Managing liquidity risk in portfolios

Market liquidity is characterised by how quickly an investor can purchase or sell an asset without causing a drastic change in the asset's price. Cash is considered the most liquid asset, while private markets, such as physical real estate or art collectibles, are relatively illiquid. BY NEO TENG HWEE

MOST investors would recall the selloff around Christmas last year, with the S&P 500 declining more than 7 per cent in one week. Markets, however, quickly rebounded and reversed all the losses. With the benefit of hindsight, one might attribute the market moves to fundamental drivers such as trade tensions, US Federal Reserve Bank tightening and global growth concerns.

However, given that those factors were much in play throughout the second half of 2018, the extreme volatility has more to do with market illiquidity than with fundamental pricing. In recent years, markets have also seen more instances of "flash crashes", the most recent being the sharp drop in the USD-JPY in early-January this year.

Market liquidity is characterised by how quickly an investor can purchase or sell an asset without causing a drastic change in the asset's price. Cash is considered the most liquid asset, while private markets, such as physical real estate or art collectibles, are relatively illiquid.

Illiquidity is compensated for by the markets by a risk premium. The best example of this is corporate bonds. It has been observed across many markets that the level of credit spread over-compensated investors for actual credit losses, a phenomenon known as the "credit spread puzzle".

However, the credit spread puzzle can easily be explained if we consider the liquidity risk in corporate bonds. Investors would recall the unusually high bid-ask spread in bonds during the Global Financial Crisis (GFC) in 2008.

A case in point would be the bid-ask spread of the CapitaLand 4.35 per cent 10/19 bond, which reached a high of 12.5 basis points during the GFC, according to Bloomberg data *(See Chart, Figure 1)*.

Investors should be concerned about liquidity because liquidity or market depth in some asset classes may have deteriorated recently, while market depth may also ebb and flow with the changing risk appetite of investors. Since the GFC, the value of global financial assets has risen sharply. The global tradeable bond market is now estimated at US$52 trillion, up from a pre-crisis US$25 trillion, while global equity market capitalisation stands at about US$80 trillion, up from about US$60 trillion *(Figure 2)*.

Extreme volatility has more to do with market illiquidity than with fundamental pricing. In recent years, markets have seen more instances of "flash crashes", and since the Global Financial Crisis of 2008, the value of global financial assets has risen sharply. PHOTO: REUTERS

Financial reforms

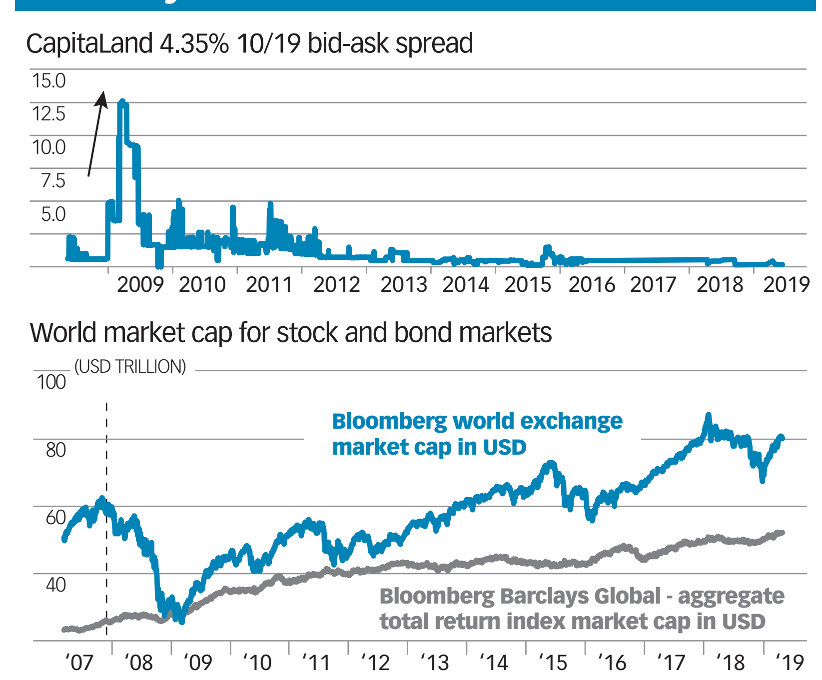
Financial institutions and capital markets are important as they build trust and also reduce the problem of uneven information between the producers and consumers of capital. However, the capacity of financial institutions to play the role of intermediary has declined. This is the result of various financial reforms, proposed by the Basel Committee on Banking Supervision, which sought to strengthen financial institutions and avoid systemic repercussions if they were to fail.

Due to higher capital charges, primary dealers have been reducing inventory positions accordingly. During market shocks where investors are looking to reduce positions at the same time, the downward price impact will be amplified.

During the late-2018 selloff, it was argued that prudential regulations on the G-SIB's (Globally Systemically Important Banks) buffers could have led to a decline in liquidity as dealers de-risked to avoid hefty capital charges at the year-end. The recent conclusion of the Fundamental Review of the Trading Book by the Basel Committee will likely dampen market-making capacity further. Besides regulations, the micro-structure of financial markets since 2008 has also evolved in ways that might impact market liquidity. One such change is the move towards passive investing, which has led to a decline in the share of actively managed funds.

> "Investors should be concerned about liquidity because liquidity or market depth in some asset classes may have deteriorated recently, while market depth may also ebb and flow with the changing risk appetite of investors."
> **Neo Teng Hwee**

Volatility



Source: Macrobond, UOB Private Bank

De-risking mechanism

According to JP Morgan, assets under management of the Exchange-traded fund universe has grown from about US$700 billion in 2007 to US$5 trillion in 2018. In addition, the market has also seen the proliferation of quantitatively oriented strategies, including volatility targeting, trend following and other "risk-based" models, in response to the huge draw-down experience during the GFC.

The common feature in these strategies is an automatic de-risking mechanism during periods of market weakness and/or higher volatility.

Consequently, bouts of market fear and uncertainty could result in a large number of sell orders seeking to rebalance risk. Unfortunately, this raises the level of volatility even higher. This was evident during the February 2018 decline, where many underlying assets were liquidated and performed poorly.

In aggregate, JP Morgan estimates that 90 per cent of the market trading volume is now dominated by Quant, index, ETFs and Options-related strategies, while contribution from actively managed funds has retreated.

Traditional actively managed funds could have provided liquidity in such a scenario, given their value-oriented and long-term approach. A value investor will buy assets when their valuation has cheapened, and is generally less sensitive to near-term developments.

Warren Buffet, the investing pundit, famously said that one should be greedy when others are fearful and be fearful when others are greedy, enshrining a contrarian philosophy, that is antithetical to the momentum-driven ones.

However, with the almost US$3 trillion shift towards passive investing, a large pool of potentially offsetting liquidity flows are no longer available. While volatility may have structurally declined, there will be more occurrences of "fat-tailed" or large moves in the market.

Implications for investors

- Investors should assess their short- to medium-term liquidity needs and ensure their portfolio can provide for short-term liquidity accordingly. Investors should be aware that some positions may be less liquid.
- Bond market liquidity is a function of issue size and credit ratings. For other products, liquidity is also driven by complexity.
- For leveraged portfolios, it is not advisable to maximise loanable value, but instead allow some buffer to tolerate mark-to-market movements. Liquidity events can have a contagion effect across other assets and correlation also rises during a period of market stresses.
- For investors holding long-term capital, liquidity can be extracted as a premium. Cash or liquid assets can be a strategic asset to take advantage of in a liquidity-driven sell-off.
- Taking a long-term approach and focusing on quality will reduce the relative importance of liquidity risk.

The writer is chief investment officer, UOB Private Bank.

Is Asian private equity still an attractive play?

Asia, where there is an increasing number of private equity investments, now represents 26% of the global private equity market. BY BRENDA LAU

PRIVATE equity has enjoyed a prolonged period of growth and success, and is now one of the most important asset classes among institutional and private investors. However, with the intense competition and challenging environment especially in Asia, will private equity's boom fade away sooner than expected?

There has been much talk about the global private equity bubble bursting – from cheap credit fading a decade ago, to too much money chasing after too few deals, deals are expensive, multiples are high, returns are diminishing, economic growth is slowing, trade tension, etc.

Concerns about private equity have never ended. Asia, where there is an increasing number of private equity investments, now represents 26 per cent of the global private equity market. However, the overall investment landscape is seen as becoming more and more challenging and as such, some claimed it is less attractive. Is the situation really that treacherous? Will investors abandon private equity soon?

Fundraising ebb

According to the annual Asia Pacific Private Equity Report by Bain & Company, fundraising had definitely slowed in Asia in 2018, both in terms of aggregate amount raised and the number of funds raising money. This trend has continued in the first quarter of 2019. So, have investors lost interest in private equity in Asia? Probably not. The Asia private equity assets under management is now at an all-time high. The slowing of fundraising could well be explained by a number of factors.

Firstly, the majority of the fundraising activities had already been done between 2015 and 2017. These funds still have dry powder and may not come back to the market any time soon. As a reference, dry powder in Asia increased 14 times from the beginning of this decade to the end of 2018. There's still quite some money to spend.

Secondly, Bain's report showed that the Chinese regulator is becoming more stringent about the wealth management products offered, including RMB private equity funds, which had curbed fundraising in 2018.

Thirdly, more and more large institutions such as the sovereign wealth funds, pension funds and insurance companies invest through separate accounts alongside private equity fund managers instead of directly into the funds. Some of these numbers may therefore not be captured in the fundraising data.

One interesting trend to note is investors' preference for the large/mega funds with strong track records. For high-net-worth individuals in particular, they are still in favour of brand names. That explains why certain funds are able to close within months with significant oversubscription. This trend will likely continue. Although investors are still keen to invest in Asia, they should be mindful of the price they are paying to acquire a company.

A throbbing shopping area in Shanghai. In the long run, we believe China has the potential to become the second largest private equity market in the world. PHOTO: AFP

The median M&A entry multiple, measured by EV/EBITDA, was at 14.5x by the end of 2018 according to Bain's report; whereas five years ago, it was only 9x. The average entry multiple was even higher. From observation, not only are the tech companies being priced at a level never seen before (with many anticipating a tech bubble crash in 2019 or 2020), those low-tech companies in the traditional sectors such as Consumer are also bought by private equity firms at an unbelievably high price.

However, given the fact that valuations for private and public companies are narrowing, and the public market is still booming (more or less), valuations of private companies will definitely follow. The days for buy-low-sell-high are gone, investors have to be able to identify private equity managers that can either still locate the hidden gems, or are able to create real value for the underlying companies instead of merely relying on financial engineering.

Equity returns

Asia private equity returns remain attractive, and outperform the public markets in the region over different time horizons.

However, the gap between the top-quartile and bottom-quartile managers is huge, and the difference can be as much as 15 per cent net IRR. As many funds – large or small, regional or country-focused, first-time or new strategy from an existing manager – are trying to raise money to invest in Asia, investors need to be able, or rely on experts, to perform due diligence and distinguish the really skilful managers from the mediocre ones.

Key areas to look at include background of the firm, team experience, dynamics and compensation, local experts on the ground (including relationships with local governments), investment strategy, track record, etc. Investors should be alert if any of the information is not obtainable.

From our point of view, we remain positive on Asia, and intend to increase our global portfolio's exposure from 25 per cent to 30 per cent.

Although we are not a thematic investor, four sectors are particularly appealing to us over the long term: healthcare, education, food and technology. However, as mentioned before, certain tech companies may be too expensive or too big to exit.

Therefore, in comparison, the small-/mid-sized tech companies seem more attractive at the moment.

Last but not least: China. The scale of the mainland economy is huge and is still developing, albeit at a slower pace. In the long run, we believe China has the potential to become the second largest private equity market in the world.

This will help many Chinese enterprises to expand overseas and become international corporations.

The writer is head of private equity, Asia, Indosuez Wealth Management.