The Fluid State: Rethinking Liquidity, Resilience, and Portfolio Design

By Benjamin Kelly| August 10th, 2026

While much recent commentary has focused on the Strait of Hormuz—and the implications for oil supply—the more consequential question for institutional investors lies elsewhere: **the true liquidity profile of portfolios under stress.**

A sustained supply shock of meaningful magnitude is already exerting pressure on global growth. Yet this is occurring alongside a convergence of deeper structural forces: the expansion of private markets and shadow banking; rapid technological disruption, particularly from artificial intelligence; shifting demographic dynamics; intensifying geopolitical fragmentation and resource competition; and the accelerating impacts of climate change. Each of these forces is transformative. None can be forecast with precision, and their interactions are inherently nonlinear.

In this environment, the role of asset allocators and fiduciaries must evolve. It is no longer sufficient to optimize for expected returns under "normal" conditions. Rather, **portfolio construction must explicitly account for uncertainty, nonlinearity, and the risk of systemic dislocation**. This includes preparing for outcomes that appear remote but are entirely plausible.

The Illusion of the 'Fluid State'

Over the past decade, most portfolios have benefited from what might be described as a "fluid state" of capital markets—characterized by deep liquidity, low volatility, and the ability to transact efficiently across asset classes. However, this state should not be mistaken for permanence.

A critical question emerges: **what happens when liquidity evaporates and market functioning degrades?**

In such scenarios, the distinction between mark-to-market losses and inability to transact becomes paramount. Portfolios with greater structural agility—those able to generate liquidity when it is scarce—are likely to outperform more traditional allocations that rely on static diversification and implicit assumptions of continuous market functioning.

The commonly used descriptors of "resilient" and "long-term" investing lose coherence if they are not underpinned by explicit mechanisms to protect against tail risk and ensure access to liquidity during crisis conditions.

Liquidity as Insurance, Not Strategy

Andrew Sawyer, Senior Adviser at LongTail Alpha, offers a useful framing**: explicit tail-risk protection should not be evaluated as a competing strategy within a portfolio—it should be viewed as a cost of doing business.**

This distinction is critical.

Allocations to left-tail hedging instruments—such as convex option structures—do not exist to maximize returns in benign environments. Instead, they function as **liquidity insurance** against extreme but viable scenarios. In normal markets, they incur a known cost (premium decay). However, in periods of stress, they can provide **nonlinear, explosive liquidity** precisely when other portfolio components are impaired—either due to illiquidity, gating, or severe drawdowns.

For trustees and governance bodies, the implication is clear:
Tail protection should be embedded within the portfolio as a structural safeguard, not subject to performance-based elimination during benign periods.

Structural Weaknesses in Modern "Fluid" Portfolios

Despite their apparent robustness, many contemporary portfolios contain latent fragilities. These are often masked during periods of market stability but become pronounced under stress.

1. The Rise of Private and Illiquid Assets

Institutional portfolios have meaningfully increased allocations to private markets in pursuit of illiquidity premia. While these exposures can enhance returns in stable environments, they introduce **structural liquidity risk**.

In crisis scenarios:

- Valuations may lag reality
- Secondary market liquidity may evaporate
- Capital calls may persist or increase further exacerbating liquidity needs

- Exit pathways become uncertain
- Portfolios may become imbalanced
- Distributions may evaporate

Technological tools are improving liquidity management within private portfolios, but these tools are themselves dependent—directly or indirectly—on functioning public markets. A breakdown in public market liquidity fundamentally challenges the assumptions underpinning private market allocation.

2. Overreliance on Historical Diversification

Diversification remains a cornerstone of portfolio theory. However, it is often **backward-looking**, calibrated on historical correlations that may not hold in a regime shift.

In systemic events:

- Correlations tend to converge toward one
- Traditional hedges may fail
- Liquidity demand becomes synchronized

Thus, diversification alone cannot be relied upon as a robust form of protection. Instead, portfolios must incorporate **forward-looking, scenario-based resilience**.

3. Underestimating the Speed of Market Repricing

Recent episodes—such as the rapid dislocations observed in April 2025 and the Japanese carry unwind in August of the prior year—highlight a crucial shift: **markets now reprice faster than governance frameworks can often respond.**

This acceleration is driven by:

- The growth of passive investing
- Algorithmic and high-frequency trading
- Increased leverage within hedge funds and shadow banking
- The integration of AI-driven decision-making

These forces compress the time horizon over which prices adjust and volatility propagates, creating **liquidity shocks that are both faster and deeper**.

A key governance question arises:
Do current decision-making structures operate at a speed compatible with modern market dynamics?

The Central Role of Stress Testing and Scenario Analysis

Given these challenges, **robust stress testing is no longer optional—it is foundational**.

Stress testing should extend beyond traditional historical scenarios to include:

- Hypothetical, forward-looking shocks
- Liquidity-driven events
- Multi-factor regime changes

Advances in artificial intelligence are expanding the frontier here. Techniques such as **simulation-based inference (SBI)** allow investors to explore a wider distribution of possible market states, including those not directly observable in historical data.

The objective is not prediction, but **preparedness**.

Portfolios should be constructed to:

- Participate meaningfully in upside scenarios
- Remain solvent and liquid in downside scenarios
- Adapt dynamically across regimes

Conclusion: Beyond the Fluid State

The persistence of uncertainty and structural change challenges the implicit assumptions that have underpinned portfolio construction for much of the past decade.

The concept of a perpetually "fluid" market is increasingly fragile. In its place, investors must adopt a framework grounded in:

- Liquidity realism
- Explicit tail-risk protection
- Scenario-based design
- Governance and execution agility

Ultimately, the institutions that will succeed are those that recognize a simple truth:
Resilience is not a label—it is the outcome of deliberate design choices made before stress materializes.

In navigating the increasingly complex and uncertain markets ahead, **leadership, adaptability, and structural liquidity will distinguish those who endure from those who thrive.**

Investors cannot afford to let their capital be held hostage by systemic chokepoints, whether in the physical waters of the Strait of Hormuz or the digital plumbing of capital markets. Through convex solutions in generalized options markets, agility becomes a deliberate design choice rather than an afterthought.

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