Understanding Liquidity In Investments: What Is It and Why It's Important

By Gene Sulzberger

Liquidity is a subject that many investors fail to take into account or understand. As a result their financial plans fall short of their expectations during important times such as retirement. A lack of liquidity causes more financial problems than almost any other aspect of finance. People either lose money or they have insufficient funds upon retirement because of years of investing in short term investments for a long-term goal. I will address some of the most important issues related to liquidity.

Q: What exactly does liquidity mean?

A: Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Assets that can be easily bought or sold are known as liquid assets. Liquidity is also known as "marketability."

For example large cap stocks, such as IBM are more liquid than small cap stocks, such as footwear firm K-Swiss. An owner of a large position in K-Swiss might need several days to sell in order to avoid impacting the price too much.

Have you thought about investing in assets that might take several months to sell? You may already own something like this – your own home.

Q: How would you characterize the way investors think about liquidity?

A: There has been an increasing amount of research into this subject, known as "behavioral finance." Investors often like to have the comfort of knowing that if markets are performing poorly or in a way they weren't expecting, they can easily make changes to their portfolio. Indeed, we may actually become our own worst enemies when we succumb to the urge to liquidate a portfolio when the markets are performing poorly. Even if we time an exit from the markets correctly, what about the second step? When do we then go back into the markets? How much will we be earning on our cash as we wait it out? Investors may think they have a certain risk profile, but when they are tested by a market downdraft, they may actually be more conservative than they thought.

Q: How does an investor prevent making rash decisions?

A: Having a wide range of liquidity profiles in an investment portfolio is one way of counteracting the urge. Over the past few years, especially since the 2008 financial crisis started, I am seeing more and more prospective clients sitting on large amounts of cash. They are paralyzed and unable to make investment decisions. This occurs while 'safe' cash yields almost nothing and inflation has been over 2%, meaning a negative real return on cash. Practically the same applies to 'safe' US treasury bonds, what with 10-year Treasuries yielding under 2%. At the same time, I believe that it is possible to construct portfolios with a mixture of liquid and illiquid securities that have a reasonable chance of generating a higher return than cash over the long term.

Q: As related to the subject, what is the major difference between institutional investing and private investing?

A: For an institutional investor, such as a pension fund, with long-term liabilities, it might make perfect sense to invest in real estate and private equity. In theory, institutional investors should be able to act logically during times of market volatility, since a team of professionals who can operate with a high level of emotional distance guides them. However, private clients investing on their own cannot easily draw on the collective experience of a team of investment professionals (unless they work with an investment advisory firm).

Q: Explain the phenomenon that has emerged in recent years involving the investment industry's attempt to offer clients the best of both worlds – investing in hedge funds or private equity with less onerous liquidity terms.

A: In the US, there is a proliferation of hedge-fund-like mutual funds offering daily liquidity. In Europe, there are the UCITs (Undertakings for Collective Investment in Transferable Securities) funds, with similar goals. In general, these products, being available to the public and not just to very wealthy and/or more sophisticated investors, are subject to strict regulatory guidelines on their ability to make investments.

Investors need to understand their risk and liquidity profile. Investment policy statements, prepared as part of a robust investment program done in conjunction with a professional asset management firm, can help in this process, but are not foolproof. While there is no unique liquidity profile that applies to all investors, having a mix of liquid and illiquid investments may provide psychological benefits during times of market turmoil. This mix may also boost long-run investment returns.

Gene Sulzberger is senior vice president with PRS Investment Advisory and works with U.S. and international clients in helping them meet their wealth management goals. He is also an attorney who practiced law focusing on estate planning and trust and probate administration. He has over 20 years of experience in the industry. For more information, you can contact Gene at gene.sulzberger@prs-efg.com or 305-459-5450.