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What is Liquidity?

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Are your investments liquid or illiquid?

When a holding is liquid, it simply means you can sell it anytime the market in which it trades is open for business, without losing your proverbial shirt in the exchange. If it's illiquid, you cannot sell it, at least not for anything near what it's worth.

Degrees of Liquidity

Cash and cash equivalents (such as checking or savings accounts) are the most liquid assets of all. All day, every day, you can almost always find somebody who will gladly give you something relatively worthwhile in exchange for your cash.

At the other end of the spectrum, some investments are highly illiquid, which means your ability to trade in and out of them whenever you please is strictly limited.

For example, many hedge funds and similar closely held vehicles may routinely impose lockup periods, during which you are prohibited from selling your investment. You may be prohibited from withdrawing any of your money until you've owned the holding for at least a year, plus your ability to withdraw funds after that may be limited to specific windows of opportunity such as once per quarter or twice per year.

Also, normally liquid investments can become illiquid under duress. As Ben Carlson observed on his Wealth of Common Sense blog, the following adage applies so well, it's become a bit cliché: "Liquidity is like oxygen. You don't notice that you need it until it's not there."

To cite an extreme example, during the September 11th 2001 attacks, the New York Stock Exchange and NASDAQ markets did not open for business that Tuesday; they remained closed until the following Monday. During that time, investors could not trade on either exchange, effectively rendering most of their investment portfolio illiquid for those four days.

Individual securities or sectors can also shift dramatically from liquid to illiquid, especially if investor panic sets in. An example is when the bottom dropped out on the Collateralized Debt Obligation (CDO) market in 2007, contributing to the subsequent global financial crisis.

Finding Middle Ground

Between these extremes of highly liquid/illiquid holdings, you'll find most of the investments that are most familiar to you. Mutual funds; exchange-traded funds (ETFs); stocks and bonds; and similar publicly held, exchange-traded securities are typically relatively liquid. They don't flow in and out of your accounts as freely as cash, but even in turbulent markets you can usually sell them in a same-day transaction. (Mutual funds trade once daily at the end of the trading day. Individual securities and ETFs trade at prices that fluctuate throughout the day.)

It's also worth noting, some investments can be more or less liquid or illiquid, depending on how you hold them. Real estate is a prime example.

- **If you own a piece of property directly,** it's relatively illiquid. Even in a stable market, it can take days, weeks, or months to sell your property once you're ready to do so.
- **A privately traded Real Estate Investment Trust (REIT)** may be at least as challenging to unload whenever you please. Typically, the private REIT's board – not you – will decide when and how trading is permitted.
- **An exchange-traded public REIT mutual fund or ETF** is usually as liquid as any other mutual fund or ETF. Even though the fund's underlying holdings may be relatively illiquid, you can usually sell your shares in that fund whenever public markets are open for business.

Liquidity: A Part of the Plan

Bottom line, cash (and cash equivalents) is the closest you come to having a completely liquid asset. This means it's important to have plenty of it on hand to cover near-term spending needs. We recommend budgeting for expected expenses as well as the inevitable surprises.

That said, cash will only take you so far. It's highly likely to lose rather than gain worth over time, as inflation eats away its spending power.

As such, a degree of illiquidity – or the inability to convert an investment back into cash whenever you please – is essential to building wealth. It's the stuff from which investment returns are made.

We suggest managing liquidity as one consideration among many, achieving a balance that's right for you. Maintain enough liquidity to ensure you're never forced to sell a less-liquid investment just to get at the cash. Accept a degree of illiquidity in your soundly structured portfolio, to judiciously seek premium market returns over the long-term. Understand when illiquidity is essential to pursuing higher returns, versus when you're just taking on extra risk, without much else to show for it.

Could you use some assistance on making these determinations? We're here to help! Contact us today.

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Source: Dimensional Fund Advisors LP.

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