From the CIO's Desk

Why Liquidity Criterion is Crucial for Fund Selection? – *March 2022*

Rough market conditions expose hidden portfolio risks

Tough market conditions such as the present one that we are facing, expose investors to drawdowns in their portfolios. Less obviously but more seriously, that drawdown can turn into permanent damage if investment managers have not taken the necessary precautions while constructing their portfolios. We believe, it is just as important to think about risk management as it is about maximising returns. Maximising returns could come with "hidden" risks that are lurking in a portfolio, only to be exposed in difficult market conditions. In this note, we highlight one such risk which most investors, advisors and managers tend to overlook in good times but can really hurt their portfolios in challenging market conditions.

Most investors and their advisors often ignore portfolio liquidity

Most investors and their advisors use past performance track record, brand & quality of holdings as some of the key factors to shortlist and select funds. Liquidity is rarely used as an important consideration, perhaps because it rarely matters when times are good. However, in stressed times like these liquidity becomes perhaps the most critical factor in evaluating pooled funds. Here, we use the word liquidity 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.

How accidents can happen if one overlooks liquidity

Many accidents in the investment management industry have happened due to the mismatch between available liquidity for investors of a pooled fund product and underlying liquidity of the asset class. This mismatch arises when capacity constraints of a strategy are ignored. Over time, the fund often becomes too big with respect to the underlying asset class-leading to pockets of illiquidity. While in good times, it does not matter, the trouble starts when circumstances turn adverse. This typically happens due to exogenous events. In rough times, the underlying liquidity of an asset class (say small & midcaps stocks) starts to dry up. Typically, poorer the quality of a stock, higher the shrinkage in its liquidity. Naturally, it gets difficult to find buyers for such stocks in bad times. Inevitably, 'bid ask spread' widens. If the percentage of such poorer quality stocks is high, portfolio performance starts to deteriorate.

At this stage, smarter investors rush for redemption. To meet these redemptions, the 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 those investors who do not redeem are severely compromised, as the overall quality & liquidity of the portfolio worsens rapidly. This tends to affect portfolio performance even further. Sometimes, the outcome for investors is even worse.

Why Liquidity Criterion is Crucial for Fund Selection? – *March 2022*

Small/Mid cap mandates are most vulnerable - measure your portfolio liquidity
Liquidity can be easily computed using publicly available data and can be used as a relative measure to compare various pooled funds like mutual funds and PMSs. This concept is extremely relevant for small cap and midcap mandates. It is also useful to evaluate multi-cap and large & midcap mandates where fund sizes are large. We would strongly urge you to make liquidity measure an integral part of your checklist while selecting and evaluating pooled funds.

At Girik, how do we think about liquidity?
In our investment process, we factor in liquidity at the portfolio construction stage itself and not as an afterthought. So, while sizing individual bets in our portfolio, we pay close attention to this aspect. We also closely monitor 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 believe it is important to balance performance with liquidity in the long-term interests of all our investors.

End