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Illiquidity Investing

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"The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of most skilled investors to-day is to "beat the gun", as the Americans so well express it; to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow." (J.M. Keynes, The General Theory of Employment)

A more beautiful expression of both the desired and the actual nature of stock market investing has probably never been written. Nor have times changed since Keynes wrote it in 1936. Fortunately, he also developed a theory of investment and finance which we can directly use to improve both investment results for our clients and also the general functioning of the financial markets for the society as a whole. We have chosen to call this method Illiquidity Investing.

The fluctuations in employment and income characteristic of a free market economy are caused in the first instance by fluctuations in real investment spending. These in turn are caused by the manner in which real capital assets are owned, i.e. privately (in portfolios called corporations), and financed, i.e. primarily by debt, all-be-it debt sitting on a varying base of equity. The equity of these corporations is in turn owned by individuals or institutions, and traded in a place called a stock exchange. The owners of stock market equity are cursed with a very uncertain view of the future, having to make decisions now about the present value of earnings and cash flows that will come 5, 10, or even 20 years from now. Such decisions are, by their very nature, uncertain in the extreme, and subject to violent changes at a moment's notice (just remember Oct, 1987).

Investors are well aware of this uncertainty. Vast amounts of money and time are devoted to penetrating it and so predicting the future course of the stock market. Essentially all the research done by the Wall Street brokerages and reported in publications such as Barrons or the Wall Street Journal is devoted to this end. The stated aim of many famous mutual funds and most investment advisors is to "do better than the market" by penetrating this uncertainty. Well over 90% of the total trading volume in the market consists of investors with differing views of the future trading assets back and forth. One name often given to this activity is tactical asset allocation, and, given the uncertainty involved in stock ownership, the temptation to engage

in it is nearly overwhelming for all investors.

If you own stocks, or are thinking of buying them, the way the temptation has, or will, come to you is something like this: "Stocks seem cheap (expensive) now because earnings, interest rates, the p.e. ratio, the dividend yield, etc. is low (high). Therefore, I will buy (sell) now and sell (buy) later, when the condition has changed." Respectable academic studies indicate that a successful program of tactical asset allocation (some variation of buying when the market is low and selling when it is high) can earn 18% per year in total return, as against the approximately 10% average return of a "buy and hold strategy with the S&P 500, mainly by keeping the investor out of the market during the terrifying falls it can take. It all seems so easy. Just buy when the market is cheap and sell when it is expensive. It seems especially easy and compelling when you have failed to do so. You bought stocks, and now the market is falling, and you are watching your net-worth evaporate. The rule that then becomes operative is that we tend to do today what we wish we had done yesterday. Sell! Sell! Sell!

Illiquidity Investing rejects the method of tactical asset allocation. We accept the risk of owning stocks, and never sell them. We do not time the market, and do not aim or wish to be out when it is falling. The theory we rely on to be adequately paid for the risk we thus assume was developed by Keynes and called by him the theory of liquidity preference.

Liquidity in a stock consists in its being as similar as possible to the most liquid asset, namely cash. Cash is liquid because its cash value (its selling price, denominated in money) is always certain. Cash is identical to itself. You can trade dollars for dollars at any time and volume with no price markdown. Stocks are similar to cash to the degree to which their expected earnings and cash flows (dividends) are also certain. Thus, the most liquid stocks (stocks most similar to the most liquid asset, cash) are those with the most nearly certain cash flows. These are the big stocks, represented in the US market primarily by the S&P 500.

The degree of liquidity of any stock can be measured by what is known as its bid-asked spread, stated as a percent of its selling price. Stocks with a narrow spread are more liquid, meaning that 1) positions can be bought and sold frequently while not harming total returns through paying a wide spread and 2) large positions can be bought and sold into firm and relatively certain bid or asked prices. A narrow spread is an indication of what is known on Wall Street as a good market for the stock. Stocks ranked by the bid-asked spread will show the big, financially strong, profitable, and thus relatively predictable stocks at the top, and the small, financially distressed and thus

relatively unpredictable stocks at the bottom.

Keynes pointed out that liquidity is valuable. Liquidity is a source of certainty in an uncertain world. The more uncertain we are, the more we value liquidity. Keynes' name for this phenomenon was liquidity preference. He used it to construct an entire theory of free-market finance. As we said above, stock investing is a very uncertain business, and liquidity will be prized. The liquid stocks thus carry a liquidity premium. They are more in demand and are given higher prices exactly because they are liquid. The degree of liquidity preference embodied in the price of the liquid stocks will vary with the degree of liquidity preference in the general society, which itself varies, sometimes sharply, over time.

In his book John Maynard Keynes, Hyman Minsky stated the logic of liquidity preference theory as follows: "The explicit and implicit cash flow (of a stock), $q - c + l$, (where q is the expected cash flows, c is the cost of investing, and l is the liquidity premium) is capitalized to yield a value of the asset which is the demand price. Keynes holds that "in equilibrium the demand prices...in terms of money will be such that there is nothing to choose in the way of advantage between the alternatives" (GT pp 227-28). Inasmuch as l is an income in kind and $q-c$ is a money flow, it is a combination of explicit and implicit cash flows that is capitalized at a common rate to yield the demand price for q yielding capital assets. However, the ratio of q to the demand price will vary inversely with the implicit yield l of the asset. If an asset is liquid the cash flow in the form of interest and profits per dollar of market value will be smaller than if the asset is illiquid. The visible rate of return on an asset will vary inversely with the quality of the market for the asset, or with the time to maturity, or with other measures of the ease of disposal and the certainty of its sale price." (Minsky pp 81-82)

In another book on finance, Minsky put the point this way: "In Keynes' view, each capital and financial asset is a combination of quick cash and future income. Each liability is a dated demand or contingent commitment to pay cash. As a result of the nature of debts and contracts, there will always be a subjective return from holding quick cash. The quantity of money determines the amount of quick cash that will be held, and thus the subjective returns from holding money. The money prices for those assets which can be sold or pledged for quick cash only at a cost and with varying degrees of certainty but which yield cash income streams will have prices that adjust to the standard set by the subjective return on money." (Can "It" Happen Again, pp 94).

Any investor engaged in tactical asset allocation will prefer the liquid stocks. This is because the bid-asked spread must be paid every time the stock is traded, and also because these investors do not wish to be "stuck" in illiquid assets for which large price concessions must be made if one wants to get out of them when the market turns. In their paper "Liquidity and Stock Returns", Financial Analysts Journal May/June 1986, Yakov Amihud and Haim Mendelson have constructed a mathematical model of how illiquidity affects stock prices and total returns. They demonstrate that liquid stocks should have higher prices (measured against a "fair value" price for the company as computed by a dividend discount method of valuation) and thus lower expected returns. Vice versa, the illiquid stocks should have lower prices, and higher expected returns.

Thus, theory predicts that, over a full market cycle, the total return to illiquid stocks should exceed that to liquid stocks, in order to compensate investors for the illiquidity risk (i.e. the fact that they cannot be easily sold, especially in times of a very bad market, when liquidity is especially prized, and illiquidity especially feared). How much more? And, is there evidence for the theory being true?

As to how much, illiquid stocks should pay something around the same as can be earned by successful tactical asset allocation models with the liquid stocks. Investors who engage in tactical asset allocation have gone to business school (or their mutual fund managers have) and they have the numbers in their heads concerning the excess return they expect to capture by timing. Studies done at the University of Michigan indicate that first time investors need to be taught the lessons of financial investing ever anew, and through bitter personal experience. Book reading seems to be no substitute for winning and then losing in a market bubble. This was true even for Keynes, who made and then lost three fortunes in commodity speculation before giving it up. It has recently been true for Orange County, California. Even though there is little evidence of practical success in tactical allocation, fresh fish are ever entering the market and are willing to pay more for liquidity than wisdom might dictate. Needing the liquid stocks to play their game, and being full of confidence about their newest secret computer driven trading model, they will be willing to pay the non-allocators something approaching what they expect to gain. The non-allocators are those who hold the illiquid stocks, stocks that cannot be used in the market timing game. Thus, one would expect the illiquid stocks to generate something close to the 18% per year return potentially available to successful tactical asset allocation.

As to the evidence, Amihud and Mendelson have provided some very strong studies. They used trading data on all NYSE stocks from 1960 to 1980. They formed 49 portfolios grouped by the bid-

asked spread, controlling for beta (market risk), re-set the portfolios each month, and computed total return (capital appreciation plus dividends) for each. They found that the portfolios behaved exactly as a liquidity preference theory would predict, with the least liquid portfolios doing best, and the most liquid portfolios worst. Their data was adjusted for volatility, so that these excess returns cannot be the result of payment for volatility risk. Rather, the illiquid portfolios seem to be earning a pure illiquidity premium. Furthermore, the return to the most illiquid portfolios was very similar to the 18% number claimed by the (very few) successful tactical asset allocation models. (See their article "Liquidity, Asset Prices and Financial Policy", Financial Analysts Journal, Nov-Dec 1991)

These considerations lead to several suggestions:

1.) The development of illiquidity based stock index funds. Such a fund would rank all traded (US) stocks by their bid spread. Based on research, some parameter would be selected, and all listed stocks with spreads greater than this parameter would be purchased. That a company might have "poor future prospects" would, of course, not be a reason to keep it out of the portfolio. The portfolio would be continually rolled out of stocks as their spreads narrow and the funds placed into new wide spread positions. The fund would thus behave in a way similar to the "lender of last resort" of the central bank, only it would be the "buyer of last resort". There is a Wall Street saying that the function of bear markets is to move stock from weak to strong hands. An illiquidity index fund would have the strongest hands of all. Such a fund would have to be marketed with explicit liquidity constraints on its shareholders, as it would be very vulnerable to runs.

2.) Research is needed on just how to use illiquidity funds. Specifically, should one develop, say, 10 funds, one for each decile of liquidity, and then change the fund composition of a client portfolio as the client liquidity needs change, or should one always use the most illiquid stocks, and then meet liquidity needs by adding cash.

3.) Presuming that the illiquidity premium holds also for the bond market (which of course it does), should one develop separate illiquidity funds for fixed income, or should they be incorporated into the stock funds, which then would simply always buy the most illiquid assets, whether equity or debt.

4.) The illiquidity premium is not a violation of market efficiency. Illiquid stocks are not "too cheap". Rather, their "low" price accurately reflects the non-cash income or penalty of Keynes' "liquidity preference" or Minsky's "1". Illiquidity investing is not another name for value investing, though the portfolio compositions will be broadly similar. This

is a reliable investment method, not one that will self destruct when "everyone" knows about it. This is an investment method with a firm, sophisticated, and articulated financial theory behind it.

5.) The illiquidity risk is a real risk. Presumably, cash is more valuable in the uncertain times of a recession, which is the time when the illiquid stocks will put in their worst returns (both absolute and relative to the liquid stocks).

6.) However, many if not most investors place too high a value on liquidity, liquidity that they do not in fact need or use. Tactical Asset Allocation needs the liquid stocks. Hedge funds need the liquid stocks. Market timers need the liquid stocks. They are willing to pay for the liquidity. Let them have it. Other investors think they need liquidity because they have not been exposed to the liquidity preference theory. A recent study concludes that most investors look at their portfolios too often. One should look at an equity portfolio about as often as one looks at the value of one's home - about three times in a life. By looking too often, and wanting to have the liquid stocks in case the look might lead to some action (which it in fact seldom does) most investors only do themselves harm. Liquidity is really needed only as the end of the planned holding period on the portfolio approaches. Investors who have a "buy and hold" policy for other reasons might as well get the illiquidity premium by using the illiquid stocks.

7.) A very widespread, conscious, and explicit use of the illiquidity premium is really only possible if illiquidity index funds are developed. An index fund designed to capture the illiquidity premium, only and always, is really the only way these stocks can be held and added to with some comfort in the face of a falling (and increasingly illiquid) market. The tool should be designed for the job it is intended to do.

8.) The illiquidity effect should be more apparent in new, relatively thinly capitalized, and inexperienced stock markets. This would lead to using the illiquidity index method world wide.

9.) The development and use of illiquidity index funds would have a beneficial effect on the capital markets and society generally. These are the ultimate in contrarian funds. They stabilize rather than stir up markets. They would provide negative rather than positive feedback when the markets become disorderly. They would provide the long term and committed capital that Michael Porter and Lester Thurow have been speaking about for some time. They can be an American analog to the "strong hands" financing provided to German and Japanese corporations by their banks. They would hold the equity of start-

up companies doing interesting things, and of financially distressed companies trying to turn themselves around. Of course, they would also hold the true dogs of the investment world. But then, even a dog can have his (or her) day.

Our investment method is designed to capture this illiquidity premium. It has four main parts.

1. Client education and preparation for falling markets. Holding illiquid stocks requires holding them when the markets become illiquid. The courage to do this comes from firm conviction that the strategy will eventually pay off.

2. Proper cash/stock asset allocation, based on the liquidity needs and planned holding period of the investor.

3. Use of illiquidity based index-funds, funds which are designed explicitly to capture only the illiquidity premium, and to never fail to capture it. Only these kind of funds can be comfortably held and added to as the market fluctuates.

4. Portfolio rebalancing and adjustment as the holding period comes in.