



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Liquidity

(Part Two) Liquidity is a fundamental quality for a security, a financial instrument, and both portfolio managers and investors have to be very aware of it. Unfortunately the matter of liquidity is pretty topical and relevant due to the current market conditions, which have caused illiquidity for many products and financial institutions. The problem is being addressed through ordinary and exceptional means by central banks and the US Administration, and such initiatives are the subjects of extensive reviews by all media. Thus we limit our analysis to some practical faces of the complex matter, from a manager and investor's perspective. What does it mean for a security to be liquid? In general terms it means the possibility to regularly purchase and sell it throughout the scheduled trading hours, at a fair price, as well as to be settled in due time. In practical terms that is the availability of a trading counterpart, which is willing to sell when the investor wishes to buy, and is willing to buy whenever the investor wishes to sell. And the spread between the bid and ask prices is expected not to be too wide in order to make the trade "fair". When it comes to purchasing, the lack of a selling counterpart may not be a big problem indeed: the investor can likely find another similar or equivalent instrument to include in his or her portfolio. Currently problems of liquidity on the purchasing side may be found, as a matter of instance, in selecting the so called "grandfathered" bonds, the ones issued before March 2001 and then Eurotax-exempt. Very few of them are now left, particularly among the USD issues. Investors who hold them, keep them in their portfolios and are not so willing to give them up.

On the contrary when liquidity arises on the selling side, that may be a source of troubles for an investor, and current market conditions are fully of such worries. In practical terms, conditions of illiquidity may vary: the most serious case is the one in which the financial instrument is no longer marketable as it becomes worthless, and the investor loses his or her money in full. Such events are pretty common, throughout past and today's financial histories.

In other less dramatic circumstances the instrument's issuer may suspend the payment of interests but regularly redeem principal at the date of expiration, or change into a new product, with different features, yields and durations. In such cases liquidity is often restricted.

There are also many cases in which the security may be traded, although at a very discounted price, which the investor however accepts due to fears of even worsening future conditions. Also problematic may be the suspension of trading (then a *de facto* illiquidity) for periods of hours, days, even months, however sometimes followed by normal resuming of operations. A wide range of conditions, all of them to be found under the current stormy and uncertain market conditions, which we will consider a bit more deeply further down. GLT

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