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Illiquidity, or the hidden cost of selling in stressed markets

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A safe way to preserve capital is not to sell into a stressed market. If despite careful planning and sound risk management selling is unavoidable, be aware of pitfalls and stumbling blocks that lead to increased realized losses.

Black Swans, Gray Rhinos and the Liquidity Trap

There is overwhelming empirical evidence, that investors cannot get the timing right, destroying value when assets are sold in a turmoil (as they act after the shock) and re-enter the markets (missing the early part of the recovery). As argued in "Buy Low and Sell High" end of last year, a carefully constructed investment portfolio is built to withstand shocks within the investor's risk tolerance whilst pursuing the long-term objectives.

Economic shocks are by definition unexpected and/or unpredictable. Whilst economists argue, that we are now dealing with a "Gray Rhino" and not a "Black Swan"[1], the impact of both events is catastrophic. Some investors may fall into panic and sell, others are forced to liquidate (need for cash, margin calls, etc.).

Challenge: Nothing is more liquid than cash

Let us look at some of the key challenges, especially when selling pooled investment vehicles, such as mutual funds and exchange traded funds (ETF). It is unknown to many investors that in times of market stress (illiquidity), they may not be compensated the actual value of their share of the Net Asset Value (NAV) of the fund, or that there is a risk of their assets being frozen.

One of the key challenges for fund managers is the fact that the cash they get (subscriptions) and are expected to pay in case of redemptions, is more liquid than the assets they hold in the fund. Since the global financial crisis (2008), most developed financial markets have put more stringtent regulations in place that require asset managers to develop liquidity management frameworks that deal with that liquidity mismatch with the objective to protect (long-term) investors.

Most common practices include:

1. Passing transaction costs on to new or redeeming investors

When subscriptions and redemptions are significantly out of balance and cannot be met with cash reserves, the fund is forced to trade securities in the market, thereby incurring transaction cost (commissions, bid/ask spreads, taxes, etc.). Mutual funds increasingly have "Swing Pricing" in place, that allow them to pass part or all additional transaction cost to exiting or entering investors. "Partial Swing" is most common, where after a flow threshold (e.g. 1% of NAV) a "Swing Factor" is applied, effectively discounting the proceeds a redeeming investor receives or adding a premium over NAV a new investor has to pay. A swing factor could be as low as 0.10% in normal market environments but reach high single digit percentages in stressed environments when bid-ask-spreads are wide.
The swing factor is typically set by a governing body of the fund (e.g. "pricing committee", as disclosed in the prospect) and depends on the specific market environment. In extreme cases, it can change on a daily basis.

1) pandemics are deemed highly probable but neglected threads, Grey Rhinos, a term coined by Michele Wucker, and not "rare, beyond normal expectation", a Black Swan as per Nassim Nicholas Taleb

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2. Restricting or slowing down access to capital

“Gating” and “Side Pockets” are terms many investors got familiar with during the global financial crisis in 2008. Unfortunately, for most investors both left a bad after taste, even if they were in place to protect their interests. For many funds those tools were the only way to deal with the mismatch between liquidity of cash and the invested assets. Coming out of the crisis, funds have become more active in discussing the liquidity of their portfolios in stress scenarios and the last-resort tools they may use. Also, investment vehicles were designed more carefully ex ante, trying to match the liquidity of the structure with the underlying investments.

Some investors don’t realize that liquidity risk doesn’t just apply to alternative investments, such as hedge funds, but also to plain-vanilla mutual funds. As a manager invests in less liquid assets, such as smaller companies, he or she may choose (or be forced by the regulator) to introduce provisions that address the liquidity risk in exceptional circumstances. This may lead to delayed or even “frozen” redemptions. Again, slowing down access to capital is in the best interest of investors as it allows the manager to sell assets across the portfolio in a risk-managed fashion, instead of being forced to fire-sell the most liquid, and probably least risky assets, first and leaving remaining investors holding the higher risk assets.

A less common practice but probably most feared by informed investors is the “distribution in kind”, found in some prospectus of mutual funds, ETF, and even hedge funds. A manager facing a wall of redemptions could pass on underlying investments rather than cash and the investors end up holding what they tried to sell in the first place…

ETFs and the liquidity that disappears when needed most

Mutual funds are traded end of day at a clearly determined NAV (except for instance swing pricing is applied). ETFs on the other hand are traded throughout the market’s opening hours, suggest higher liquidity. However, in fast moving markets, paid prices can deviate significantly from the NAV of the underlying portfolio. In the week of March 9, 2020, the Vanguard Total Bond Market ETF for instance traded at a discount of up to -6.2%, and VanEck’s High-Yield Municipals ETF even up to almost -20%. Whilst investors had to stomach realizing painful market losses, they had to accept steep discounts on top of them.

How to prepare for the next Black Swan or Grey Rhino?

The seemingly trivial answer to that question is preparing for the unexpected. Keeping large parts in cash is not the answer as we may face negative real returns and retain no upside. Gold is also problematic, as it doesn’t offer any yield and incurs storage cost if held physically. Diversification across many different assets and frequent rebalancing (taking profits) are a good starting point. Further, carefully reviewing liquidity terms of funds that apply in “normal market environments” but also understanding clauses that could be triggered in extraordinary circumstances are key to weathering a potential liquidity squeeze. Including those findings in stress tests of the consolidated investment portfolio helps balancing the trade-off between the investor’s willingness and ability to stomaching short term impacts of shocks and achieving the long-term objectives.

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