Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

An Illusion of Liquidity

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In a world that is increasingly enthusiastic about the future, it is always useful to test the portfolio against potential downside scenarios. One of those is a significant drying up of liquidity. Such a scenario is not entirely inconceivable given that major central banks will start winding down a $10 trillion excess balance sheet over the next few years, the Chinese have reversed their positive credit impulse of +3% of global gross domestic product in 2014-2016 to -3% in 2017, rates are rising from zero, and the U.S. deficit of $1.3 trillion needs to be financed by the markets.

The question is where the pain from a liquidity crisis would be felt the hardest. In 2007/2008, it was at the banks. That is a lot less likely this time around, not only because the banks are better capitalised but also because they have changed their attitude to risk. A great example is the Credit Suisse VelocityShares Daily Inverse VIX Short-term ETN, which gained notoriety by losing 96% of its value in the recent spike in equity volatility. The remarkable thing is that Credit Suisse did not sustain material financial loss from this value destruction—except for the loss of a nice little income stream and some reputational damage. The bank also did its utmost to protect itself from litigation claims through strongly worded risk statements in the prospectus—which is well-worth a read.[1]

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"If not the banks, where is the problem most likely to occur?"

[1] Source: Bloomberg L.P. From the prospectus of Bloomberg ticker XIV US EQUITY: *"As explained in "Risk Factors" in this pricing supplement, because of the way in which the Closing Indicative Value of the ETNs and the underlying Indices are calculated, the amount payable at maturity or upon redemption or acceleration is likely to be less than the amount of your initial investment in the ETNs, and you are likely to lose part or all of your initial investment. In almost any potential scenario, the Closing Indicative Value (as defined below) of your ETNs is likely to be close to zero after 20 years, and we do not intend or expect any investor to hold the ETNs from inception to maturity."*

If it is not the banks, where is the problem most likely to occur? Liquidity is a bit like a New York rooftop bar. Whilst the night is balmy, people come up the elevator in small groups. When it suddenly starts to rain, everyone tries to get into the lift at one time, most of them already quite inebriated. The biggest crunch is likely to be in the most popular rooftop bars.

Since 2008, exchange-traded funds (ETFs) and other quantitative products have clearly been pulling in the punters. In 2007, MSCI World "index style" holders, as defined by FactSet, held on average 4% of the free float in the companies we hold. Today, it is 12% and unevenly distributed.[2] In some names, index funds hold up to 25% of the shares.[2] There is little experience of how these vehicles would behave in a sustained downturn, but what we have seen in recent flash crashes is that some of the vehicles sold off significantly more than their underlying assets.[2] That may have to do with two factors: one is the relative ease with which these funds can be sold, even by retail investors, and secondly, the investment banks that manage the redemption and creation of the ETFs will require a very large spread before they can take the arbitrage risk during a sell-off.

Hence, it is likely that in a material liquidity shortfall, ETFs may sell off further than the underlying holdings, dragging down the underlying holdings below their fundamental values. The effect is likely most significant where the underlying holding is a lot less liquid than the ETF itself, namely, in corporate bonds. The Bank for International Settlements highlighted this issue in 2015, pointing out that bond ETFs provide an "illusion of liquidity" that is doubly hampered, first by the ETF market makers' unwillingness to trade[3] and furthermore by the shrunken inventory and risk appetite of market makers in the corporate bond markets. Whilst the bond market is likely the most challenged market in a liquidity squeeze, there are concerns about equities as well, particularly where the ownership of the stock is dominated by index-style products.

> "In the event of a liquidity crisis, the combination of relative operating outperformance and relative derating should provide us with attractive potential investment opportunities."

We have always taken liquidity into account when deciding whether a stock enters a portfolio and with the size of the position. With this in mind, we reviewed the share of index-style funds amongst the holders of companies. While we may experience some temporary setbacks in a liquidity scenario where ETFs sell off heavily, we would regard such a relative sell-off as a potential investment opportunity.

In the real world, liquidity constraints predominantly create problems for companies with material financial and operating leverage. More specifically, companies that have to refinance their debt will struggle in this scenario, as they did in 2008/2009, forcing them to cut dividends, sell their family silver and/or raise equity at the most dilutive moment. Quality companies, as we have been defining them for the last 20 years, have robust balance sheets and the ability to fund their growth mostly out of the existing cash flow. By being less susceptible to negative operating leverage, absolute earnings performance should remain stable, and relative outperformance should be significant in such a scenario. There is also a lot less probability of financial distress for the companies in our portfolio. In the event of a liquidity crisis, the combination of relative operating outperformance and relative derating should provide us with attractive potential investment opportunities.

[2] Source: https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-us-equity-market-structure-october-2015.pdf

[3] Source: https://www.bis.org/publ/arpdf/ar2015e.pdf

RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

INDEX INFORMATION

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

DEFINITIONS

An **exchange-traded fund (ETF)** is a marketable security that tracks an index, a commodity, bonds or a basket of assets like an index fund. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold. ETFs typically have higher daily liquidity and lower fees than mutual fund shares, making them an attractive alternative for individual investors.

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