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Complacency affirmed, But will Liquidity be the new prize?

February concluded with a stumble across world stock markets, rolling in one day from a nearly 9% drop in China to a 3.5% fall in the S&P 500. The stumble itself concerns us less than does the popular reaction to it.

Investor and media response seemed paradoxical, at once jumping to overblow the magnitude of the fall while taking a peculiar comfort in it, as if to say, "The sky has fallen! The sky has fallen! ... Well, jolly good, at least we've got that bit of worry out of the way."

Losing 3.3%-4.0% in a day (depending on index) is unpleasant indeed, but hardly a five sigma event. Altogether, February 27's spasm undid a scant three months' gains on the Dow, NASDAQ and S&P 500. Hardly a drubbing to mark the end of one bull cycle and lay in a bottom for the next, yet that's how some seemed to respond – even as investors and pundits lamented the hardship endured, they soon got back to buying again. It's ok, they concluded, because we've had a good scare thrown into us, and any further pain will be quarantined in the grubbier corners of speculation.

So have we seen the end of complacency? On the contrary, complacency has been reaffirmed. Credit spreads remain tight, liquidity remains easy, and notwithstanding a pummeling in the subprime mortgage arena, the markets haven't unraveled.

So let me say a few things: 1) The sky has not fallen. 2) The weather may yet get stormy. 3) Investing in marketable assets means facing market risk (it's part of why they tend to pay more than cash in the long run). 4) Volatility itself does not fully describe risk; needing cash and not having it is a closer definition, so if you need cash, confirm that your portfolio is set up to deliver it.

This point about cash needs exploring. If a single cliché embodies the market economies of the last half decade, it's this: "A world awash in liquidity." Gosh knows, I've uttered such words myself. But when a phrase becomes accepted as paradigmatic, as this one has, its days are numbered.

Liquidity can evaporate fast. How can this be, when there are still so many dollars out there in corporate coffers, in foreign nations' reserve accounts, in hedge, private equity and mutual funds? How can liquidity dry up when there seems to be so much cash across the system?

Two answers. First, cash is a necessary *but not sufficient* precondition for liquidity; liquidity is better described as being *cash imbued with the intent to MOVE*. If cash owners decide to sit still rather than converting to assets, liquidity shrinks. Thus market liquidity depends on the *willingness* of a marginal bidder with access to cash.

Second, the post-millennial sources of cash have been increasingly financial rather than productive. By this I mean that more of the liquidity pumping into the markets of late has originated not from truly generative processes (physically transformative or value-adding) but from mutual consent across nations and institutions and individuals, namely a persistent comity of willing financiers abetting willing investors by ever more finely engineered and complexly structured instruments.

This gets to the *ability* of the marginal bidder to fund his purchase. Increasingly it depends on the *willingness and ability* of a financier. What happens when the financier is no longer so inclined, or has imploded or been delisted? What happens if comity falters or complexity fails?

Well, the system locks up. Liquidity itself – so cheap of late – becomes the prize.

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