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How to Deal with the Challenges of Liquidity Risk Management

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Boston – March, 14, 2014 – In response to the 2008 financial credit crisis, investment firms have recognized the need for more robust liquidity risk management tools and best practices. However, due to continually shifting regulations and detailed fund and investment structures, fund of funds, endowments, pensions and institutional investors continue to struggle with liquidity management and reporting within their investment portfolios. The following dives into the liquidity risk challenges facing firms today and explains how managers are attempting to overcome these challenges.

Defining liquidity risk and its effect on funds

Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. The concept of liquidity is comprised of illiquid assets, which are the result of liquidity risk and cannot be instantly sold due to value uncertainty and lack of a market. Liquidity risk broadly refers to the concept that an asset or security cannot be traded at the rate needed to achieve returns and bypass losses.

Worldwide economic challenges such as rising liquidity costs, a more uncertain market and lower levels of market assurance have become much for prevalent in the past several years and have contributed to the liquidity management challenges facing funds today. Liquidity risk's ability to negatively impact and compound other types of risk, such as credit risk, is also worrisome for the financial markets. These consequences make it even more imperative for firms to get a handle on their liquidity risk management practices.

Hedge funds and fund of funds are directly impacted by liquidity risk. Hedge funds experience both position and fund liquidity. Fund liquidity refers to how fast the stated terms will allow an investor to exit a fund investment, whereas, position liquidity denotes how quickly the instruments employed in the strategy can be converted to cash at a known value. Typically, fund of funds offer greater liquidity than hedge funds. This is mostly due to their investment strategy, which primarily involves investing in groups of various unregistered hedge funds rather than stocks, bonds or other securities.

Linking data management to liquidity

Data management continues to be a serious challenge within many investment portfolios due to a range of issues, including complex structures, side pocket interests, gating complexities and regulations. This is due to funds' limited analytical capabilities and lack of a centralized, systematic approach to examining liquidity risk. Because liquidity has the ability to affect many other types of risk, it's important for firms to take a systematic approach to analyzing liquidity. Employing a siloed approach prevents managers from fully understanding their liquidity position on a wider scale.

The lack of efficient data management technologies has prohibited firms from accurately predicting cash flows. This has become a major problem due to harsher regulations and the struggle of keeping data up to date. As a result, firms are now using advanced financial automation platforms. Software solution providers have been able to create these platforms to systematically manage their portfolios, perform complex analytics and provide robust reporting, both internally and externally to the firm. Additionally, there has been a recent shift in the investor and allocator community that calls for cutting-edge liquidity analysis capabilities. Using this advanced platform is one way that fund of funds are dealing with the stringent requirements.

How are firms dealing with liquidity risk management challenges?
Tools like the Ledgex Platform are particularly useful when it comes to data management, which is directly linked to a firm's liquidity management practices. In order to achieve optimal liquidity management efficiency, it's critical for data to be collected, analyzed and conveyed at a variety of aggregate levels. Many funds have incurred substantial financial costs in addition to having their liquidity risk management procedures severely stalled because they haven't taken proper data management measures

These software tools also enable funds to gain further understanding of their internal liquidity management practices, therefore allowing them to achieve a greater level of operational efficiency within their technology infrastructure. An added benefit is the ability to streamline data management practices across all facets of the firm, defining its level of liquidity risk and enabling portfolio management, monitoring, reporting, and risk and compliance tasks to be run more effectively. In today's competitive environment, funds also need tools that allow them to support key requirements, including investor level gates and stacking gate support, liquidation scenario modeling, cumulative and spot liquidity analysis, hard and soft locks, and ad-hoc redemption frequencies.

Following are some frequently asked questions regarding the challenging issue of liquidity risk management:

Q: How do firms define the various forms of liquidity risk to which they are exposed?
Firms should take precautions in order to identify the various different kinds of liquidity risk that they encounter. Once these risks have been identified, they should be directed to the areas of the firm that are most affected. Transparency among members of the firm is critical to ensure that liquidity risk is correctly evaluated in current and future business endeavors.

Q: How can firms effectively execute their liquidity funding strategies?
Firms can put efficient policies and procedures in place to ensure that all aspects of liquidity funding are properly managed.

Q: How can firms measure and monitor future liquidity risk?
As well as making sure the precautionary measurement procedures are in effect, firms should make a concerted effort to predict the future cash flows of assets, liabilities, off balance sheets and liquidity rations.

Q: How can firms analyze liquidity?
Increasingly, firms are looking to applications, such as Ledgex, to deliver liquidity management functionality.

About the author

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Brian Macallister, managing director at Ledgex Systems, has been designing and working with financial services applications for 20 years. As the principal architect and product visionary of the Ledgex platform, he is responsible for leading the company's engineering, support and client service teams. Ledgex is transforming the way fund of funds, endowments, pensions and family offices manage their portfolios, make investment decisions and meet investor demands. The platform is an integrated technology suite that features four modules: Ledgex Portfolio Manager, Ledgex Manager Research, Ledgex Liquidity and Ledgex Investor Relations.