The Joy of Illiquidity

By Editor Test *Tue, Mar 9, 2010*

The legendary Roger Ibbotson told money managers that there's hidden gold in low-turnover stocks.

Illiquidity was a prime suspect in the recent financial crisis. So it was curious to hear someone praise the virtue of illiquidity at the annual Morningstar/Ibbotson Conference in Orlando last week.

But when Roger Ibbotson talks, people listen.

The Yale School of Management professor, who founded the research firm of Ibbotson Associates in 1977 (and sold it to Morningstar Inc. in 2006), also has a nine-year-old hedge fund, Zebra Capital. One of its raison d'êtres: to exploit the "illiquidity discount."

"We short all the exciting stocks," the lanky, 66-year-old Ibbotson joked as he described Zebra's preference for stocks with healthy earnings but very low trading volume and low prices.

Illiquidity, either in stocks or in bonds, should be viewed as an investment style distinct from capitalization, value/growth, maturity or credit risk, he said in plugging the Milford, Conn.-based Zebra Capital's services.

Overlapping with the universe of alternative investments, these low-turnover assets include private real estate, distressed debt, hedged equity, natural resources, commodities, private capital and emerging market equities, Ibbotson said.

"Liquidity seems to have an impact on realized and expected returns across all types of securities and across all locations," Ibbotson and Yale colleague Zhiwu Chen wrote in a June 2008 paper, "Liquidity as an Investment Style."

 "Liquidity is valuable in any security, and the market seems to be willing to pay a high price for it," they wrote. "Correspondingly, the market accepts a lower return for liquidity. Liquidity seems to be an investment style that is different from size or value. This result seems to hold up in almost any equity market subset and in any location."

The flipside of the illiquidity discount is the liquidity premium. That is, investors are generally willing to pay more for a stock or bond that, for one reason or another, offers the kind of liquidity reflected in high-volume trading.

For any given size or style, the more illiquid the stock, the higher its historical (1972 to 2009) compound annual return, Zebra Capital's research shows. Even among value stocks and small-cap stocks, the illiquidity discount appears to boost performance by an extra point or two. (See Data Connection on today's homepage.)

Over those 37 years, for instance, the least liquid of the smallest small-cap stocks outperformed the most liquid, 17.87% to 5.92%. The least liquid of the largest large-cap stocks outperformed the most liquid, 12.29% to 9.46%.

Looking at value vs. growth stocks, the least liquid of the value stocks outperformed the most liquid, 20.63% to 12.33%, and the least liquid growth stocks outperformed the most liquid, 11.36% to 3.32%.

While high liquidity small-cap stocks underperformed high liquidity large cap stocks, 5.52% to 9.46%, high liquidity value stocks outperformed high liquidity growth stocks, 12.33% to 3.32%.

(Data showing whether or not these relationships held true during time periods smaller than 37 years was not immediately available.)

Much of Ibbotson's talk was aimed at explaining portfolio behavior in the financial crisis. Contrary to conventional wisdom, he said, diversification in stocks and bonds worked during the crash—it just didn't work as well as people expected it to. But a mix of stocks and bonds offered significant portfolio protections, as expected. "Stocks and bonds are great diversifiers," he said.

Diversification within asset classes doesn't work as well as most people assume, Ibbotson said. Many investors still misinterpret the famous 1986 Gary Brinson study on variations in pension fund returns to mean that differences in asset allocation account for 90% of portfolio returns.

In reality, systematic risk (also known as market risk, aggregate risk or un-diversifiable risk) accounts for as much as 70% of a portfolio's returns, he said. Asset allocation, as commonly understood, accounts for only about 16% of returns.

"People don't understand that diversification doesn't take away the 70% caused by the market," Ibbotson said. "That's why they're asking, 'Why didn't diversification work in 2008?'"