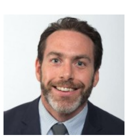
Obsession with liquidity comes at a price

Liquidity has long been an essential need for investors, but the huge desire for highly movable financial assets over the past few years may be overblown because it is likely hindering future returns

Tim Boyle/Bloomberg



DAVID PETT

January 11, 2013
6:36 PM EST

Filed under
Investing

Liquidity has long been an essential need for investors, but the huge desire for highly movable financial assets over the past few years may be overblown because it is likely hindering future returns.

“Liquidity is very important,” said David MacNicol, president and portfolio manager at MacNicol & Associates Asset Management in Toronto. “But having too much liquidity can come back to haunt you.”

It’s the burning theatre scenario . . . Everybody wants to be first out

While there are dozens of definitions of liquidity, it most simply refers to the ability to convert one type of asset — for example, stocks — into cash or some other asset type without suffering any loss of value. Investors generally prefer greater liquidity and in order to accept less of it, they usually require greater compensation in the form of higher returns.

At least, that's the theory. But many investors have abandoned this rule of thumb since the 2008 financial crisis and liquidity is all they seem to crave. "It's the burning theatre scenario," Mr. MacNicol said. "Everybody wants to be first out."

He thinks many investors have gone too far. Many individuals he sees have long-term investment horizons and no real immediate need for liquidity, yet they are stacking their portfolios with highly liquid short-term assets that earn weaker returns and carry potential risks such as inflation.

"Bill Gross sees inflation as a 2013 event," Mr. MacNicol said. "If you have too much liquidity and are invested in low-yielding assets like Treasuries or cash, the ultimate liquid asset cost, inflation, is a big bogey that investors will have to fight."

Mr. MacNicol believes less liquid investments that earn potentially higher returns should be part of a well-balanced portfolio, just as they have been for some of the country's biggest pension funds in recent years.

He runs an alternative asset trust that invests in both private equity and real estate for his clients and also separately manages the MacNicol 360 Realty Income Fund, which holds real-estate assets, mostly located in the United States. He asks clients for a two-year commitment, at which time they can take back all of their capital if they like, and he only invests 10% to 15% of their total portfolio in this kind of illiquid fund.

If it's true that less liquid investments tend to outperform more liquid ones in the long run, then the same may hold true among stocks, according to a new study published in the Financial Analysts Journal.

The study, which analyzed U.S. mutual funds, found that equity funds that hold relatively less liquid stocks have outperformed funds that hold more liquid stocks by more than 2.65% over the past 15 years.

"Surprisingly, the outperformance of the mutual funds that hold less liquid stocks was primarily due to superior performance in down markets," the study's authors said. "One possibility is that during periods of turmoil, high-liquidity managers may be more likely to trade; thus, the most liquid stocks may, in fact, suffer the steepest declines because there is a greater propensity for their owners to trade them."

Ultimately, Mr. MacNicol said it's important investors figure out their time horizons in order to assess how liquid a portfolio needs to be. "If they are truly short term and very very nervous about the market, they should be as liquid as possible. If they have three-to-five-year time horizons, they can look at more illiquid scenarios and, hopefully, better returns.”

0 **Comments**
Share your thoughts

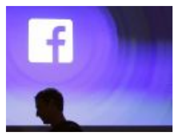
INVESTING

'A high-ball opening offer': First Quantum reels as Zambia slaps it with $7.9-billion tax bill

Amazon vaults ahead of Google parent Alphabet in market value for the first time

Couche-Tard shares plunge the m in two years after U.S. store sales slow

Joe Chidley: China's mastering the fine art of dealing with Trump on trade



Facebook just lost $60 billion — more than Tesla's entire market cap — in two days

Facebook bulls aren't throwing in towel just yet over company's da scandal

Show More ▾

TOP STORIES

Fed raises interest rate, steepens path of hikes as outlook strengthens

The Fed is now implying there will be three rate increases next year, compared with two 2019 moves seen in the last round of forecasts in December

'A high-ball opening offer': First Quantum reels as Zambia slaps it with $7.9-billion tax bill

The dispute offers another example of the rising tensions between mining companies and the government leaders in cash strapped countries where they operate

Mark Zuckerberg says Facebook 'made mistakes' in Cambridge Analytica data scandal

Zuckerberg said the company 'made mistakes, there's more to do, and we need to step up and do it'

Scotiabank CEO shoots down globa watchdogs' red flags over Canadiar debt

Brian Porter says banks are in a better position to weather future crises