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Illiquidity Investing

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On Christmas Evening in Rome at a dinner party at Esther Fano's (Jim and Esther are a couple) Jim handed me a memo headed Illiquidity Investing. He told me what it contained and we discussed his ideas.

Jim uses the exposition in my John Maynard Keynes book of Keynes' theory of asset valuation in markets where uncertainty exists as the taking off point for an approach to portfolio investing. The formula that Keynes put forth is that

$$P(a) = f(q, c, l) \text{ where}$$

q = the expected cash flows, c = the carrying costs, and l = the liquidity premium.

Jim takes the position that many portfolios are more liquid than is necessary. I argued in my book that the cash flow market price ratio would be lower for liquid assets than for illiquid assets

If many pay too high a price for liquidity it means that the income flows in excess of carrying costs from a portfolio of illiquid assets should be greater than the income flows from a portfolio of liquid assets.

Jim holds that the liquidity - Illiquidity of an asset is reflected in the concession that a potential seller must make as against the price that a buyer pays: i.e. the difference between the bid and the asked price at some market maker is a measure of illiquidity.

Pinney hypothesis is that those assets with a high ratio of the difference between bid and asked price to market price will have a greater ratio of their q's to their market price. Jim writes "over a full market cycle, the total return to illiquid stocks should exceed that to liquid stocks, in order to compensate investors for their illiquidity". He further claims that "illiquid stocks should pay something around the same as can be earned with by successful tactical asset allocation"

Pinney takes the strong view that there should be no other measure than the bid-asked differential as a ratio to price in selecting assets for such a portfolio. He also argues that these assets should be held for long periods: in conversation he suggested that the investors should tie up their money for a minimum of ten years.

Note that if the bid asked spread increases when firms fall into hard times and decrease when firms prosper, a portfolio management rule to buy assets whose bid asked ratio increases and sell assets whose bid asked ratio decreases would mean that there will be a realized capital gains aspect to such a portfolio rule.

Pinney argued against any management rule: he would hold assets through the life of the holder, or at least to a change in status.

Pinney cites two studies by Yakov Amihud and Haim Mendelson:

"Liquidity and Stock Returns," Financial Analysts Journal May/June 1986

"Liquidity, Asset Prices and Financial Policy" Financial Analysts Journal Nov/Dec 1991