Robins Advising

An Idea Worth Considering…

Liquidity and Bathing Suits

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Warren Buffet once said, "You only find out who is swimming naked when the tide goes out." He was referring to the fragility of some investors during market downturns. His words are instructive in looking at investing both during the Covid pandemic and beyond it.

The Covid crisis began in the first quarter of 2020, causing dramatic drops in equity markets across the world. Many clients experienced a rash of margin calls. Those not wearing a bathing suit, so to speak, were exposed to volatility and were often forced to sell at depressed levels to cover loan positions. In many cases, banks proactively sold client positions to cover shortfalls without consultation. It was not a pretty picture, leaving many portfolios depleted and relations strained. Keeping a close eye on liquidity was key to weathering that storm.

As we now know, markets quickly recovered, reaching spectacular highs, restoring and creating significant wealth for clients able to take part in the recovery. Using Buffet's metaphor, we still find ourselves at high tide, which *begs the question* of what we can do now to ensure that we are not exposed when low tide returns.

Two of today's most important investment trends make it imperative both that advisors gain a clear understanding of their clients' liquidity needs and that they gauge their clients' ability to accept and weather volatility. It is this understanding that must guide the investment decisions being made.

As we move towards the end of the 3rd quarter of 2021, markets are at historic levels, and yet there is still broad consensus that value can be found in being fully invested. Clients today can benefit from the ongoing plentiful supply of inexpensive, virtually free cash, which makes borrowing to invest quite attractive. They can employ leverage to enhance the already high market returns, with impressive results in many cases. Private banks have seen margin loan volumes to private clients rise to high levels. Such strategies make perfect sense, until the tides goes out.

In addition to leveraging portfolios, another important investment trend to improve returns has been to diversify holdings away from public markets and into private investments, including private equity, real estate, and other private debt instruments. The so-called "endowment model" has gained a lot of interested adherents, driven higher portfolio allocations to private investments, and has created a lot of value along the way. Some of the leading private equity firms, such as KKR and Blackstone, have conducted surveys of UHNW families and found – not surprisingly - that these families wanted to buy exactly what they were selling. Large wealth managers, such as UBS, have also been advocating the endowment approach, both for diversification and to hold investments that outperform public markets over the longer term.

I advocate the endowment approach: I think there is a lot of value to be found in private investments, particularly as public markets become quite expensive. I offer three suggestions in this regard:

First, within the private investment space, there are a lot of diverse opportunities, with many of the most attractive funds and other investments either difficult to access or demanding high minimums that prevent many clients from entering. This places a key responsibility on advisors to screen and select the right investments, as well as to find ways to access the sought-after funds. Private investments can themselves be expensive and not easy to value, so proper advice is essential.

Second, since many private investments are designed with lock-ups and/or significant penalties for early withdrawals, taking early redemptions may prove both costly and could also erase any potential gains they might offer.

Third, as private investments in a portfolio increase, reporting and monitoring become essential to understand both performance and the liquidity dynamics of the portfolio.

Taken together, using leverage and allocating to private investments can enhance returns and yet also impact liquidity. This *begs the question* of how clients can avoid being caught without a bathing suit when the tide recedes. Let me offer a few thoughts. First, there are indications that interest rates may soon begin to rise in some markets, and that liquidity may begin to tighten. This will not happen suddenly nor uniformly. The US seems likely to take the lead, while the ECB seems likely to move more slowly. Such rate hikes would have implications for the respective equity markets in the US and Europe, as well as for leveraged positions in dollars versus euros. Advisors need to follow these trends and to understand underlying exposures.

Markets do seem quite robust at present, and forecasts are generally positive as regards their trajectory. However, since we do not have a crystal ball, as regards rate and market movements, we must ensure that clients are well positioned in terms of liquidity to handle any margin pressures, to remain invested in their private holdings, and to weather inevitable changes in economic conditions. Put simply, *we can sometimes predict what might happen, but we can always prepare for what could happen*.

This may seem obvious to many of you who are reading this, and if so, that is great. Experience shows time and again, however, that this basic principle is often overlooked. When conditions change, they can expose clients to unpleasant surprises. And when corrections do occur, lenders are often less patient and less open to individual client circumstances as margin pressures grow.

In early 2020, a lot of people were left swimming naked, and it was not a pretty sight. As we move towards 2022, there is the potential for similar problems to arise, albeit for different reasons. There are terrific opportunities today to enhance returns through leverage, as well as through excellent private investments. So long as we keep an eye on liquidity, it is much more likely that clients will have their bathing suits on, and this is a good thing for everyone.