Defrosting liquidity: there are a whole of lot icebergs floating around out there

On 10th March 2015, BlackRock asset management organised an extremely enlightening seminar about the liquidity of investment portfolios and how it can be increased through ETFs. Geert-Jan Kremer (KAS BANK Treasury) participated in the concluding forum of experts. He discovered that confusion is looming about the word 'liquidity'.

What is missing as it stands now are new words for liquidity, because this word, which in itself is clear, has two rather different meanings in two different worlds. This should not to be a problem as long as the two worlds don't meet. But that is exactly what is happening under the prevailing market conditions.

Market liquidity versus cash liquidity

For investors, liquidity is the extent to which a portfolio can be bought or sold without incurring additional costs. These costs could be the fees for withdrawing from a fund, corporate finance costs to find a buyer for a mortgage portfolio or

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market impact when a large package of shares are offered at the same time on a thin market. Let's call that **market liquidity**.

For bankers, on the other hand, liquidity is the extent to which they can deliver when an acute cash requirement arises. This could involve drawing down on credit (a run on the bank), but also the extent to which a higher collateral requirement for derivative positions causes an outflow of money because the underlying markets are in flux. Let's call this **cash liquidity**.

These two worlds are now coming together because of EMIR. This means that investors must at the very least think about cash liquidity. For instance, by considering exchange-traded funds (ETFs).

ETF or government securities

An ETF is much more liquid than a standard investment fund, with its option of joining or withdrawing once a day, so market liquidity increases tremendously with ETFs. It's easy to see that cash liquidity will be better: if I need money to deposit for collateral today, then I can consider selling part of my position. So it is similar to a share or a bond.

The interesting part is that ETFs can also be used in securities lending. If money is received as collateral, then you have the best of both worlds: exposure to the market and funds to serve as security. In other words, an ETF is virtually a repurchase of government securities. Yet there is a subtle difference; if the market is in a state of flux, it won't be easy to borrow against ETFs. Why not? Because a bank in the Euro zone can always borrow money from the ECB if they deposit the right collateral, the "ECB eligible paper". Government bonds from countries in the Euro zone, and RMBSs, covered bonds, agencies and so on as well, are all suitable for this. Which is not the case if the bonds are packaged in an ETF.

So investing in an ETF leads to a (considerable) improvement in cash liquidity in comparison with an ordinary fund, but it does not offer access to high-quality collateral when liquidity must be attracted quickly.

And so...

ETFs have a clear role in the analysis of a fund's cash liquidity. If a fund can be considered extremely limited or non-liquid, ETFs can be classified along with shares and bonds which are liquid in the market. But when the ETF includes government bonds, it is most probably better to invest directly in bonds from a cash liquidity point of view.