Is there a need for a Chief Liquidity Officer?

Liquidity risk can be more damaging to portfolios than volatility risk. That's why institutional funds need dedicated liquidity management, especially at the overall fund level and over a long horizon.

By *Dr. Michelle Teng*

We have all been trained to regard return volatility as the main measure of portfolio risk. Relying on well-established multi-factor risk models, VaR models, credit default models and their own hard-earned experience, most institutional fund Chief Investment Officers (CIOs) have a good understanding of their portfolio's ex ante return volatility.

Often, assisting the CIO is a Chief Risk Officer (CRO), dedicated to measuring and monitoring the portfolio's volatility as market conditions change and as new asset types are added to the portfolio. The CRO is also responsible for alerting the CIO whenever portfolio risk guidelines are violated. Some funds consider the CRO's role so important for good risk control and fund governance, that the CRO may report directly to the fund's CEO, not the CIO.

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Controlling ex ante volatility risk is an effective way – although not guaranteed – to avoid large unexpected negative returns, either negative absolute returns or negative returns versus a benchmark, which are certainly key CIO concerns.

Yet, for long-term institutional investors, volatility risk is rarely life-threatening. Volatility comes and goes. Importantly, volatility events generally don't require that a CIO immediately sell assets to raise cash.

Although volatility events may increase ex ante portfolio volatility estimates, the CIO can usually, if required to return to a risk target, rebalance risk exposures over time and minimise the cost of any rebalancing using liquid derivatives. In the face of volatility spikes, the CIO's worry isn't about raising cash, but being able to ride out the event and avoid a costly rapid portfolio de-risking that requires selling risky assets usually after the market has already declined.

Consequences of a ‘cash spike’

However, there are events that can threaten a fund's survival: a sudden need to raise cash, that is, a ‘cash spike’. A CIO unable to meet their cash obligations is faced immediately with an unavoidable and usually distasteful task: portfolio assets must be sold and willing buyers must be found.

While asset volatility could lead to a cash spike, there are other causes of cash spikes that may arise from other areas within or outside the fund. The challenge for the CIO is the integration and management of the fund's overall liquidity risk.

Unlike volatility risk, liquidity risk forces the CIO to make unattractive and costly portfolio decisions. Given the potential greater severity of liquidity risk versus volatility risk, the key question for a CIO is whether their organisation

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has the skills and clearly defined responsibility to manage the fund’s liquidity risk.

What makes fund liquidity management distinct from a typical CRO’s portfolio or asset risk orientation? Firstly, it is the need to integrate all aspects of a fund’s liquidity demands and sources: top-down asset allocation, bottom-up private market deal-making activities, and internal and external operations. Secondly, it is the need for a long horizon in a world brimming with large and growing portfolio allocations to illiquid private assets.

A long horizon perspective

To integrate all liquidity demands and sources across the entire fund, liquidity management needs a long horizon perspective, much longer than typically required for many asset volatility risk scenarios. Given the possibility of government policy changes, a fund needs to monitor the liquidity consequences of large external liquidity demands.

For example, some government groups are encouraging plans to bolster retirement outcomes and support national economic growth by embracing illiquid private assets, while – at the same time – other government groups are proposing to give pension owners more ‘pension freedom’ to access pension assets. Both sets of policies would work to exacerbate fund liquidity risk. These policies should naturally pop up on the radar of the liquidity management team.

CIOs have learned the hard way about the unanticipated consequences of well-intentioned government policies. For example, UK regulators aspiring to minimise funds’ funding volatility encouraged funds to invest in LDI strategies that use leverage to extend asset duration to better match liability duration. However, only a few funds thought through the liquidity implications – massive cash variation margin calls and forced selling of assets – of a gilt sell-off as occurred in September 2022, ironically instigated by the government itself.

Opportunity to enhance performance

Just like a robust traditional risk function will monitor and keep at hand a list of effective hedges against market movements, a best-in-class liquidity management role should identify, evaluate, and keep at-the-ready possible external liquidity facilities. A comprehensive cost-benefit analysis would help the CIO determine whether a particular liquidity facility, and what size, might be useful.

A strong liquidity management role would also quantify the sensitivity of a fund’s liquidity risk in alternative situations – just like what a CRO does for different adverse market scenarios. For example, how would the portfolio’s performance and liquidity risk change with a 10-percentage point higher allocation to private equity? Crucially, a portfolio’s liquidity risk doesn’t necessarily increase linearly with allocations to illiquid assets.

Importantly, high-quality liquidity management can enhance portfolio performance beyond just helping the portfolio avoid liquidity events. Oddly enough, it isn’t uncommon to find that some funds currently have more liquidity than they need, which could be invested elsewhere to enhance expected portfolio returns. A liquidity management team should be able to identify this hidden opportunity cost, measure any excess liquidity and have a plan on how to put it to work.

Given the importance of liquidity management, why don’t we observe many funds with a dedicated liquidity management team, or perhaps even a designated Chief Liquidity Officer? While a new and separate liquidity management role may generate cumbersome organisational overlaps and internal confusions within a fund, the long-term benefits are likely worth any added effort and stress. Ultimately, it is a fund’s decision whether now is the time to either appoint a Chief Liquidity Officer, beef up liquidity management expertise and analytics, or confirm and validate that the existing investment and risk management teams can adequately analyse, monitor, and manage overall fund liquidity. ■

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SUMMARY

Given the growth in illiquid asset allocations, good portfolio liquidity management must integrate a fund’s liquidity demands and sources over a long horizon and measure the consequences of large external liquidity demands, especially in adverse markets.

A strong liquidity management role would quantify a fund’s liquidity risk across many scenarios and identify at-the-ready external liquidity facilities.

High-quality liquidity management can enhance portfolio performance by recognizing the opportunity cost of holding too much liquidity.

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