

The Surprising Bond Between CAPM and the Meaning of Liquidity

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Liquidity is a hot word these days. But liquidity is an elusive concept. One day it is a glut, and the next day it is seized up. We have had a mishmash of definitions of liquidity, ranging all the way from money in the bank to a state of confidence. Keynes liked to refer to “liquidity preference,” but now we have private equity whose charms arise explicitly because the equity is no longer liquid. When quantitative asset managers talk about their models, they know that there is an important omitted variable: “liquidity.” In the postmortem of many one-time high-flying hedge funds, liquidity is the omitted variable that sunk 'em.

Here are some odd thoughts about liquidity. Perhaps these notions may confuse the issue, but you might also find them enlightening.

We seldom think about liquidity in terms of the Capital Asset Pricing Model, but CAPM reveals the true nature of liquidity. The more liquid an asset, the greater the dominance of systematic risk over specific risk. Indeed, systematic risk is a precondition of liquidity. Money is the most liquid asset of all, and when the price level changes, every single unit of money, in paper or on the books, will lose or gain value. Neither the amount of money nor its form matters. The further we move away from money, from Treasury paper to Aaa corporates to high-yield and junk, from large-cap equities to small-caps to private equity and to works of art, the more specific risk we take on. And the more work we have to do before we are willing to own the asset.

Here is a conundrum. If systematic risk is by definition non-diversifiable, why is liquidity—the paragon of systematic risk—so desirable that its required return is below the required return on any other asset? I offer two answers to explain the low returns on liquidity despite the lack of diversification. First, you may actually need the money at some point, so you have no choice in the matter. Second, you are lazy.

Lazy? I am not being facetious. If all of us—and I mean all of us—were less lazy, we could probably manage fine without liquidity.

Consider money. Money beats bartering, because barter requires research into the nature of the item being offered in an

exchange. With money, any penny or dime or dollar bill or checking account serves as well as any other for making payments denominated in dollars. It was not always thus. Once upon a time, before deposit insurance, before the Federal Reserve, and before the national banking system, all instruments purporting to be means of payment were not the same. Banks with less than impeccable financial statements were non-par banks, whose banknotes or customers' checks traded at less than face value. These discounts provided compensation to the holder for the research required before accepting such instruments in discharge of debts. In those instances, everyone was a bank examiner. Note how we need more research as we go down in liquidity from Treasury paper to Aaa corporates to Baas and to junk. It follows that the rating agencies contribute (or at least have contributed) to market liquidity because they spare investors the trouble of carrying out their own credit research.

And stock indexes. How much research do you need to buy an S&P 500 index fund or futures as compared with the research you would have to do if you wanted to pick and choose just a few among those five hundred stocks? No wonder the five hundred together are more liquid than any one or even ten of them—and in this case diversification comes along for the ride. No research!

The more liquid the asset, the more that liquidity means WYSIWYG—What You See Is What You Get. The values of all assets with so much similarity move up and down together, because they are interchangeable with one another. When it comes to the most liquid kinds of assets, such as money or Treasury bills, *liquidity and systematic risk are one and the same thing.*

I am not just playing with words and concepts. On the one hand, the lower the degree of diversification among its individual components, the more liquid an asset class. On the other hand, liquid assets offer relief from doing homework, and that makes them desirable and worth owning even though they offer low expected returns along with the risks of no diversification. Like it or not, relief from homework, or, to be more blunt, the appeal of laziness, appears to be a more compelling quality than the inability to use diversification to manage the systematic risk in liquid assets.