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- **Illiquidity issues** – considerations when managing cash during volatile markets and in the face of contribution breaks

The increased uncertainty triggered by the spread of COVID-19 has led to unprecedented levels of financial market volatility, which has reduced liquidity and subsequently increased the transaction costs for buying and selling assets. At the same time, lock-down measures implemented by authorities across the world have put considerable strain on corporate cash flow, which increases the probability of sponsors requesting a suspension of deficit repair contributions into their pension schemes. This note explains why the loss of deficit repair payments, coinciding with reduced liquidity, should be a concern for trustees, given it can have implications for the cost of funding benefit payments.

If a scheme receives deficit repair contributions, they are typically used to pay pension benefits each month, as opposed to being invested (unless the scheme is cashflow positive, which is increasingly rare these days). This means it's unlikely that pension assets would need to be sold to raise cash, and this has two advantages; one it saves on transaction costs, and two it means there are more assets earning return to help close the funding gap. So if deficit repair contributions were suspended, schemes may suddenly experience frequent requests for cash, and be faced with difficult decisions regarding when to sell assets (given this will potentially crystallise losses) and, given lower liquidity, which assets to sell to ensure the damage of transaction costs are minimised as much as possible.

The term ''liquidity' refers to the ease with which an asset can be converted into cash. When investors turn risk averse, this typically means riskier assets fall in value. Volatility is highest if this process happens very quickly or regularly, because it results in surges of panic selling. If everyone is selling, it means no-one is buying, and so it becomes difficult to transact. The same can apply when there is a surge in buying, for instance when investors pour into 'safe-haven' assets, or when sentiment suddenly improves, causing risky asset prices to rebound. This is why high market volatility is often accompanied by poor liquidity.

When liquidity is low, two things typically happen depending on the nature of the asset class being traded; either trading is not possible, or if it is, it becomes a lot more expensive. To give an example of the former, consider asset classes such as property or hedge funds. During periods of sustained risk aversion, there is a good chance of a surge in redemptions from funds that manage these types of risky assets. This typically results in redemption requests being 'gated', which means the fund manager can restrict the amount that can be redeemed, or even halt redemptions entirely. This is because the manager of the fund is simply not able to sell the underlying securities (think office building) quick enough to be able to raise the cash to return to investors. Therefore, during periods of volatility, it is difficult to release cash from some assets in a timely manner.

Other than in very extreme circumstances, gating is not common when buying or selling liquid assets, such as equity or corporate bonds. However, the cost of the transaction usually becomes

much higher when liquidity is low. To give an example, consider corporate bonds, for which dealing spreads (the difference between the buy price and the sell price) has been elevated at around 65 basis points for the past few years (compare this to large cap developed equities, where spreads are often less than 10 basis points). At the end of March, the dealing spreads for corporate bonds were around 5x higher, up to 3.5% (!) depending on the type of corporate bond. This means, if you were selling £6.0 million of corporate bonds, you would only receive £5.8 million after transaction costs - £200,000 that has disappeared forever. With costs as high as this, one might decide to sell equities instead; but they have just fallen 30%, do you really want to crystallise that loss?

These few examples suggest trustees need to think carefully about how to raise cash. I appreciate matters of liquidity will be new for many trustees, and the detail confusing. So with everything that's going on, I can imagine these concerns are not high on the trustees list of priorities. That's why I believe fiduciary management is the right way to manage pension schemes. Of course I would say that, because I work for one, but I also mean it. Fiduciary management means there is (or should be, if the fiduciary manager is any good) a portfolio manager dedicated to monitoring the assets on a daily basis, and managing liquidity risks. I have seen, on many occasions, that significant money can be saved as a result of proper care and attention when it comes to managing liquidity, and making informed decisions on when and what to trade. By being smarter about execution, it's very easy to completely offset the added costs of fiduciary management i.e. all the benefits of fiduciary management, and for free. We understand that every pound saved in efficient execution is a pound that doesn't have to be paid by the sponsor, or earnt in return, which is why we take it so seriously.

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