity comes from long-term investors who have strong nerves, i.e., they can withstand price volatility. The high-frequency trader with a microsecond investment horizon isn't really willing to "take the other side of the trade." He's willing to hold the hot potato for a fraction of a second, but true liquidity comes from investors who are willing to grasp the potato for a longer period. Short-term investors can deliver high RPMs, but not torque.

We believe the best possible source of liquidity is a long-term investor with no leverage and a contrarian investment philosophy. The worst possible source of liquidity is a short-term investor with high leverage and a momentum philosophy. Contrarian investors are hard-wired to buy when everyone else is selling, so they are obvious sources of liquidity. Momentum investors are liquidity sinks.

Leverage is the enemy of liquidity, since high leverage forces investors into short-term thinking and momentum-driven behavior. High leverage can mean that you have weak nerves and no staying power: you're worried about margin calls and other surprises that would force you to transact. And high leverage can spawn momentum trading. When your position is moving against you, the margin call forces you to sell into a falling market or buy into a rising market.

These facts about liquidity have important consequences for both investors and regulators. Since contrarian thinking is an essential source of liquidity, the herding instinct is a prominent threat to liquidity. The investment business has evolved toward a perilous concentration of power: never before have so few decided so much on behalf of so many. And those few think increasingly alike. Large institutional investors constantly compare themselves with other members of their "peer group," which encourages mimicry and herding. The best antidote is to ask: How am I different from others of my peer group, so that I might buy what they're selling and sell what they're buying?

The investment business has evolved toward a perilous concentration of power: never before have so few decided so much on behalf of so many.

As for regulatory matters, the so-called Volcker Rule rightly attempts to curtail various proprietary trading abuses, but ideally it would be crafted carefully so as not to impair the ability of broker/dealers to commit capital in order to provide liquidity to customers. Additionally, various kinds of financial transaction taxes ("Tobin taxes") have been proposed. Critics complain that such taxes would "throw sand into the wheels of commerce." Again, any such tax would ideally be designed to avoid unintended consequences that would be harmful to ordinary investors. However, some of the anti-tax rhetoric is based on the conviction that anything that slows markets damages liquidity. That conviction confuses liquidity with speed. If we want markets with more horsepower, what we need is not higher RPMs but more torque.

BNY Mellon Asset Management is one of the world's leading asset management organizations, encompassing BNY Mellon's affiliated investment management firms and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. • The statements and opinions expressed in this document are those of the authors as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon, BNY Mellon Asset Management International or any of their respective affiliates. This document is of general nature, does not constitute legal, tax, accounting or other professional counsel or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon Asset Management International Limited and its affiliates are not responsible for any subsequent investment advice given based on the information supplied.

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investment you may get back less than you originally invested. • While the information in this document is not intended to be investment advice, it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for use by professional and wholesale investors only and not for onward distribution to, or to be relied upon by, retail investors. • Products or services described in this document are provided by BNY Mellon, its subsidiaries, affiliates or related companies and may be provided in various countries by one or more of these companies where authorized and regulated as required within each jurisdiction. This document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country in which such distribution or use would be contrary to local law or regulation. This document may not be distributed or used for the purpose of offers or solicitations in any jurisdiction or in any circumstances in which such offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements. Persons into whose possession this document comes are required to inform themselves about and to observe any restrictions that apply to the distribution of this document in their jurisdiction. **The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.** • This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management International Limited.

In **Australia**, this document is issued by BNY Mellon Asset Management Australia Limited (ABN 56 102 482 815, AFS License No. 227865) located at Level 6, 7 Macquarie Place, Sydney, NSW 2000. Authorized and regulated by the Australian Securities & Investments Commission. • In **Brazil**, this document is issued by BNY Mellon Serviços Financeiros DTVM S.A., Av. Presidente Wilson, 231, 11th floor, Rio de Janeiro, RJ, Brazil, CEP 20030-905. BNY Mellon Serviços Financeiros DTVM S.A. is a Financial Institution, duly authorized by the Brazilian Central Bank to provide securities distribution and by the Brazilian Securities and Exchange Commission (CVM) to provide securities portfolio managing services under Declaratory Act No. 4.620, issued on December 19, 1997. • Investment vehicles may be offered and sold in **Canada** through BNY Mellon Asset Management Canada Ltd., a Portfolio Manager, Exempt Market Dealer and Investment Fund Manager. • In **Dubai, United Arab Emirates**, this document is issued by the Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. • In **Germany**, this document is issued by WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH, which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. WestLB Mellon Asset Management Holdings Limited is a 50:50 joint venture between BNY Mellon and WestLB AG. WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH is a wholly owned subsidiary of this joint venture. • If this document is used or distributed in **Hong Kong**, it is issued by BNY Mellon Asset Management Hong Kong Limited, whose business address is Level 14, Three Pacific Place, 1 Queen's Road East, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission and its registered office is at 6th floor, Alexandra House, 18 Chater Road, Central, Hong Kong. • In **Japan**, this document is issued by BNY Mellon Asset Management Japan Limited, Marunouchi Trust Tower Main Building, 1-8-3 Marunouchi Chiyoda-ku, Tokyo 100-0005, Japan. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • In **Korea**, this document is issued by BNY Mellon AM Korea Limited for presentation to professional investors. BNY Mellon AM Korea Limited, 21/F Seoul Finance Center, 84 Taepyungro 1-ga, Jung-gu, Seoul, Korea. Regulated by the Financial Supervisory Service. • In **Singapore**, this document is issued by The Bank of New York Mellon, Singapore Branch for presentation to professional investors. The Bank of New York Mellon, Singapore Branch, One Temasek Avenue, #02-01 Millenia Tower, Singapore 039192. Regulated by the Monetary Authority of Singapore. • This document is issued in the **UK** and in **mainland Europe** (excluding Germany), by BNY Mellon Asset Management International Limited, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Services Authority. • This document is issued in the **United States** by BNY Mellon Asset Management.

BNY Mellon holds over 90% of the parent holding company of The Alcentra Group. The Group refers to these affiliated companies: Alcentra, Ltd and Alcentra NY, LLC. Only Alcentra NY, LLC offers services in the U.S. • BNY Mellon ARX is the brand used to describe the Brazilian investment capabilities of BNY Mellon ARX Investimentos Ltda. • BNY Mellon Western FMC, Insight Investment and WestLB Mellon Asset Management do not offer services in the U.S. This presentation does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon holds a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC). • BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • BNY Mellon Western Fund Management Company Limited is a joint venture between BNY Mellon (49%) and China based Western Securities Company Ltd. (51%). The firm does not offer services outside of the People's Republic of China. • Hamon's services are offered in the U.S. by Hamon Asian Advisors Limited. BNY Mellon holds a 19.9% interest in Hamon Investment Group Pte Limited, which is the parent of Hamon Asian Advisors Limited and Hamon Asset Management Limited. • The Newton Group refers to the following group of companies: Newton Investment Management Limited, Newton Capital Management Limited, Newton International Investment Management Limited, Newton Capital Management LLC, and Newton Fund Managers (CI) Limited. Except for Newton Capital Management LLC and Newton Capital Management Limited, none of the other Newton companies offers services in the U.S. • BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by BNY Mellon.

BNY MELLON
ASSET MANAGEMENT

The Alcentra Group
BNY Mellon ARX
BNY Mellon Cash Investment Strategies
BNY Mellon Western Fund Management Company Limited
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
The Newton Group
Pareto Investment Management Limited
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited
WestLB Mellon Asset Management

©2012 The Bank of New York Mellon Corporation.