



*"Unequaled Personalized Service"*

**July 2010**

## **Market Commentary: Business Liquidity vs. Financial Market Liquidity**

Since the May 6<sup>th</sup> market imbalance, otherwise known as the “flash crash,” there has been a lot of discussion regarding “liquidity.” The term *liquidity* is frequently used in the context of the business world and the financial markets; however, the meaning or type of liquidity can vary. In this communication we differentiate between the two types of liquidity as it relates to publicly traded companies and offer our perspective as to the importance of each.

Definitions for the purpose of this letter:

- **Business Liquidity:** Access to cash or credit facilities on a daily basis.
- **Financial Market Liquidity:** Ability to convert a security to cash with minimal price impact.

### **Business Liquidity**

Business Liquidity is essential; it’s the lifeblood of all businesses. Without it inventories can’t be financed, payroll can’t be made, bills can’t be paid and the economy comes to a screeching halt. For short-term needs, companies access cash through their bank accounts, lines of credit, overnight lending, the commercial paper market or other means. Longer-term financing needs are typically met with bank loans or the issuance of securities (stock or bonds).

### **Financial Market Liquidity**

Unlike Business Liquidity, Financial Market Liquidity is not essential for businesses on a day-to-day basis. The Financial Market Liquidity of publicly traded stocks and bonds is generally good; an owner of such a security can usually sell it quickly and receive market value (less selling commissions). On the other end of the liquidity spectrum (less liquid) are real estate and closely held (think private) businesses. The selling process for both is far more complex than selling a publicly traded security and the lead time to complete a sale is often lengthy (think weeks or months versus minutes or hours). While investors are often concerned about Financial Market Liquidity, businesses typically are not—as it has little bearing on their daily operations. Investors (or speculators) don’t want to get “stuck” in a position whereas businesses are more concerned about having access to cash or equivalents.

### **Background**

While corporations need daily access to Business Liquidity, their need to access capital markets (stock/bond market) is typically infrequent (securities then trade between investors in the secondary market—stock exchanges). Arguably, neither companies nor “investors” need to see securities traded every day let alone every second or millisecond. When EBS invests in a company it’s typically with a three to five year time horizon. With this perspective in mind, we aren’t generally concerned with what transpires in seconds. “Traders” or speculators feel differently.

In September of 2008, we saw what happens when businesses lose access to liquidity. Fear had gotten so bad that banks were afraid to lend to one another (as evidenced by the spike in LIBOR—the rate at which international banks lend unsecured funds to each other). The banking system virtually came to a halt. The Reserve Primary Money Market Fund “broke a buck” when the fund’s board decided to value its short-term Lehman Brothers’ investments at zero due to the firm’s bankruptcy filing. In the ensuing state of chaos, many corporations were denied access to short-term financing. The municipal bond market froze and credit spreads widened (yields increased). Corporate bond yields rose too. This period reminded everyone why Business Liquidity is paramount. Given the generally large hoards of cash on companies’ balance sheets today, it appears that management teams took note.

In today’s market, high frequency traders (speculators) want Financial Market Liquidity and measure it in terms of “milliseconds.” While all market participants require some reasonable amount of Financial Market Liquidity, high frequency traders have transformed a marketplace designed to give businesses a way to access long-term capital into a Las Vegas style casino (not really, but you get the point). Through super-computers and sophisticated programming, trades are made on currencies, commodities, stocks and bonds, and these trades play out in fractions of a second. Organizations that conduct such activities have long argued that they provide Financial Market Liquidity and that this benefits market participants. As we saw on May 6<sup>th</sup>, when the trading volume of high frequency traders was needed most, they as a group seemingly pulled out of the market. It’s typical that many trading programs hone in on the same key variables. When one computer receives a signal to stop trading—many more do also. Given what’s known today, it’s difficult for us as investors to see what value high frequency traders bring to the capital markets.

### **May’s Market Imbalance**

May 6, 2010 was a stark reminder as to what can happen when liquidity dries up. The “flash crash” (as that day’s event has been tagged) saw the Dow Jones Industrial Average drop nearly 1,000 points in the span of 20 minutes. While numerous theories abound as to what caused it, one thing is certain: businesses and investors were innocent bystanders.

A little known fact is that in today’s world only about 15% of the volume of New York Stock Exchange (NYSE) listed stocks are actually traded on the exchange. The other 85% are traded by computers—off the exchange. The human intervention of a specialist is lost. (A specialist’s job on the NYSE is not only to match buyers and sellers, but to also keep an inventory that can be used to balance the market during a period of illiquidity.) This is just one of several likely reasons why the May 6<sup>th</sup> market imbalance occurred.

Prices dropped to mere pennies per share in certain stocks like Exelon and Accenture during the event (those trades were later cancelled). Proctor & Gamble (P&G) shares traded at \$60 and then \$40 within one second of each other (to our knowledge these trades were not cancelled). P&G opened that day’s trading session at \$61.91 per share, reached a high of \$62.67 and closed at \$60.75 for a trading session loss of \$1.16 per share. If one were to only evaluate the beginning and ending share price for the day, it was a pretty average day, but the intraday low was \$39.37 per share.

Past performance is not indicative of future results. Market and economic data has been provided by third party services. This data, while believed to be reliable, has not been independently verified by EBS.

For those investors using stop-losses (predetermined price to trigger a sale order), they were blindsided. It's logical that some of those investors incurred unnecessary capital gains tax liability (stop-loss triggered sale of low basis stock) or lost significant money due to being stopped-out intraday.

In closing, we are usually proponents of fewer regulations and free markets; however, in this case, new regulations seem warranted in order to protect the validity of America's capital markets. To that end, the SEC and the CFTC (Commodity Futures Trading Commission) worked at a swift pace to implement new circuit breaker rules which were implemented on a pilot basis on June 10<sup>th</sup>. In addition, legislation that was passed last week looks to curtail banks from engaging in proprietary trading. (While the intent of the legislation is good, we would not be surprised to see banks spin-out their proprietary trading groups into less regulated entities.) In our opinion, these new rules and legislation are a step toward helping the regulatory structure catch up with today's market structure, which should help boost investor confidence. Even if it doesn't, there should be little impact to the long-term value of solid business franchises run by competent management teams.

Sincerely,

EUBEL BRADY & SUTTMAN  
ASSET MANAGEMENT

*Disclosure: The reference to Exelon, Accenture and Proctor & Gamble is not a recommendation to buy or sell those securities. Those securities were simply chosen as examples of securities whose share prices were extremely impacted due to the market imbalance that occurred on May 6, 2010.*