ATLAS
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Subject: The Importance of Liquidity in Investment Portfolios

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Imagine being at an auction, bidding on a rare painting. Suddenly, a lost Monet comes up for bid—but the money you need to purchase it is tied up in real estate or a private equity fund. You have to watch someone else walk away with the deal. This scenario illustrates the critical importance of liquidity in an investment portfolio. Liquidity, or the ease with which assets can be converted into cash without affecting their value, offers investors a sense of control, flexibility, and the proactive ability to seize opportunities or address emergencies. In the current economic environment, where short-term interest rates are high and illiquid investments face greater volatility, the benefits of building a liquid portfolio are even more pronounced.

Defining Liquidity: A Crucial Safety Net for Investors

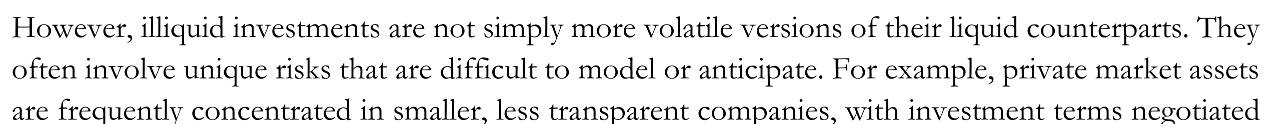
Liquidity is the ease with which an asset can be quickly converted into cash at its fair market value. Highly liquid assets, like cash and publicly traded stocks and bonds, can be sold within days without a significant discount to their value. In contrast, illiquid assets—like private equity, real estate, or business ventures—require much longer to sell and often at a substantial discount if sold under duress (Thrivent, n.d.; Shen, 2018).

Having a significant portion of your portfolio in liquid assets allows for greater financial flexibility. This flexibility becomes especially important during times of economic uncertainty, providing a strong reassurance that you can meet your short-term needs without being forced to sell illiquid holdings at a disadvantage. And when unexpected opportunities or emergencies arise, this reassurance can make all the difference in your investment strategy. Liquid assets are not just a tool for financial flexibility but a source of confidence in your investment decisions.

The Illiquidity Premium: Higher Returns at a Price

The appeal of illiquid investments lies in their promise of higher returns. Investors are often rewarded with an 'illiquidity premium' for committing their funds for extended periods. This premium is a result of the added risks and limitations associated with illiquid assets. In simpler terms, it is like getting a higher interest rate on a fixed deposit that you can't withdraw for a certain period. For example, private equity and real estate investments often take years to mature, during which investors have limited flexibility to adjust their portfolios.

However, illiquid investments are not simply more volatile versions of their liquid counterparts. They often involve unique risks that are difficult to model or anticipate. For example, private market assets are frequently concentrated in smaller, less transparent companies, with investment terms negotiated



privately and outcomes dependent on a few key individuals (Shen, 2018). These investments might deliver high returns in certain conditions but also carry significant risks, particularly during economic downturns (CD Wealth Management, 2022).

Risk-Adjusted Returns: A Complex Trade-Off

Illiquid assets such as private equity and venture capital often promise higher returns. However, they come with a price—lower flexibility and higher risks during market volatility (National Bureau of Economic Research [NBER], 2004). Many institutional investors find this trade-off appealing, as the potential for higher returns outweighs the lack of liquidity. However, this lack of flexibility can become a liability for individual investors or those who need regular access to their funds.

As research from the National Bureau of Economic Research (2004) suggests, illiquid assets can suffer significantly during market downturns or crises, and investors may find selling them at reasonable prices difficult. The 2008 financial crisis, for example, saw widespread "flights to liquidity," where investors rushed to convert illiquid assets to cash, often at substantial losses. Such situations highlight the importance of maintaining a balance between liquid and illiquid investments.

Liquidity in a Portfolio: Protection Against Uncertainty

Maintaining a significant portion of liquid assets in a portfolio is not just about being prepared for emergencies but also about capitalizing on opportunities. In times of economic downturn, liquid assets allow investors to buy undervalued securities, real estate, or other investments when prices are low. Moreover, investors holding liquid positions can respond quickly to market changes, rebalancing their portfolios as needed (Shen, 2018).

At Atlas, we advocate for a balanced approach that includes both liquid and illiquid assets. While real estate, private equity, and other illiquid investments have their place, the benefits of liquidity cannot be overlooked. Liquid assets provide a buffer, ensuring you can access funds when needed without selling investments at an unfavorable time (CD Wealth Management, 2022).

Short-Term Rates: Attractive Opportunities for Safe Money

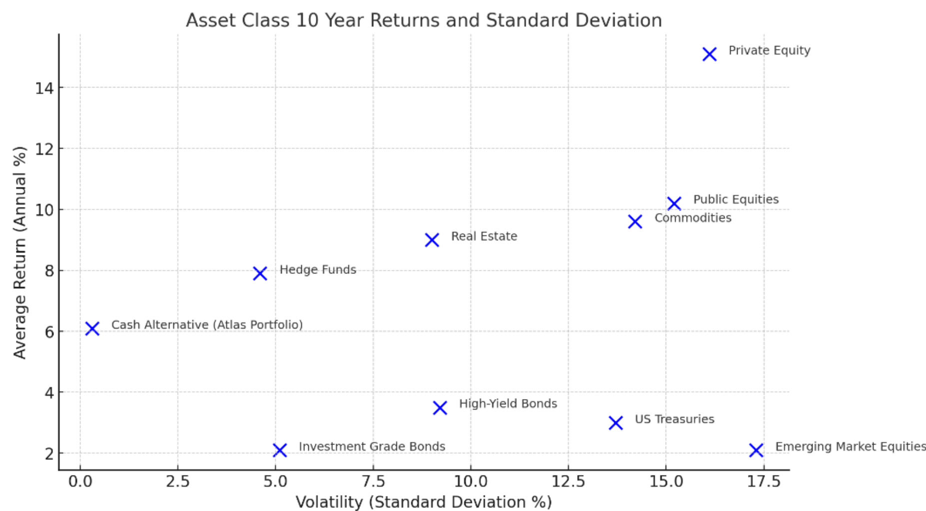
Currently, liquidity offers the advantage of generating substantial returns even on traditionally conservative investments. With short-term interest rates at historically high levels, investors can achieve attractive risk-adjusted returns on liquid assets. For instance, our Cash Alternative portfolio delivered over 5% returns in 2024, with a low standard deviation of just 0.33%, compared to the 2.1% standard deviation of US Treasuries. This highlights the potential for liquid, low-volatility assets to provide competitive returns while preserving portfolio flexibility, underscoring the importance of maintaining liquidity in your investment strategy.

These high yields allow investors to keep money in liquid assets without sacrificing returns. This contrasts with the past, when liquid assets like money market accounts or Treasury bills offered meager yields, tempting investors to seek higher returns in illiquid investments. The current interest rate environment allows liquidity to be balanced with solid returns (CD Wealth Management, 2022).

Strategic Asset Allocation: Balancing Liquidity and Illiquidity

Finding the right balance between liquid and illiquid investments is one key to long-term success. Liquid assets provide flexibility, enabling investors to meet unexpected financial obligations or take advantage of opportunities as they arise. Illiquid assets, on the other hand, offer the potential for higher long-term returns but come with greater risks and less flexibility (Shen, 2018; Thrivent, n.d.).

The accompanying chart, titled "Asset Class 10 Year Returns and Standard Deviation," visually highlights the trade-offs between risk and return across various asset classes. As illustrated, asset classes like public and private equities offer higher potential returns but have significantly greater volatility, underscoring their risk. In contrast, options such as our cash alternative portfolio or investment-grade bonds demonstrate lower volatility with more modest returns, making them suitable for risk-averse investors or as great liquidity tools. This chart reinforces the importance of balancing both liquid and illiquid investments within a portfolio to optimize risk-adjusted returns while maintaining flexibility in response to market fluctuations.



Source: Morningstar Data

Institutional investors often segment their portfolios into liquid and illiquid components, allocating liquid assets to meet short-term needs while investing in illiquid assets for longer-term growth (Shen, 2018). A stylized asset allocation model can help investors determine the optimal mix of liquid and illiquid assets based on their liquidity requirements, risk tolerance, and investment goals. For example,

investors who can predict their liquidity needs with high confidence may allocate a higher percentage of their portfolio to illiquid assets, as they are less likely to need access to these funds in the near term (Shen, 2018).

Managing Liquidity Risk: A Crucial Component of Financial Planning

Even with the best planning, liquidity shocks can occur. These unexpected events require immediate access to cash, such as a medical emergency, a significant home repair, or the loss of a job. For this reason, it is critical to have a portion of your portfolio in liquid assets, ready to meet these unforeseen needs (FINRA, n.d.).

Managing liquidity risk involves maintaining an appropriate balance of liquid and illiquid investments and ensuring sufficient cash flow to cover financial obligations. Institutional investors often use models that incorporate liquidity risk into their asset allocation decisions, ensuring that they have enough liquid assets to meet unexpected cash needs while optimizing the portfolio for long-term growth (Shen, 2018; NBER, 2004).

In particular, illiquid assets may impose an "opportunity cost" on investors, as these assets cannot be easily sold or rebalanced. This means that during times of market stress or when new opportunities arise, investors in illiquid assets may find themselves locked into positions that no longer align with their investment strategy (Shen, 2018).

Conclusion: Liquidity as the Foundation of a Resilient Portfolio

Liquidity is often overlooked until it is needed, much like a spare tire in your car. You do not think about it until you have a flat, and then you are grateful it is there. Similarly, liquidity allows you to navigate unexpected bumps in the road—whether they come in the form of a financial emergency or a market downturn. At Atlas, we emphasize the importance of maintaining a liquid portfolio that provides flexibility, confidence, and the ability to seize opportunities.

While illiquid assets have their place in a diversified portfolio, striking a balance is essential. By ensuring that a significant portion of your investments are in liquid assets, you can safeguard your financial future, meet unexpected challenges, and take advantage of opportunities as they arise. In today's high-interest-rate environment, liquid assets also offer competitive returns, making them an even more attractive component of a well-rounded portfolio.

At the end of the day, liquidity is about control—control over your investments, control over your financial future, and control over the opportunities that lie ahead.

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