

Investment Liquidity: The 'Sleepers Risk'

June 2016

If there is one topic the investment community struggles to convey to investors, it's the concept of 'risk'. Most often it's some form of volatility measure or capital loss potential. While these concepts capture the effect of risk, we are more interested in the cause of risk.

Liquidity, or rather, the lack of liquidity, is potentially one of the most damaging risks to investors. Its potential to cause sizeable capital loss stems from the fact that it can have the effect of sharply repricing assets down, mixed up with the anxiety that the investment in question is often rendered inaccessible. This leads to what is commonly known as a 'fire sale'. This is exacerbated by the fact that in many cases of liquidity crisis, the perceived risk is substantially lower than the actual risk (hence the name 'sleeper').

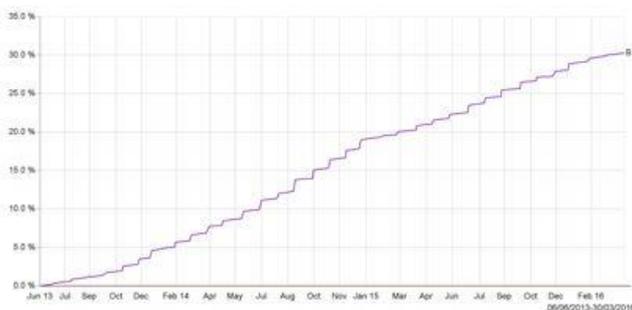
The recent EU referendum ('Brexit') has demonstrated just how this sleeper risk is something which investors need to be acutely aware of. The UK property market is currently undergoing a liquidity crisis. In recent days a number of the largest UK property fund managers have closed their funds to investor redemptions citing lack of liquidity, and have also taken steps to write down the carrying value of some of the assets. Just a few weeks ago, the UK property market was seen as a safe and attractive asset class which consequently attracted substantial investment flows, including many from South African investors. Herein lies the problem.

Why is Liquidity risk so often missed or underestimated?

There are a few common traits surrounding liquidity risk. For one it tends to stem from asset classes which have for some time exhibited returns which to rational investors appear too good to be true, but to the wider market a fantastic opportunity. Particularly in cases of 'smooth' investment returns – of which property (particularly unlisted property) is a case in point – to investors following the effect of risk (eg volatility), there would have been few warning signs, as depicted below in Chart A. The example shown is the M&G Property Portfolio, recently suspended to investor outflows:

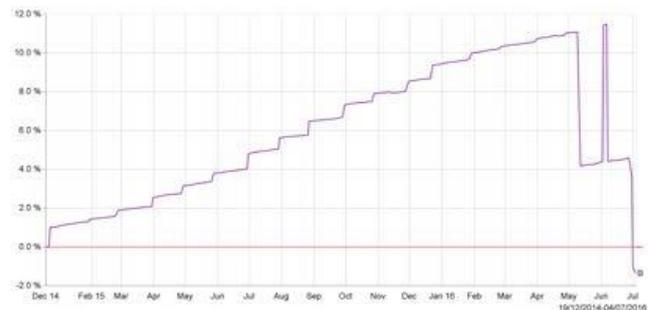
M&G Property Portfolio (GBP)

Chart A: 'too good to be true'



Source: FE Analytics

Chart B: 'reality bites!'



The second reason can be described as 'collective mispricing'. In situations where strong performing asset classes are attracting mass market support, the ability to see the potential for risk is clouded. Particularly in an environment where alternative sources of return have been limited, asset classes such as property offer investors peace of mind ("its bricks and mortar, I can touch it!"). This leads to collective mispricing, because the risks are not acknowledged sufficiently by investors.

Memories fade. Liquidity is a problem in most financial crises, and we have had a number of these in recent memory. But as time goes by, the ability to acknowledge that current investments may suffer a similar fate are downplayed. The false comfort provided by regulators and general governance after times of distress – where they tend to respond through over-regulation and disciplinary action against the culprits – provide an easier acknowledgment of 'this time it's different'.

How does liquidity risk play out?

Typically, there is a step change as opposed to a gradual trend which drives a liquidity crisis. Risk 'happens', it does not move in a straight line. Historical examples where liquidity played a role read like a who's who of financial disasters : Sub Prime Crisis (2008); Wall Street Crash (1929) and again on Black Monday (1987); Long Term Capital Management (1997), Asian Crisis (1997/1998), LTCM (1998). Even going back as far as the South Sea Bubble in the 1700's. In each case, sudden realisation (or acknowledgement) of the risks of an asset class lead to mass exit of investors, and when there is mass exit of investors, typically this includes all the buyers too. So almost overnight, a much loved asset class can find itself without a tradeable market, and in a liquidity trap.

The secondary effects can often be more damaging (referred to as 'amplification'): for example, what was the largest 'amplification' of the US credit driven disaster in 2008? The answer is QE – a global market awash in debt – in 2016 - with low growth prospects. This is potentially the biggest sleeper risk of all.

In SA we have a few potential sleeper risks: the corporate debt market for one, where investor flows have chased the higher yielding, smooth investment returns offered by companies issuing debt; listed property – a small asset class with overwhelming local demand; and the small- and mid-cap shares on the JSE - while out of favour now, do have a tendency to go through bouts of boom and bust, with liquidity being at the heart of their demise. There are other asset classes too: preference shares, private equity, even hedge funds.

What to do?

The most important protection against liquidity driven risk is to be a sceptic. Particularly in the case of managing investments, a mindset which starts with the need for an investment to earn its place, rather than be given the benefit of the doubt, will go far to avoiding traps like this. It is also important to resist the temptation – for there will be temptation! Strong, trending investment returns are the holy grail of investors and fund marketers alike, and are a very difficult temptation to resist.

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Sector		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol ¹	10yr Vol ¹
LOCAL MARKET INDICES (In Rands)									
FTSE/JSE All Share Index (ALSI)	ZAR	0.4%	4.3%	3.4%	13.0%	13.8%	12.6%	11.3%	15.2%
FTSE/JSE SA Listed Property	ZAR	-0.4%	9.6%	11.0%	14.3%	18.5%	18.8%	14.0%	16.1%
SA All Bond Index (ALBI)	ZAR	4.4%	11.2%	5.7%	6.3%	7.9%	8.4%	7.9%	7.4%
SA Cash Index (SteFI)	ZAR	1.8%	3.5%	6.8%	6.2%	5.9%	7.3%	0.2%	0.6%
Balanced Benchmark ²	ZAR	1.4%	4.5%	8.6%	13.2%	14.5%	12.5%	6.4%	6.4%
SA Inflation (1 month lag)	ZAR	1.8%	3.9%	6.1%	5.8%	5.7%	6.2%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	1.0%	0.7%	-2.8%	6.9%	6.6%	4.4%	13.2%	16.5%
Emerging Markets Equity (MSCI EM)	USD	0.7%	6.4%	-12.1%	-1.6%	-3.8%	3.5%	18.8%	23.5%
Global Bonds (Barclays Global Bond Index)	USD	2.9%	9.0%	8.9%	2.8%	1.8%	4.4%	4.4%	5.7%
Global Cash	USD	0.1%	0.2%	0.3%	0.2%	0.2%	1.3%	0.0%	0.6%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	0.4%	4.3%	3.4%	13.0%	13.8%	12.6%	11.3%	15.2%
Global Equity (MSCI World)	ZAR	0.6%	-4.9%	17.3%	21.7%	24.4%	12.2%	13.1%	13.8%
Emerging Markets Equity (MSCI EM)	ZAR	0.2%	0.6%	6.1%	12.1%	12.2%	11.3%	12.8%	15.7%
SA All Bond Index (ALBI)	ZAR	4.4%	11.2%	5.7%	6.3%	7.9%	8.4%	7.9%	7.4%
Global Bonds (Barclays Global Bond Index)	ZAR	2.4%	3.0%	31.4%	17.0%	18.7%	12.2%	12.6%	14.4%
COMMODITIES									
Gold (US Dollars)	USD	5.9%	23.7%	11.1%	2.9%	-2.9%	8.0%	19.6%	19.3%
Gold (Rands)	ZAR	5.5%	16.9%	34.1%	17.2%	13.2%	16.0%	20.1%	21.6%
Currencies (positive return = Rand weakening)									
Rand / Dollar	ZAR	-0.4%	-5.5%	20.7%	13.8%	16.7%	7.5%	15.0%	16.5%
Rand / GBP Pound	ZAR	-7.4%	-14.3%	2.6%	9.1%	12.5%	4.0%	13.5%	14.9%
Rand / Euro	ZAR	-2.9%	-3.3%	20.3%	8.0%	10.6%	6.0%	12.7%	13.7%

Spot Rates

		30-Jun-16	3-Jul-16	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Rand/US\$	Rand	14.53	14.70	12.17	6.76	7.15	4.33	
Rand/GBP	Rand	19.08	19.56	19.07	10.83	13.22	6.71	
Rand/EUR	Rand	16.21	16.31	13.54	9.80	9.09	5.14	
Rand/Aus \$	Rand	10.92	10.97	9.36	7.24	5.31	3.42	
Libor 6m \$	US\$	0.92	0.92	0.44	0.40	5.59	N/a	
Prime	Rand	10.50	10.50	9.25	9.00	11.00	20.50	
Repo Rate	Rand	7.00	7.00	5.75	5.50	7.50	N/a	
All Bond Index Yield	Rand	8.75	8.84	8.51	8.72	10.00	13.72	
Gold (\$/oz)	US\$	1,341.40	1,321.86	1,172.97	1,500.91	614.25	381.15	
Palladium	US\$	598.00	589.00	677.00	761.00	312.00	132.35	
Platinum	US\$	1,058.00	1,023.00	1,078.00	1,725.00	1,227.50	389.00	
Oil (Brent Crude) \$	US\$	50.63	50.06	63.35	111.85	72.85	19.05	
SA Inflation	Rand	N/a	6.10	4.70	5.00	4.90	6.90	

data provided by Profile Data Analytics and INET BFA