THE VIGIL

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Market Liquidity: Risk or Opportunity?

In this edition of the Vigil, we look into the concept of market liquidity, the approach investors should use to evaluate this risk, and the premium they can expect to receive in return.

"VIGIL: from the Latin word *vigilare*; keeping awake at a time when sleep is customary; an act of watching; surveillance."
– Merriam Webster

"The investment universe is characterized by constant movement and change. To successfully navigate therein one must demonstrate intellectual conviction and discipline. One must be capable of reading signs on the distant horizon while avoiding shoals in the near and present. One must also show humility and realism, and maintain a good dose of humour. In short, we must never fail at being vigilant.

Those qualities are brought forward daily by Natcan's team of professionals. The following commentary reflects the views and opinions of our team on issues impacting Canadian investors and their advisors."

- Pascal Duquette, president and CIO

>>> NATCAN

Founded in 1990, Natcan Investment Management Inc. is a subsidiary of the National Bank of Canada with approximately 30 billion dollars under management. Natcan is one of the premier institutional money managers in Canada. Our investment leaders follow their convictions with discipline and rigour to serve the best interests of our clients and their financial advisors.

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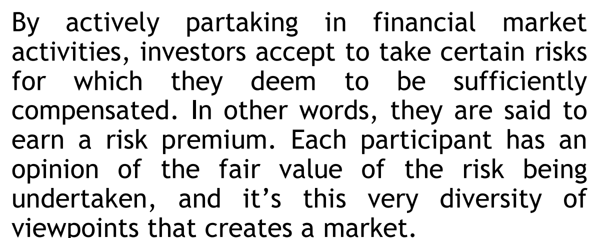

By actively partaking in financial market activities, investors accept to take certain risks for which they deem to be sufficiently compensated. In other words, they are said to earn a risk premium. Each participant has an opinion of the fair value of the risk being undertaken, and it's this very diversity of viewpoints that creates a market.

There are different types of financial risks. We speak of market risk when investors are exposed to fluctuations in an asset's price, of credit risk when they are exposed to issuer default, and of rate curve risk when assets and liabilities do not match. These three types of risk share a common ground: they are quantifiable and it is often possible to mitigate their impact. This edition of the Vigil focuses on a type of risk that is sometimes difficult to define and quantify: liquidity risk.

THE CONCEPT OF LIQUIDITY

Financial assets are considered liquid when they can be traded without triggering an abrupt variation in the price, and without generating a considerable loss. By liquidity risk, we thus refer to the probability that the ability to execute trades with ease disappears; for example, by way of important transaction cost increases.

It is hence inferred that the concept of liquidity is linked to the spread between the prices at which buyers and sellers are willing to transact (also called the bid/ask spread) as well as to the quantity of assets tradable at these prices. Even so, this information must be made available; bond markets being private, transactions are not conducted on a trading floor, as is the case with equity markets. There is therefore no central public exchange to amalgamate all transactions. This bond market characteristic is important as it illustrates the subjectivity and un-definability of the concept of liquidity.

Several elements combine to define an asset's liquidity. Yet, three are common to all:

- Investors clearly grasp the nature of the asset, and they posess sufficient data to evaluate it; there seems to be a general consensus on its fair value.
- The asset is supported by an important, diversified investor base (brokerage firms, analysts, speculative investors, long-term investors).
- The product's market value is not likely to fluctuate significantly over the short term.

Liquidity is an intangible factor that is closely linked to investor confidence. The liquidity risk of the current markets must therefore be accepted or refused as it cannot be hedged through the use of contracts. Yet, it is interesting to examine the link between market value, volatility, and liquidity.

LIQUIDITY, PRICE, AND VOLATILITY

Liquidity is conditional to investors' willingness to participate in the market. In return, this participation is largely conditional to investors' confidence in their asset valuation as well as in their ability to trade on the secondary market, if required. Volatility and uncertainty typically go hand in hand so that an increase in market volatility is often accompanied by a reduction in liquidity.

Similarly, liquidity risk and credit risk are connected. Questions pertaining to an issuer's solvency cause uncertainty that can undermine investor confidence, causing an increase in volatility, and thus reducing liquidity. The fact that liquidity, volatility, and solvency are so closely related increases the risks of substantial market dislocations.

Access to a broad, efficient, and liquid securities market is one of the main pillars of our financial system. A generalized liquidity crunch is thus likely to have a ripple effect, triggering the sell-off of other assets. When an asset's market value diverges considerably from its fundamental value, risk management procedures can compel an investor to sell the asset, regardless of the transaction cost. Doing so accelerates the asset depreciation process, often causing liquidity to dry up simultaneously, as potential buyers prefer to avoid significant market imbalances.

CALCULATING THE LIQUIDITY PREMIUM

Seeing that credit and liquidity risk premiums are interconnected, it is difficult to extract the liquidity premium and measure it. This makes for an interesting research project requiring elaborate valuation modelling. Readers will find a list of recommended readings at the end of this Vigil which contains several recent articles on methods that can be used to extract the liquidity premium embedded in corporate bonds.

There are certain instances where the liquidity premium is rendered more purely. The Canada Mortgage and Housing Corporation issues, via Canada Housing Trust, Canada Mortgage Bonds (CMB), which are bonds with semi-annual coupons explicitely and unconditionally guaranteed by the government of Canada. Their credit rating is the same as that of federal bonds. Yet, they currently trade at a premium exceeding 0.40% of federal bonds of equivalent maturity's annual return. These securities have a five-year term. An investor who wishes to hold such securites until maturity and thus capture a 0.40% annual premium should undoubtedly buy CMB's instead of federal government bonds[1]. Evidently, should that investor opt to sell the bond before it comes to maturity, there is no guarantee that CMB's will have been more profitable than governement bonds.

SACRIFICING THE LIQUIDITY PREMIUM

Asset liquidity is not a factor every investor considers. Several fixed-maturity bond buyers will hold their securities to term. In such cases, access to the secondary market is irrelevant. For instance, big pension funds allocate ever more funds to private markets, which are markets with very low liquidity levels.

Even investors who need to manage recurrent outflows and inflows will always carry a certain number of positions that will not, unless under exceptional circumstances, require to be closed in the medium term. It can therefore be interesting to invest part of the portfolio in less liquid assets.

[1] On repo markets, federal bonds are more valuable than CMB's. An investor who wishes to capture this repo premium could gauge CMB's to be worth 40 basis points less than federal bonds.

CONCLUSION

Despite its intangible nature, liquidity is essential to the good functionning of financial markets. Because it represents a risk, holding an asset for which the future liquidity is uncertain must reward investors. As such, liquidity has a price, an important factor to consider in the construction of a portfolio. It is indeed crucial to optimize a portfolio's liquidity profile to the potential needs of its investor so as to invest a certain part of the assets in less liquid securities and thus capture a liquidity premium over time. The key lies in adequately determining an investor's risk level and ensuring that he is sufficiently rewarded for the risks incurred. To sell off less liquid assets during a liquidity crunch could turn out to be very costly. Conversely with appropriate allocations, investors should be equipped to ride out storms without feeling the need to liquidate their less liquid assets, thereby receiving additional compensation.

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