Weekly Digest
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Investec
Wealth & Investment

The weekly insight into world stock markets

# Lobster Pots

Liquidity is something that I often comment on, usually in the context of monetary policy and the propensity of banks to provide loans to their customers. One key reason that the downturn of 2008 turned into the Great Financial Crisis was that inter-bank funding dried up almost completely in the absence of mutual trust, and it was ultimately the function of central banks to fulfil their duty to be the "lender of last resort". Subsequently we have had various iterations of Quantitative Easing (QE), the liquidity from which has played a large part in boosting the valuations of financial assets. The reversal of QE, known as Quantitative Tightening, was complicit in (although not uniquely responsible for) the sharp falls that we witnessed in equity and credit markets last year. Central bankers are still wrestling with the consequences and what to do next.

The other element of liquidity that is mentioned less often, but which can also have a profound impact on portfolios, is market liquidity, or the ability to execute trades in a timely and price-sensitive manner. This has been thrust into the spotlight in the last week owing to the tribulations of Woodford Asset Management. Not only has the eponymous founder Mr Woodford, struggled to be able to sell down positions in his portfolios, but he has also had to take the extreme measure of preventing investors in one of his open-ended funds from cashing in their holdings, allowing him to maintain at least some control over his need to raise cash. Thus the reference to lobster pots, which are designed in such a way that the crustaceans can easily get in – often attracted by tempting bait – but can't get out again. It is not appropriate for me to pass judgement on the situation, but it is notable that the Chief Executive of the UK Financial Conduct Authority is already proposing (or should that be admitting) that regulations will have to be tightened.

Some of Mr Woodford's problems arise from his investment in unquoted companies for which there is, consequently, no open market in the shares. Unquoted investments are not necessarily more risky, but have certainly not been subjected to the wider scrutiny required of their quoted peers on their introduction to public markets. One attraction of unquoted investments is that they can offer higher potential returns owing to the very fact that there is a limited market. This extra element of return is known as the "illiquidity premium". Investors can expect to be offered the same premium for locking up their investments for a long period of time, for example in Private Equity, which will often require funds to remain in place for at least five years. Many hedge funds operate along similar lines to avoid being forced to sell out of positions just because markets are going against them in the short term. However, as you might imagine, forced selling can create havoc with prices.

Much of what I have mentioned here concerns private or off-market activity. However, the warning must be made that public markets are also under liquidity strain. The best documented observations come from the credit markets. Huge issuance of corporate bonds has been a feature of the post-financial crisis world thanks to QE, which has squeezed investors out of government bond markets in search of higher yields. At the same time, tighter regulation and greater capital constraints have massively curtailed the ability of investment banks to hold the inventory which used to form a buffer when sellers were in the ascendant. Thus even small amounts of selling can have a disproportionate effect on prices. Some forecast that credit is the "next sub-prime" and will trigger another financial crisis, although we would point out that despite the quantum of corporate debt, much of it is held by genuine investors and not on the balance sheets of banks. Neither has it been wrapped up and repackaged into highly leveraged derivative products. So, yes, investors will take the hit in a downturn, but it shouldn't take down the banking industry this time. Even so, we can expect more volatility in this asset class.

The same is true of equities. Although overall market volatility, as measured by the VIX Index, remains low by historical standards, the "volatility of volatility" has actually risen. It is also noticeable that individual stocks seem more sensitive than ever to news flow, especially when it's bad. In a fascinating note, Matt King, the Credit Strategist at Citigroup, has tried to work out what's going on. He eliminates influences such as volatility-selling strategies (too small), or reduced uncertainty (just not so), and points the finger at QE (not surprisingly), reduced liquidity and herding. I find the latter factor very interesting, as herding is implicit in the stupendous growth of passive index investing and also the popularity of Exchange Traded Products. The fact these are deemed to be a good thing in that they "democratise" returns for smaller investors does not necessarily encompass the risks of pricing distortions.

Mr King's key point is that "price discovery" is only properly tested in times of stress, and then there can be a huge gap between the old price and the new price. He uses the nice analogy of a brick being pulled by an attached piece of elastic. It takes a long time and much effort to overcome inertia, but look out when it starts moving! Put in more financial terms, the market no longer prices risk continuously, but only when forced to do so by sellers. The challenge for us as investors is twofold. First we have to do our best to anticipate when assets are vulnerable to repricing and take appropriate evasive action. Second, when inevitable and unavoidable dislocations do occur we need to understand what is justified and take advantage of any mispricing that is purely the result of market inefficiency.

**John Wyn-Evans**
Head of Investment Strategy

## FTSE 100 Weekly Winners

| | |
|---|---|
| British American Tobacco | 9.2% |
| Imperial Brands | 8.3% |
| Evraz | 7.7% |
| BT Group | 6.9% |
| Rolls-Royce | 5.7% |
| Fresnillo | 5.7% |
| GVC Holdings | 5.4% |

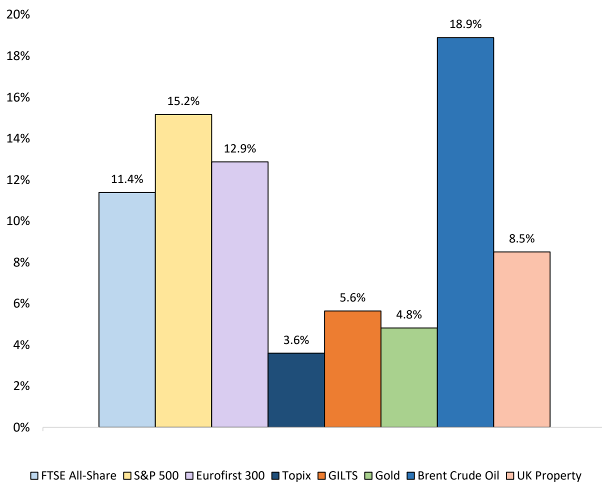
Source: FactSet

## FTSE 100 Weekly Losers

| | |
|---|---|
| Hargreaves Lansdown | -14.4% |
| Ocado Group | -6.8% |
| Royal Mail | -4.5% |
| NMC Health | -2.4% |
| Kingsfisher | -2.1% |
| Marks & Spencer Group | -2.1% |
| Just Eat | -2.1% |

Source: FactSet

## Year to Date Market Performance




Source: FactSet

## FTSE 100 Index, Past 12 Months

Source: FactSet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