Should advisers be asking tougher questions about liquidity risk?

The failure of Credit Suisse, Silicon Valley Bank (SVB) and the LDI crisis have reminded us how fragile the financial system is at times, and that, when markets react quickly, underestimating the importance of liquidity can be fatal.

Although each situation above was unique, the outcome was the same – the need for and ability to address a mismatch in assets and liabilities. Often in these situations, the perceived source of diversification (and, therefore, risk management) was either poorly managed or misunderstood, or both!

In this current environment, a gradual reduction in liquidity is a natural result of central banks' fight against inflation. But it is only in the last six months that reduced liquidity has started to create cracks in the financial markets.

In many ways, managing portfolios should also be viewed the same. Investors want their portfolio managed professionally to achieve all of their objectives (or future obligations/aspirations, if you were). So, how those assets are invested is critical.

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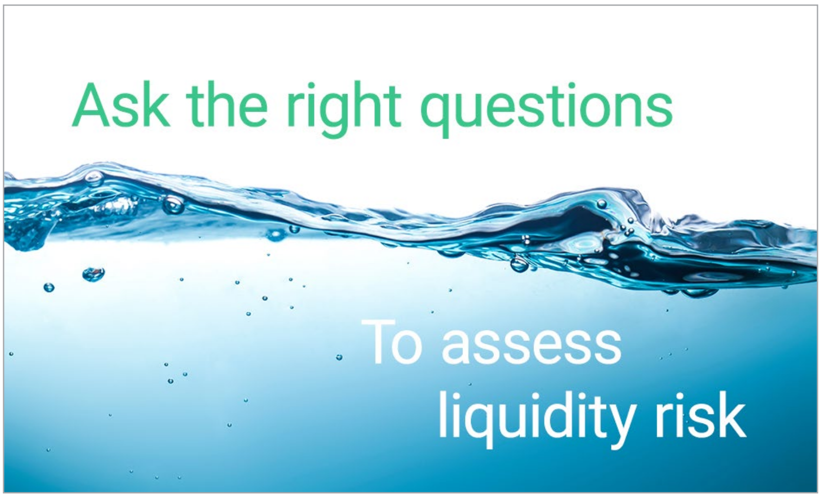
While asset allocation is the most important starting point, understanding fully the nature of diversification sources is just as relevant. What the last credit crisis demonstrated was that not all financial services firms were run the same way, and not every firm has a rigorous approach to liquidity management, as demonstrated recently in the case of SVB.

Fund managers must also apply the same methodology to how they manage their funds. They must take into consideration the nature of their investments, as well as who's investing in those funds, and how they might be used. Neil Woodford's use of illiquid small companies in a daily dealing (liquid) fund is an example of liquidity mismatch. And one of the most common fund choices available to retail investors – daily dealing property funds – is an example of a structural mismatch.



With so many IFAs completely outsourcing the investment process to their DFMs, including the assessment of liquidity risk, the only time they may become aware of this issue is when there's a crisis. However, there is still an onus on them to understand the types of risk in their clients' portfolios. Thankfully, if they ask the right questions, they should be able to understand liquidity risk better.

For instance, the kind of questions that Collidr asks of fund managers includes:

- At what speed do the fund managers say they can liquidate their holdings in an asset class? Are those estimates reasonable?
- How do they plan to liquidate their positions? What trading rules do they follow?
- Have they experience at liquidating a position of that size?
- How do their internal compliance and governance functions monitor for liquidity risks?
- Can they clearly define what liquidity means – for example, most express ownership as a % of mkt cap, but what matters is what % of the free float liquidity are you?

And questions about liquidity risk should not just cover liquidity in normal market conditions, but also in abnormal ones. It is when the markets are falling and everyone is heading for the exits that you realise how dangerously narrow the door is.

IFAs should also look for 'pockets of liquidity sensitivity' within asset classes. Recent examples of this include high exposures to longer-dated bonds, or an over reliance on technology micro-caps as a source of returns.

It is only through proper due diligence where you will be able to identify liquidity risk. For instance, a detailed analysis of bond funds would have shown which ones had an exposure to the CoCo bonds that have been so heavily hit by the collapse of Credit Suisse, and whether this exposure was significant enough to impact the performance of these funds.

It's not unusual for IFAs to question if they are happy with the returns being achieved by some funds. Whereas a better question to ask is how are those returns being generated. In the near four years since the Woodford Equity Income Fund closure, it is unclear whether some IFAs or DFMs have properly absorbed the lessons of that collapse.

So how should they approach it now?

Well, the proper diversification of any portfolio should take into consideration liquidity risks, especially if the returns of the different assets are genuinely uncorrelated. What IFAs will need to do is think carefully about what kind of premium are they getting for reducing liquidity in the portfolio, and is it worth the extra risk?