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Do not ignore `liquidity' while choosing mutual funds

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Liquidity is like a vital body parameter that most people tend to ignore - until something goes wrong. Unfortunately, by the time investors and advisors realise its importance, damage is already inflicted. In this note, we argue that the liquidity measure should be an integral part of a checklist used to select mutual fund products.

What is liquidity?
In the financial services industry, liquidity means different things to different people in different contexts. In this note, we use the word liquidity (in the context of mutual funds or any pooled investment vehicle) to refer to the ability of an investment manager to meet redemptions in an orderly manner without compromising interests of investors who are not redeeming.

What happens when you ignore liquidity
One common cause of accidents in the investment management industry is a mismatch between available liquidity for investors of a pooled fund product and underlying liquidity of an asset class. This mismatch typically arises when capacity constraints of a strategy are overlooked. Over time, the fund becomes too big with respect to the underlying asset class-leading to pockets of illiquidity.

Just as people tend to take their health for granted in good times, many investors and advisors take liquidity of a product as a given. The trouble starts when circumstances turn adverse, often due to exogenous shocks. In rough times, the underlying liquidity of an asset class starts to dry up. Moreover, typically, poorer the quality of an individual security, higher the shrinkage in its liquidity.

Naturally, it gets difficult to find buyers for such a security in bad times. Inevitably, 'bid ask spread' widens. If the percentage of such poorer quality illiquid securities is high, portfolio performance starts to deteriorate. At this stage, smarter investors who sense trouble rush for redemption. To meet these redemptions, an investment manager is forced to sell what he can (better quality liquid assets) and not what he ideally wants to (poorer quality illiquid assets). In this process, interests of investors who do not redeem are severely compromised, as the overall quality and liquidity of the portfolio worsens rapidly.

This typically affects portfolio performance even further. Sometimes, the outcome for investors is even worse.

What do we think about liquidity?

In our investment process, we factor in liquidity at the design stage itself and not as an afterthought. So, while sizing individual bets in our portfolio, we pay close attention to this aspect. We believe it is important to balance performance with liquidity in the long-term interests of all our investors. And, of course, we monitor fund liquidity regularly as the underlying market liquidity keeps changing depending on circumstances. Not only do we keep our eyes on the overall liquidity of the portfolio

but also on that of individual stocks. The objective is not to be forced to change the complexion of the portfolio while meeting redemptions.

We express liquidity in terms of how many days will it take us to convert our equity holdings to cash to meet redemptions. For this computation, we consider market liquidity of individual securities on a rolling average basis (to factor in changes in underlying liquidity) and impact cost by limiting orders to a percentage of total volume traded. Liquidity can be easily computed using publicly available data and can be used as a relative measure to compare funds. This concept is extremely relevant for all pooled small cap and midcap mandates. It is also useful to evaluate multi-cap and ’large & midcap’ mandates where fund sizes are large.

Add liquidity to your checklist

Most investors and advisors use past performance track record, brand & portfolio quality as some of the key factors to shortlist and select funds. We strongly advocate that the liquidity measure should also be an integral part of this checklist. It is true that liquidity becomes critical in tough times and may not matter much when times are good. But, is it not better to do a regular health check-up for prevention rather than having to rush to a hospital in an emergency?

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