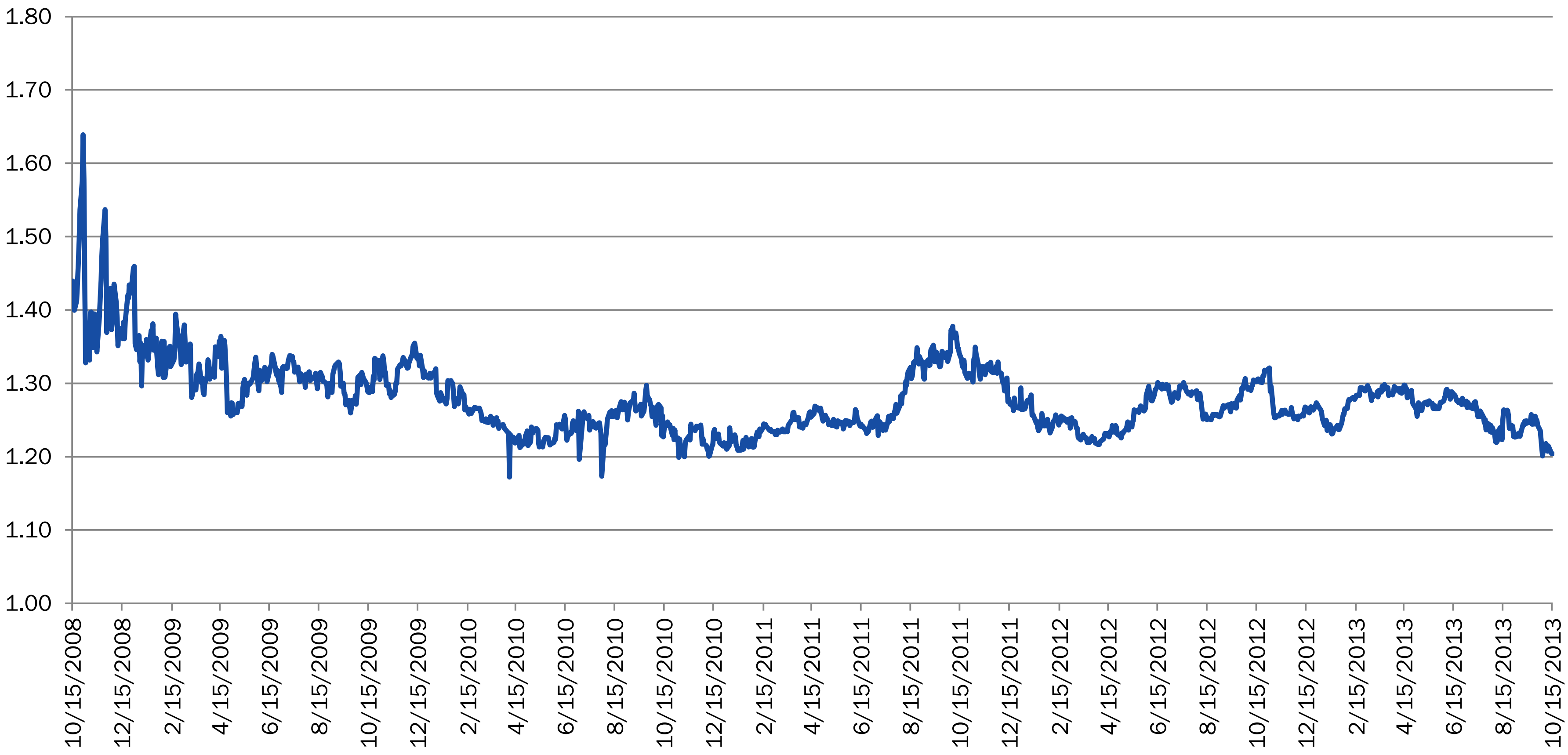
Grant's Interest Rate Observer, 10/22/2013
Uses and Abuses of Liquidity

- What is liquidity? The ability to realize (or be) cash.
- Broadly, liquidity comes in two forms:
  - Natural: income, maturity or a transaction process inherent in the investment
  - Transactional: the ability to sell, or to a much lesser extent, hypothecate, an investment
- Liquidity is dynamic.
- Liquidity is contextual, e.g.:
  - Investor size
  - Constraints
  - Capital terms
- Sufficient liquidity with a margin of liquidity "safety" is optimal.
- Excess liquidity is benign (if it isn't over-utilized); but irrelevant.
- Illiquidity may be, but is not necessarily, associated with potential additional return.
- Inexpedient liquidations of positions detract materially from long-term returns and are among the greatest perils facing investment management businesses.
- Nevertheless, liquidity needs to be managed intelligently both as an opportunity and as a risk.

Ratio of Lennar Corporation Class A vs. Class B



The Price of Illiquidity: The Case of Lennar

- Lennar (LEN and LEN/B) is a leading U.S. homebuilder.
- Per the 2012 Lennar 10-K, page 115: "The only significant difference between the Class A common stock and the Class B common stock is that Class A common stock entitles holders to one vote per share and the Class B common stock entitles holders to ten votes per share."

	Class A	Class B
Price, 10/16/2013	$33.94	$27.80
Shares outstanding (mm)	163.1	31.3
Share float (mm)	157.8	9.8
Market cap (mm)	$5,523	$870
Short interest (mm shares)	32.9	0.08
Average daily volume (mm shares)	5.64	0.054
Market value average daily volume (mm)	$191.40	$1.50
Max size @ 20% of 10 day average volume (mm)	$382.80	$3.00
S&P 500 Index constituent	Yes	No
Listed options?	Yes	No

- Outright long: A or B depending on spread and investor size
- Outright short: short A, long puts on A or sell A calls
- "Indifference zone on B": long B, short A calls – current ATM call premium 3.5-4% per month. The A strikes may be adjusted depending on directional opinions and A/B changes.
  - P&L = Δ B + Δ A + Σ A premiums
  - If the B holding period exceeds a year, Δ B will implicitly be long-term and (Δ A + Σ A premiums) will be short-term