

# Liquidity

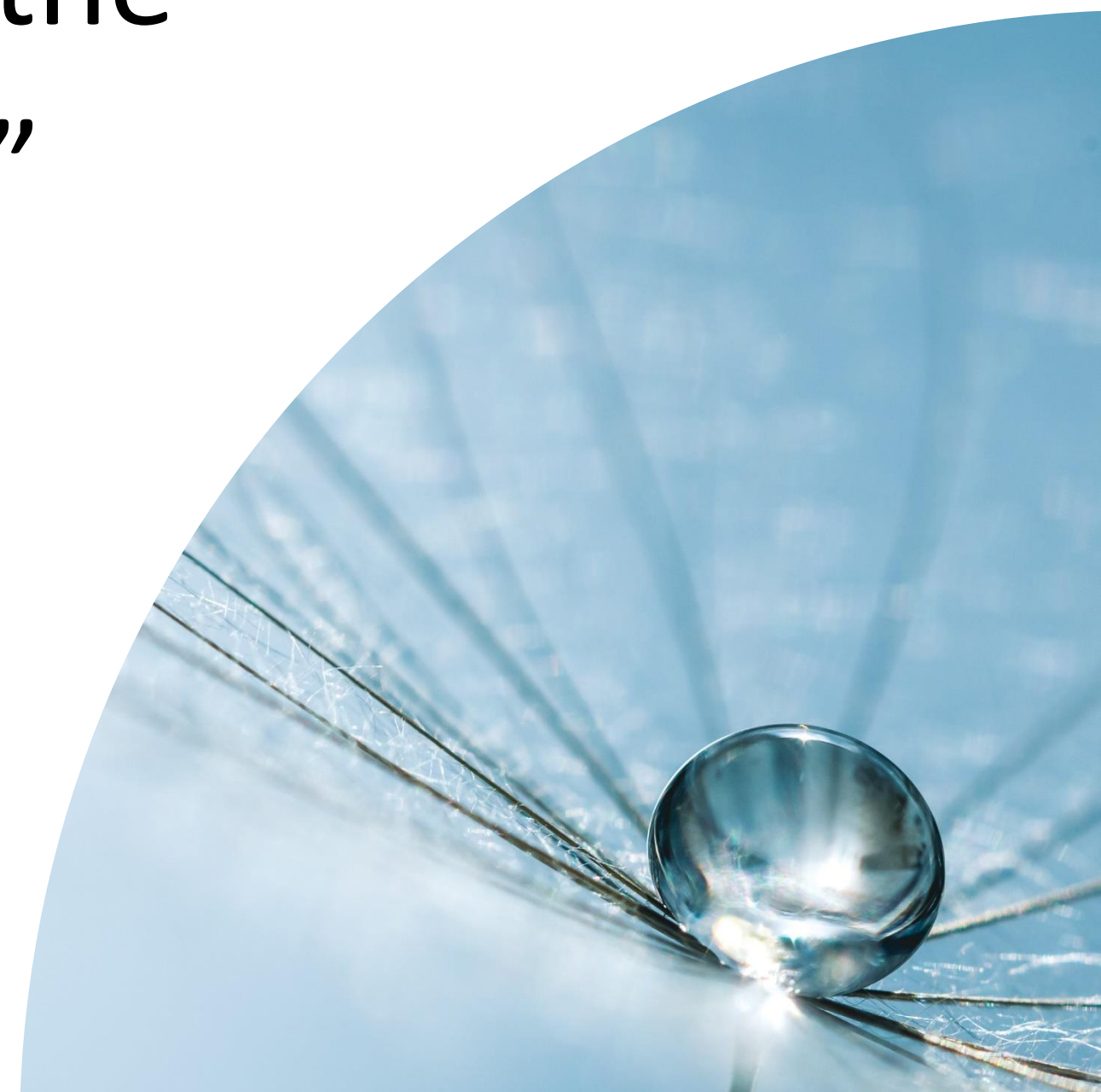
## The Financial Air You Breathe

### “Tickling the Dragon’s Tail”

FPPTA FALL TRUSTEE SCHOOL 2023

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# Outline

Define Liquidity

Why this matters to you

The liquidity premium

Illiquidity and the legacy of loss



# Outline (continued)

The current state and what got us here

- Great Financial Crisis
- Monetary, Fiscal and Regulatory Policy response

The search for yield/return

- Asset allocation shifts

Implications of less liquid portfolios

Some suggestions and thoughts



# What is liquidity?

## Liquidity

- Buy/sell something quickly at/near the current price
- It requires relative balance between buyers and sellers
- Imbalance creates illiquidity

Central bank goal of financial market stability  
—often requires liquidity provision



# The Liquidity Risk Premia

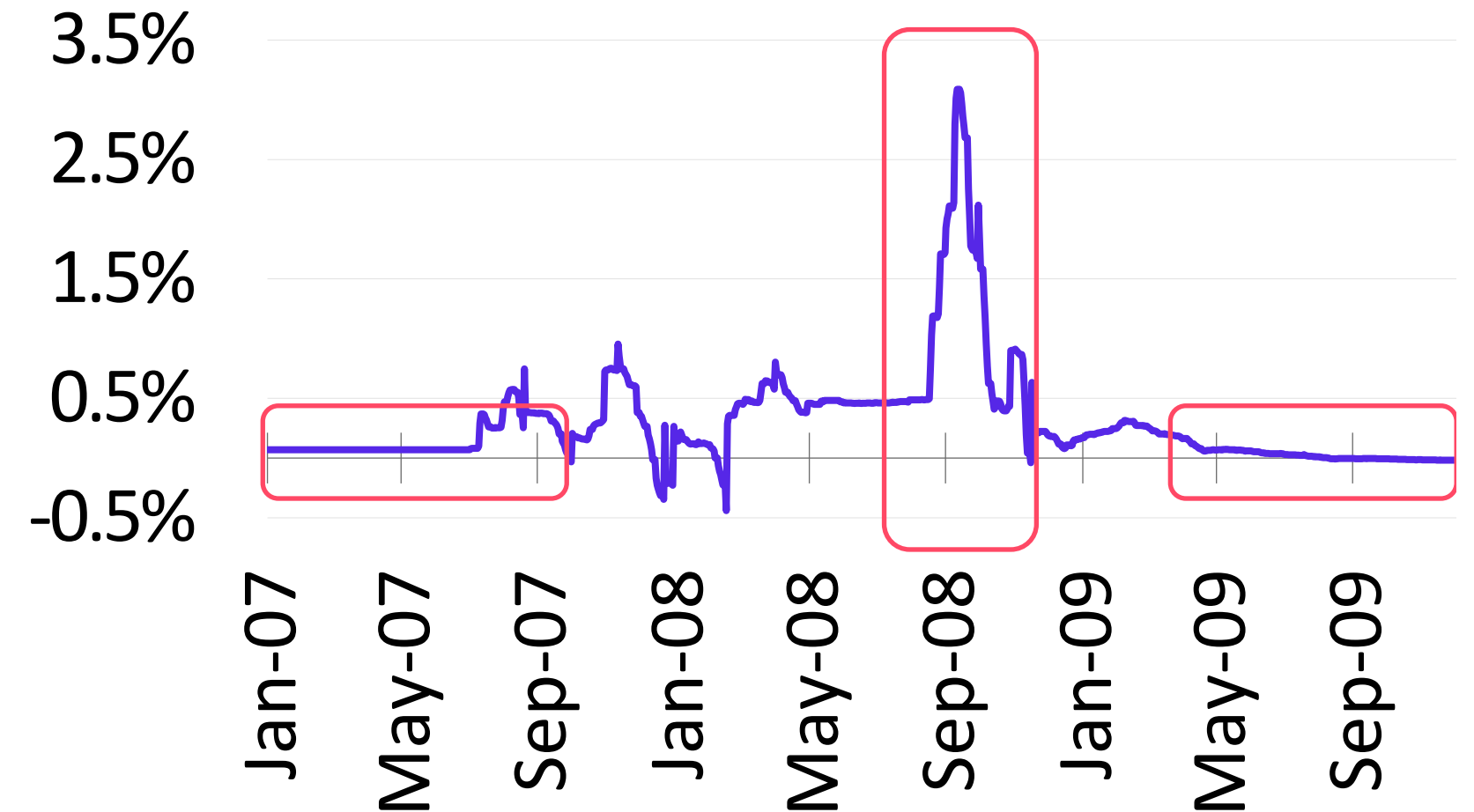
Analogy to air

- Abundance/scarcity

Extremely episodic

- Pays almost nothing most of the time but
- Pays massive amounts when liquidity is scarce

1-month LIBOR less Fed Funds Target Rate\*

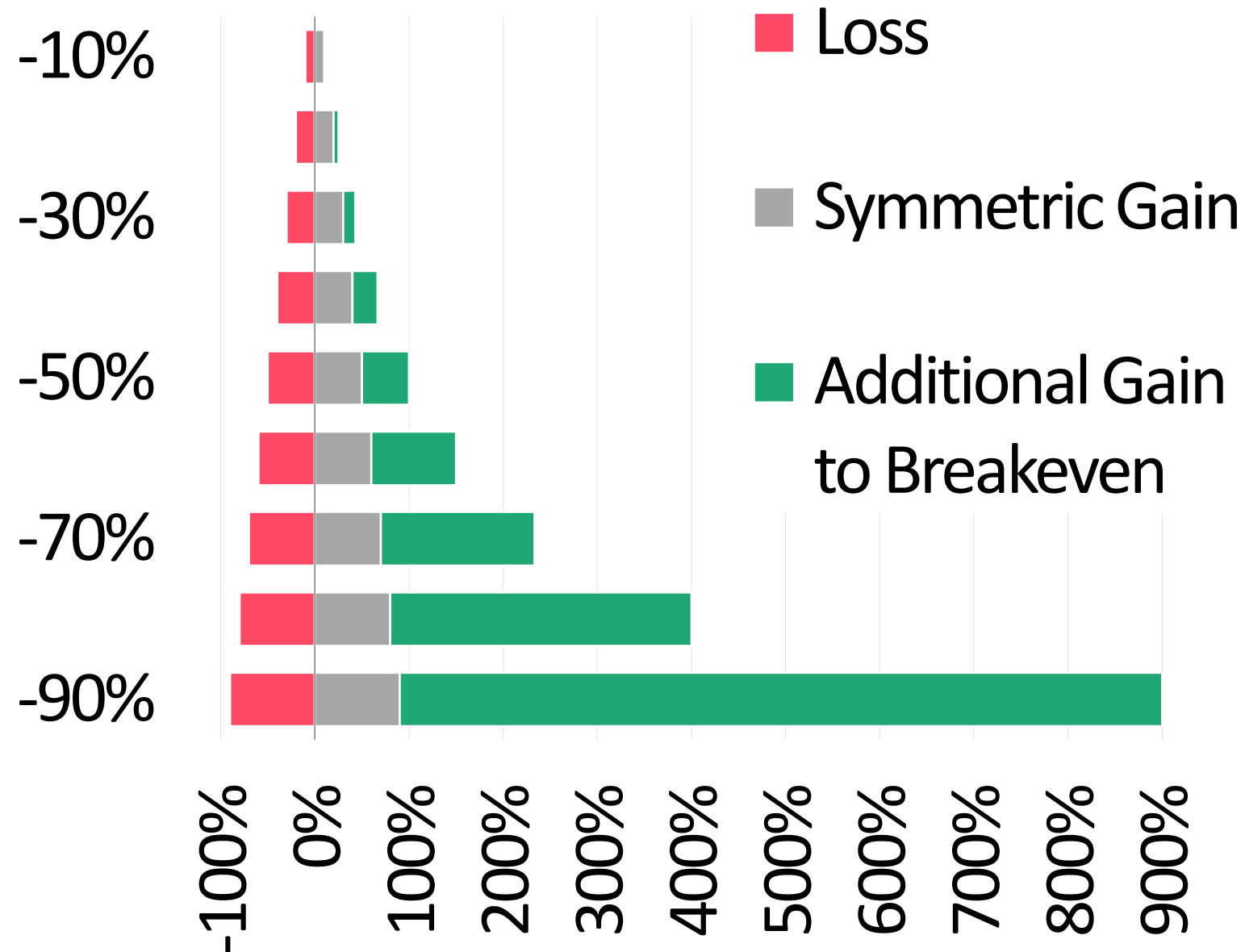


**This is NOT a premium earned for holding illiquid assets.**

\*Source: Bloomberg and Allspring 31-Jan-2007–31-Dec-2009—Fed Funds Target middle rate



# Legacy of loss



Losses require larger gains to get back to even

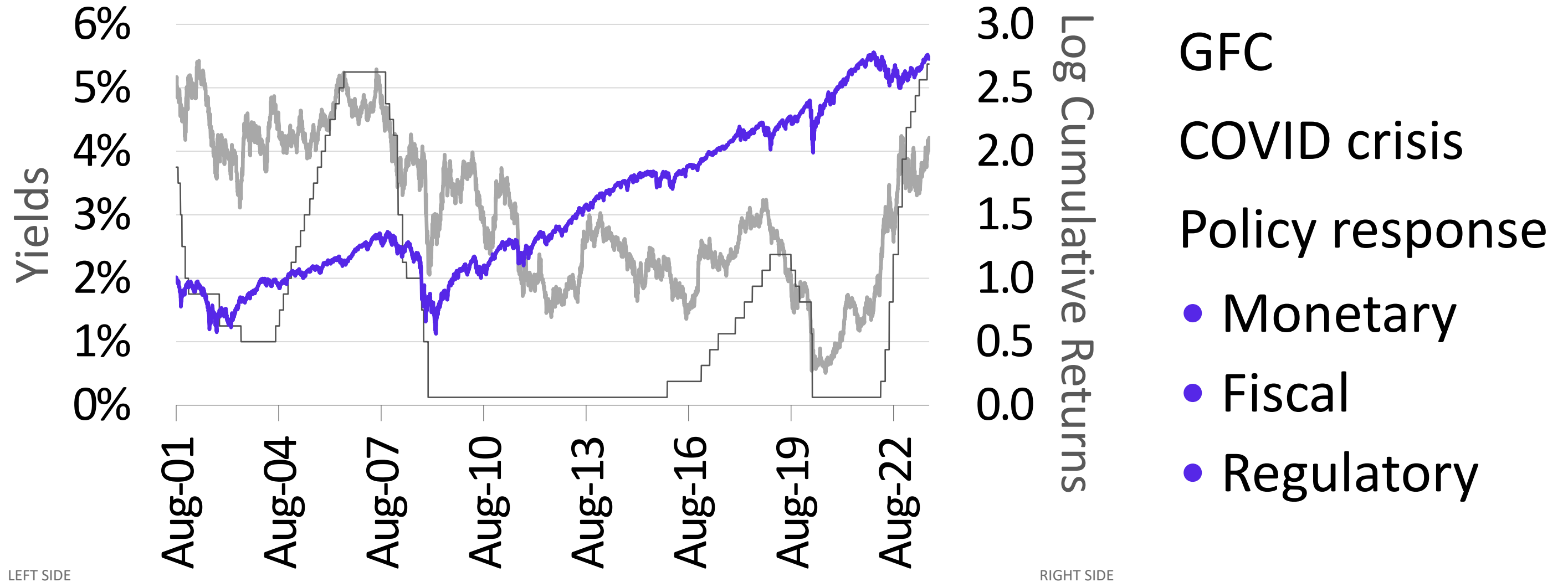
- Why? Less capital to grow

Larger the loss—greater the asymmetry

Cash outflows compound the problem



# How we got here



LEFT SIDE

— 10-year Treasury  
 — Fed Funds Target Rate

RIGHT SIDE

— Log Cumulative S&P 500

Source: Bloomberg and Allspring 01-Aug-2001–15-Aug-2023.



# Impact on asset allocation

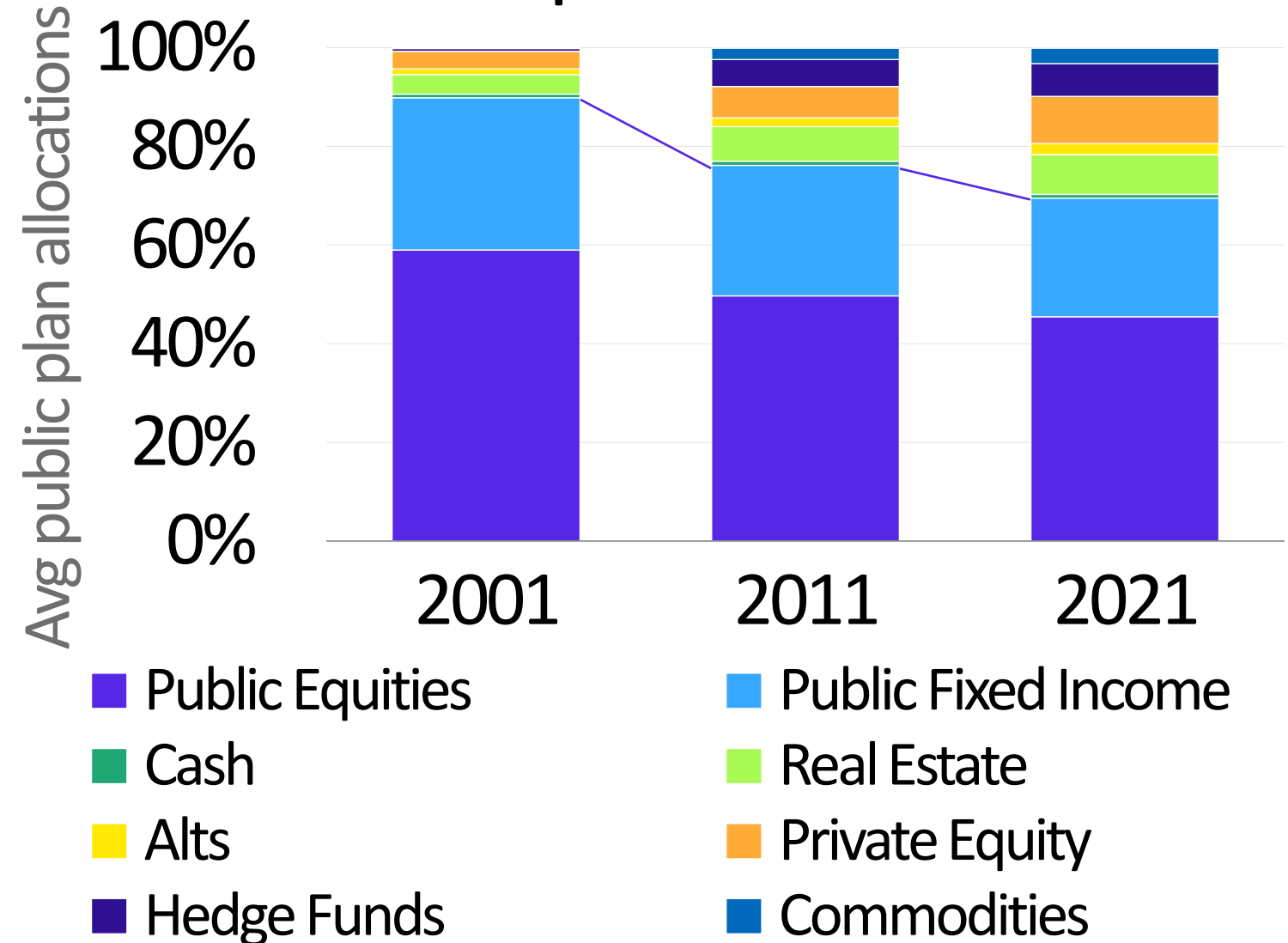
Shift out of liquid into less liquid

- High level shift
- Shift within Fixed Income

Concern:

What happens as the entire system becomes less liquid?

Shift to less liquid assets



Source : [Downloadable Data | Public Plans Data](#) and Allspring as of 11-Jul-2022. Number of plans used in averages 2001: 111; 2011: 169; and 2021: 142.

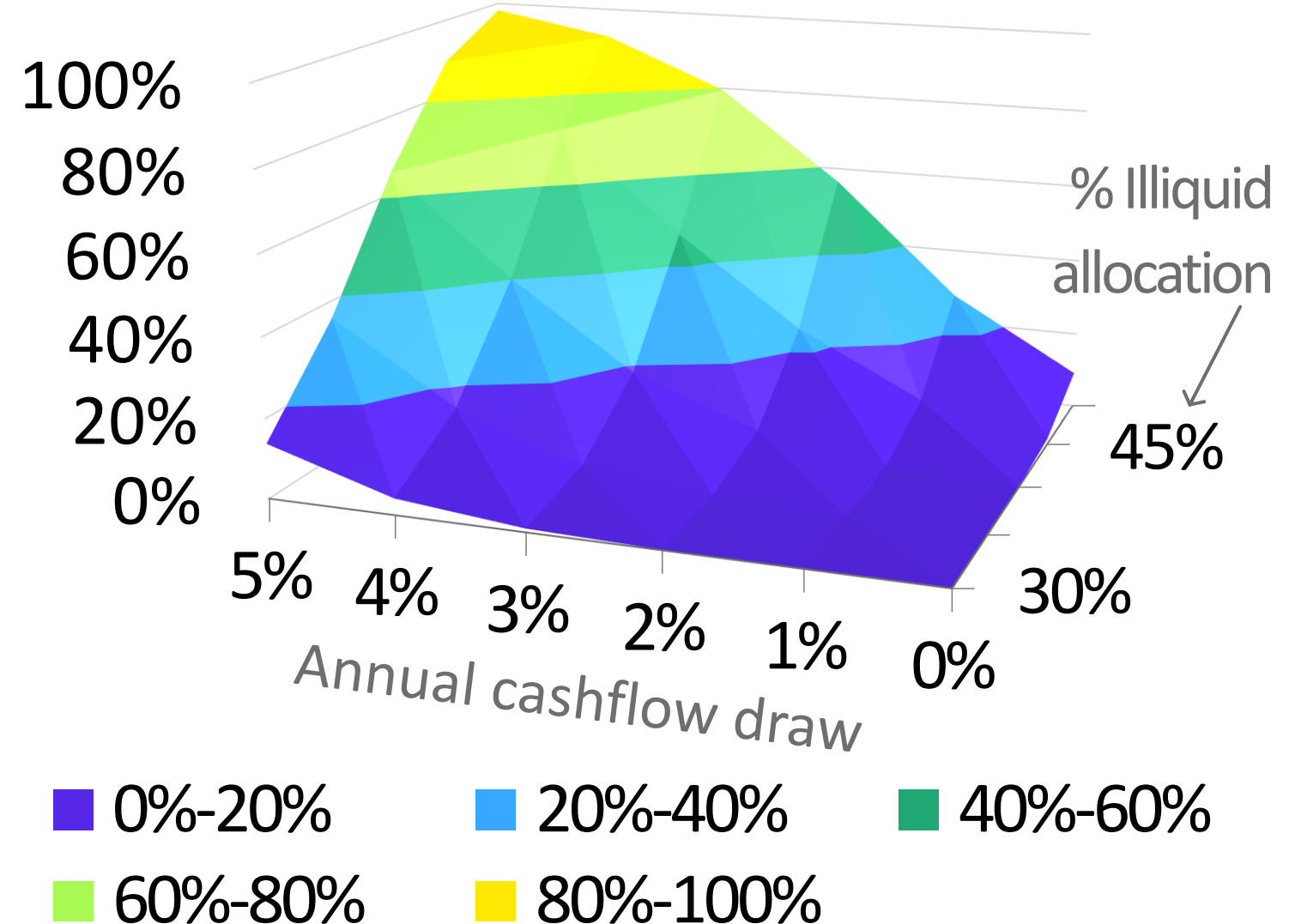




# System-wide impact: Conclusions

- 01 Secondhand smoke
- 02 Tipping point
- 03 Tipping point determinants
  - Size/duration market shock
  - Cashflow demands
  - Size of illiquid holdings

Probability liquid assets < 15%



Source: Whitney, Duane and Kevin Kneafsey "Tickling the Dragon's Tail—A model of the systemic impact of increased illiquid asset holdings in times of market stress" 2022 Allspring.



# What can you do? Manage Liquidity

Cashflow driven investing

Protect liquid assets

- Explicit downside protection
- Diversify liquid assets—liquid alternatives

Recognize that you are part of a larger system—

Certain things will happen regardless of what you decide.



# Every risk contains an opportunity

**Public markets:** Explicit downside protection

**Private markets:** Secondary markets cannot accommodate necessary liquidations

**Liquidity provision:** When liquidity is scarce, liquidity providers are extremely handsomely paid

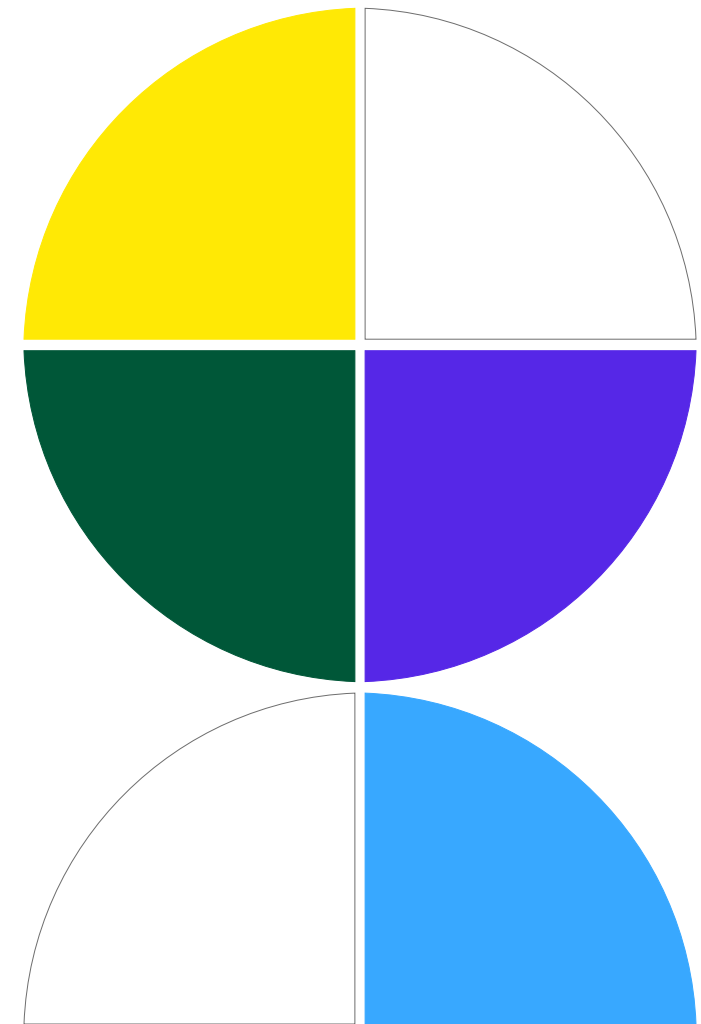
**Long volatility:** Volatility models underestimate the volatility of stressed markets with large illiquid holdings

**Trending markets:** On way down and way up



# What to watch?

- 01 Broad equity markets
- 02 Interest rates and inflation
- 03 Existing and new canaries
  - Private REITS
  - Regional banks
- 04 Unexpected events





# Conclusions

Liquidity is all about balance—Illiquidity about imbalance

Liquidity matters to you in at least three areas:

- Setting asset allocation policy
- Thinking about risk management
- Being opportunistic in the provision of liquidity



# Conclusions (continued)

The liquidity risk premium is like air

Systemic reduction in asset liquidity: Implications

- Secondhand smoke
- Tipping point
- Tipping point determinants
  1. Size/duration of market shock
  2. Cashflow demands
  3. Size of illiquid allocations

# Disclosures

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# Thank you

