

# Liquidity Risk and the Small Investor: Using Knowledge to Your Advantage

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According to the online business dictionary, the definition of liquidity risk is "the probability of loss arising from a situation where (1) there will not be enough cash and/or cash equivalents to meet the needs of depositors and borrowers, (2) sale of illiquid assets will yield less than their fair value, or (3) illiquid assets will not be sold at the desired time due to lack of buyers." Auction rate securities (ARPs) [that were discussed last week](#) are one example of the latter.

However, there are other culprits that are at least as common as ARPS. Being aware of them means the small investor can better protect himself from losing money. These securities or assets with liquidity risks include thinly-traded stocks, collectibles, CDs and load mutual fund shares. Hedge funds, annuities and some insurance products fit in this category as well. The upshot is that retrieving one's money after investing in one of these may require a long time horizon (collectibles, CDs, mutual fund shares, annuities and some insurance products) or alternatively, the invested monies may never be recaptured (thinly traded stocks, hedge funds).

## A True Story

*Not too long after I started working in the investment industry a friend of mine at another firm told me a story. He was asked to invest a small sum of money for a working woman, a waitress I believe. She had only ten or twenty thousand dollars and the money was important to her. I asked what he recommended. He told me, "I selected a broadly diversified managed mutual fund, an A share."*

Class A mutual fund shares are one example of a common investment that carries a liquidity risk. They require a front-end load up to 5.75 percent. A large part of that sales charge goes to the advisor who sold the fund. He wants to get paid for choosing the product and thereby justifies to himself that he is worth this money. That is where his obligation (mostly to himself) stops. Overall, index funds perform better than managed funds over time, so his selection is not likely to do better than a less expensive choice.

Meanwhile, your broker has been paid while you carry the risk of owning the fund. If your advisor's choice does poorly, you lose, times 2. Your initial load is gone and the remainder of your investment is diminished. In addition, there are on-going charges that are being expensed to your account that are costing you money. Not only did buying such a fund come at a price. Selling it could mean big bucks out of your pocket too.

The solution is to avoid load funds and buy no-load funds. Better yet, buy index or exchange traded funds that mirror the market with low operating costs that are passed on to the clients. Then, if the trend of stocks doesn't cooperate, you lose less money.

Another way to suffer an even greater financial loss is to buy and sell stocks that are not in demand and not often exchanged. These are called thinly traded stocks. They are inherently risky and by their nature may never return the initial investment to the investor. Likewise, for hedge funds that almost always require a time commitment before the funds can be withdrawn, risk can be the word of the day. Some of them produce huge losses and an inability to return capital instead of the hedging they were designed to do.

A common motto among those in the investment industry is, "know your client." This wisdom should be doubled in the reverse for an investor. The client should know not only his advisor, but in addition, the potential for risk as well as gain of any recommendation he is making. The client puts himself in jeopardy because he isn't aware of the [potential consequences](#) of an investment decision, one of which could be unexpected disappearing money.

