Creating a Liquidity Action Plan

The financial crisis of the mid 2000s taught us the disadvantages of not having adequate liquidity options. Equity market can be volatility has increased recently and interest rate policy can be uncertain. Tech bubbles, financial crises and pandemics are themselves unusual, but significant, unexpected market disruptions from time to time are not. Having a plan to access your financial assets during such disruptions, is important.

Introduction

There can be tension between managing short-term cash needs while maintaining your long-term investments strategies. This tension can rise when markets become volatile.

First, it is important to understand the concept of liquidity. The term “liquidity” does not describe a security type, asset class or investment strategy. Rather, liquidity refers to how quickly an asset can be converted into cash.

For example, most publicly traded securities can typically be sold for cash settlement in three business days. However, the speed with which a security can be sold does not mean that the seller can get an attractive price.

Below, we will look at setting up your long-term strategic reserve plan and some tactical options you might need to employ to make short-term adjustments.

Strategic planning

Strategic planning refers to the overall reserve structure that you intend to maintain over the long haul. We believe that the primary objective for your strategic reserves plan is to match program needs with fund availability.

Reserve structures usually include:

-Operating reserves: This is your working capital for current expenses. This reserve pool is usually invested in cash and equivalents.

-Short-term reserves: This pool is to provide cash if needs arise above and beyond the regular working capital. Short-term reserves can also be held for spending needs beyond the immediate budget cycle, such as making major investments in processes. Since this reserve pool doesn’t have a long time horizon, it tends to be invested in short-term high quality fixed income, avoiding volatile investments like stocks.

-Long-term reserves: This pool is typically established once your current and near-term needs are met. These reserves can be used as an endowment, providing routine financial support each year. With economic shifts and business cycle changes, these assets can be earmarked to ensure specific program continuity.

Tactical Planning

Tactical liquidity planning involves making real time shifts to your strategic plan.

It can become necessary to make tactical shifts to handle either planned or unexpected circumstances. Such circumstances could be internally or externally motivated.

Planned events typically provide more time to make adjustments. These cases can arise when you initiate new programs that could require more capital than regular income streams would likely generate. If reserves would be used to make the investment, it makes sense to remove equity volatility from the equation by moving money out of the long-term reserves and into either short-term or operating reserves.

Unplanned changes are often the result of outside forces, such as a downturn in a business cycle or an unanticipated interruption in a major revenue source. Responding to this type of issue requires a current inventory of your financial assets. It further requires a determination of the status of the markets into which you would sell. You would likely tap your short-term reserves first, unless there could be significant losses from selling those securities. Long-term reserves might be tapped if the equity markets are doing relatively well. In the case where selling either short-term or long-term assets is unattractive, a credit line or other borrowing facility could bridge the gap.

Conclusion

A liquidity action plan is similar to a fire drill exercise. You must run through the scenario in order to assess your options. Before a crisis strikes, you should determine what financial resources are available to satisfy operational liquidity demands and what, if any, obstacles might interfere with raising capital when you need it.

No one wants to be forced to make quick decisions when the business is not going well. When the markets are also volatile, the price for bad decision making rises. Real-time adjustments to long-term plans should be considered in advance. If properly thought out and designed ahead of time, your plans can be executed in an orderly manner. Ultimately, an efficient plan can help minimize the negative impact of volatile markets or softening economic circumstances.

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