Liquidity and "Character"

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You're an investment genius. Virtually every asset you own has enjoyed remarkable returns these last several years. And it was all so easy. You just showed up. It was magic.

In Nashville's MLS Area 2 (Southwest Davidson County), average residential real estate values have increased by close to 50% over the last five years. Likewise, over this same period, the S&P 500 index has increased by over 55%. Depending on the location, Nashville commercial real estate values have seen growth in multiples of these percentages. Since 2016, investors have added over 6,500 new hotel rooms in greater Nashville competing with roughly 6,000 short-term rentals available on airbnb.com and vrbo.com. We are opening over 100 new restaurants each year in Nashville, and so on and so forth. It is truly breathtaking.

Like moths to a flame, this Music City phenomenon has attracted a multitude of new investors, from Middle Tennessee and around the country. By now, all of us have heard boasts from friends and acquaintances (or we've boasted ourselves) of the staggering returns earned on this or that. Many see this financial spectacle as a once-in-a-generation event, even once-in-a-lifetime. Those early investors and more active investors enjoyed wild profits for their efforts. The butcher, the baker, the candlestick maker – everybody wants to get a piece of the action. Your child's (or grandchild's) fifth grade teacher is now operating a pedal tavern. Your barber has moved into real estate development.

Banks in many ways are among the beneficiaries of all this excitement. Certainly, there is more loan demand. Unfortunately, however, we are seeing more and more loan requests from individuals with limited liquid assets, i.e. without any cash. They are simply scrambling to get into the fray. I hear you: "Of course they don't have any cash. That's why they need a loan." But surely you appreciate that liquidity is a safety valve giving you the capacity to pay your obligations when things go south. It's "insurance." How much "insurance" you need depends on the risk associated with your cash flow and balance sheet. If you lost your job or source of income, how many months of cash reserves do you need to pay your bills until recurring income is found again? Adding debt to your balance sheet materially compounds this liquidity requirement.

Bankers are concerned when loan applicants are breezy about their own liquidity. Oh, they can sell this investment or leverage that asset and get whatever liquidity they need. Perhaps. But, in all likelihood, the sad moment when you NEED to sell an asset to raise cash will coincide with a marked depression of asset prices and overall market liquidity. Countless non-real estate private investments have virtually zero liquidity in a downturn. Many real estate assets have some liquidity capacity but at much diminished values.

A person's credit score is universally viewed as a measure of "character." Your willingness, discipline and ability to pay your obligations on time is an important gauge of your financial temperament, morals and capabilities. Likewise, your level of liquidity is also a critical indicator of fiscal probity.

In short, every financial catastrophe, big or small, personal or corporate, is in its final measure a crisis in liquidity. Don't let it be one of yours. ▪

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