
Liquidity and Personal Risk Management

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What Did You Say?

“You can say the same thing to two different people and get entirely different reactions.”

Liquidity

What level of liquid assets should an individual (family) have?

Why does it matter?

Lots of bankruptcy out there (here!)

We are in a “1099 world” (Forbes)

Growth of illiquid “asset locations”

Evidence

What level of liquid assets (cash and cash equivalents) do individuals have?

Sample of Robinson College masters students (N=33) taking introductory personal financial planning course

Evidence

- ❖ Mean (median) net worth - \$134K (\$91K)
- ❖ Mean (median) gross income - \$91K (\$80K)
- ❖ Mean (median) credit ratio of required payments on debts to gross income – 23% (22%)

- ❖ Overall picture is that of a financially healthy upper-middle income group with good potential

Evidence

- ❖ Consider ratio of liquid assets to monthly expenses of the same group
- ❖ Mean (median) – 2.3 months (1.3 months)
- ❖ About 35 percent of sample (12/33) had less than one month's expenses in liquid assets

Evidence

- ❖ What explains liquidity level?
- ❖ Simple regression of liquidity on other factors
 - ❖ Positive association to net worth
 - ❖ No association to credit ratio
 - ❖ Negative association to gross income

Discussion

- ❖ How much liquidity is enough?
- ❖ Theory: Balance the costs and benefits of liquidity
- ❖ Lots of research in corporate settings; in personal settings the research is more ad hoc
- ❖ Rule of thumb – four to six months household expense
 - ❖ What business runs with negative net working capital?

Discussion

- ❖ Rules of thumb seemed tied to job change and/or short term health problems
- ❖ Liquidity a useful asset in the “bad draw” states of the world
 - ❖ individuals tend to be risk averse
 - ❖ a substitute for costly insurance/borrowing

Examples of Liquidity's Hidden Benefits

- ❖ Ability to increase property deductibles, such as auto and homeowners
 - ❖ Moving auto collision/comprehensive deductible from \$500 to \$1000 could save \$150-200 or more a year.
- ❖ Cancel short-term disability insurance; retain long-term disability insurance
 - ❖ Premiums for the former (which end after 90 days, typically) often higher than those for the latter (which could pay to age 65)

Benefits - Continued

- ❖ Staying out of short-term revolving debt trap caused by the “unexpected” expenditure
- ❖ Example: Individuals rarely anticipate major maintenance items
 - ❖ Often projected annual expenditures assume zero cost for home maintenance
 - ❖ Professionals suggest budget of 1-1.5% of property value per year
 - ❖ Fixed expense is higher than you think - “Now that is cool”

What is the Cost of Liquidity?

- ❖ Foregone opportunity to invest in higher-yielding assets
 - ❖ Yield curve is fairly flat right now, however
- ❖ Tax penalty since “unconstrained” liquidity need be in an after-tax account earning interest
- ❖ Should take advantage of tax-advantaged specialty buckets for liquidity, such as flex med account, HSA, or 529 plan (even short term)

Bottom Line

- ❖ Individuals and families tend to have a higher level of “operating leverage” than they realize
 - ❖ Once lifestyle is struck, a lot of costs are fixed
 - ❖ If income (revenue) is volatile – trouble comes quickly in downturn
- ❖ Combined with high financial leverage, this situation is especially dangerous (think of yourself as Delta)
- ❖ Build liquidity as a risk management tool in this environment, especially if you are subject to volatile revenue (and more of us are...)