

Preserving Liquidity

why & when

One of those numbing terms employed by bankers and others in the financial industry, *liquidity* suggests an ambiguous combination of comfort (think hot cocoa) and threat (floods, cloudbursts, melting M&Ms). The news media report recurrently on “liquidity crises” or “liquidity problems” affecting markets, industries and companies. But liquidity is an important concept for anyone concerned with financial well-being and other financial objectives. It has implications for the creation and protection of wealth, as well as for family well-being.

In its broadest financial sense, *liquidity* is cash availability, or the ability to convert to money in its most immediately usable form. A person, company or organization with ample liquidity is one that can produce in a short time all the cash he, she or it might reasonably need. (The meaning of “in a short time,” as one might expect, differs according to circumstances and

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perspectives.) For investors, *liquidity risk* arises from the difficulty of selling an asset to produce cash in a timely manner.

Why is liquidity important to me? Life’s contingencies are the primary reason. These includes the possibility of emergencies, catastrophes or unforeseen needs

requiring the outlay of substantial amounts of money—in addition to what may or may not be covered by insurance, even *until* insurance claims are paid. Life’s contingencies can also include unforeseen opportunities—to make a business investment, say, or buy assets or real estate on exceptionally favorable terms—provided one acts expeditiously.

To the individual or family, financial liquidity can be significant just to maintain a lifestyle in changing circumstances or conditions—during career shifts, business changes, job losses, financial reversals, location changes, other life events, recessions, market slumps—again, life’s contingencies. But even *expected* needs—college expenses or retirement, for example—require liquidity at some point.

Sources. Liquidity usually depends on the kinds of assets one has. Pocket change is *ipso facto* a liquid asset, as is the balance in one’s checking account. On the other hand, a house and most other “real” assets are *illiquid*—because converting them to cash (by selling them) takes substantial time. And urgency to sell usually affects price inversely. While ample cash or cash equivalents means ample liquidity to meet contingencies, there is a trade-off. Because cash is a non-earning or low-earning asset—really a wasting asset, given inflation—holding large amounts of cash usually comes at the expense of long-term asset growth.

With planning, though, it is possible to assure sufficient liquidity without compromising long-term financial goals. There are several possible sources of liquidity, depending on one’s situation. An investment portfolio can provide liquidity, although different investments have radically different degrees of liquidity.



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continued

Stocks. Since they can be sold quickly and the proceeds credited to a checking account in a few days, stocks of publicly traded companies are quite liquid *under normal market conditions*, stock mutual funds almost equally so. Liquidity may come with a severe penalty, though, in adverse conditions. (Stock-market lows are a time to buy, not sell.) Shares of privately held family businesses and partnerships, on the other hand, are usually *illiquid* assets. Like real estate, they are not easily or quickly convertible into cash.

Bonds. Treasury securities, especially short-term notes, enjoy a high degree of liquidity, as do many other bonds, depending on maturity and the market for them. Long-term bonds, however, risk losses if sold when yields are higher than when the bonds were bought. Bonds enjoy a statistical benefit, though, rarely declining in value as much as stocks. What may be more, they have potential for maintaining or increasing value when stock prices decline.

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Borrowing and other sources. A home-equity line of credit provides a way of converting real estate value into cash without selling the homestead. There is a cost to using the line of credit, of course, and borrowings must be repaid, but the access to cash in a time of need can be worth much more. Certain kinds of life insurance and annuities, but *only* certain kinds, can also contribute to liquidity. Even a regular paycheck or other income can be a source of liquidity—assuming it is not already wholly committed to expenses—allowing for borrowing.

In any case, an assessment of liquidity needs and development of strategies to meet them should be high on any list of topics for review with a financial advisor.

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