Brinker Capital

Innovative Solutions Series

bond market liquidity:

cause for concern?

“Liquidity is always there when you don’t need it—and never there when you do.”

This aphorism aptly paraphrases the liquidity crunch of 2008-2009, which adversely affected even the “safest” of assets, such as money market mutual funds, as credit tightened severely and sellers greatly outnumbered buyers across the breadth of capital markets.

Seven years later, liquidity has regained its buzzword status, this time in reference to fixed income. In a Spring 2015 survey of investment managers by Fitch, 49% of respondents were "concerned" about reduced liquidity in the U.S. corporate secondary bond markets, while 37% were "very concerned." Prudent financial advisors should not take liquidity for granted, but should also recognize that risks can be mitigated.[1]

In this paper we will address the following factors that affect bond market liquidity:

- The marked decrease in bond dealer inventories, even as bond issues grow
- Worry that bond mutual funds and bond ETFs — marketed as liquid instruments — increasingly are holding securities that are themselves potentially illiquid
- Brinker Capital’s position of strength to bond illiquidity

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Dealer inventories are shrinking while bond issuance and capitalization are growing

Participants have witnessed a marked decrease in bond dealer inventories in the midst of growing outstanding capitalization of debt. This poses a potential threat to market liquidity — the ability to facilitate buying and selling of an asset while minimizing changes in that asset's price.

U.S. corporate debt outstanding has more than doubled since 2008, as Figure 1 shows. This increased issuance is the expected result of the Federal Reserve's easy money policies, which have motivated companies to issue long term debt at record quantities.

Amidst rising issuance, an accompanying decrease in dealer inventories is largely due to regulations that have removed incentives for banks to hold large balances of bonds in their inventories. These include Basel III (global capital requirements framework) and the Volcker Rule (element of Dodd-Frank that restricts proprietary trading by bank desks).

Smaller inventories have in turn contributed to wider bid/ask spreads and smaller daily turnover, which has decreased from around 95% to around 65% over the last six years. Figure 2 illustrates how widening spreads have been seen across the spectrum of credit grade.

Figure 1: U.S. corporate debt liquidity ($B USD)

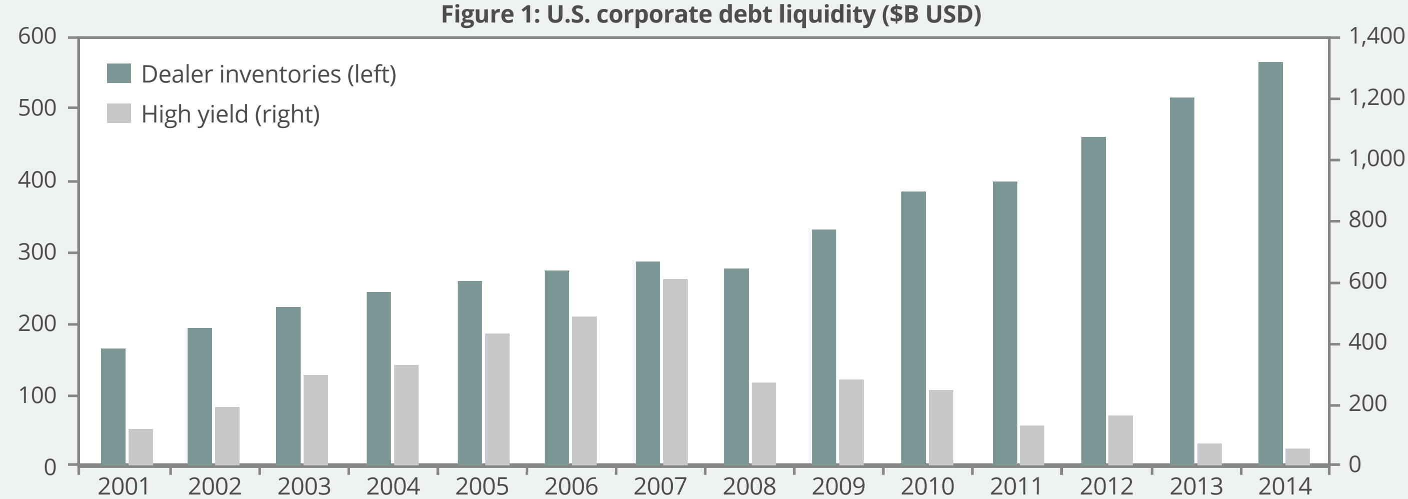


Figure 2: Widening spreads - today versus 2007

	1/31/2007		1/31/2015		Change	
	LCS (%)	Bid-Offer	LCS	Bid-Offer	LCS	Bid-Offer
U.S. Credit Corporate	0.531	8.5 bp	0.951	13.2 bp	+79%	+55%
U.S. High Yield Corporate	1.276	1.28 pts	1.550	1.56 pts	+21%	+21%

Figure 1 Source: J.P. Morgan Asset Management. Figure 2 Source: MarketAxess, Barclays Research.

Financial regulators have historically been criticized for their acute recognition lag. That is, they have sometimes shown up to the game late, as was the case during the 2006 domestic housing bubble. However, SEC Commissioner Daniel Gallagher seems to be aware of growing concerns. In a March 10, 2015 speech, Gallagher acknowledged a possible threat. He noted that:

- Bond dealers' inventories have decreased by over 75% since the pre-Financial Crisis period.
- The time to liquidate a position is now seven times as long as in 2008.[2]

Gallagher certainly deserves some praise for being relatively ahead of the curve. However, a concrete plan to mitigate market liquidity risk is absent from his transcript. Bloomberg recently reported that FINRA is scheduled to meet with a portion of the $39 trillion U.S. bond market's largest players to discuss the issue, with a switch to electronic trading platforms near the top of the discussion list.[3] However, there has been limited news of action on this front.

Notwithstanding whatever FINRA is up to, teasing out the logic here illuminates the possibly dubious assumption that, in their prime, bank proprietary trading desks served to stem selloffs by "stepping in" as buyers at the right time. Bank dealers, who trade for their own accounts and have their own independent profit and loss statements, will be motivated to take the other side of a trade in "normal times" to profit from bid-ask spreads, but they will not necessarily be impelled to provide liquidity to panicked sellers in times when everyone else rushes for the exits. The mere existence of a dealer does not guarantee price stability. Matt Levine of Bloomberg phrases it this way:

> *"The dealer's function is really about smoothing trading across time, not about preventing price moves. If someone is selling now, the dealer will buy, and if someone is buying in five minutes, the dealer will sell, and most of the time that is a reasonable, volatility-dampening business model. But if everyone is selling for days, it would be dumb for the dealer to keep buying all the way down. This is just not the function of a dealer."*[4]

Additionally, while bank inventories may be dwindling, nonbank dealers have stepped in to fill the cracks in some places. While this effect is difficult to quantify, it is alluded to in a recent *Wall Street Journal* article authored by Citadel CEO Ken Griffin, who champions these overlooked "other sources" of liquidity.[5]

Prevailing concerns over fund representation and structure

On a separate front, there is worry from a variety of commentators that mutual funds and ETFs, which commonly market themselves as liquid instruments, increasingly are holding securities that are themselves potentially illiquid in times of high redemption demand.

Kara Stein, also an SEC Commissioner, had this to say about mutual fund liquidity representation in mid-June 2015:

> *"The liquidity of registered funds is one area where it seems that regulation has drifted into 'buyer beware.' A retail investor looks at a mutual fund and expects that he or she will be able to get money out of a fund very quickly if needed. A retail investor is generally not performing cash flow analyses on mutual funds to test their true liquidity."*[6]

Stein is referring to redemption risk stemming from the liquidity terms of the fund. Howard Marks of Oaktree Capital and Bill Gross of Janus Capital (formerly PIMCO) recently devoted entire newsletters to the subjects of market liquidity and redemption risk. Marks spends much of his March 2015 memo speaking in terms that are general but nonetheless insightful. "The key criterion isn't 'can you sell it?'" He asks, "It's 'can you sell it at a price equal or close to the last price?'" His implied answer to this question, for products such as high-yield ETFs and their close cousin, senior loan ETFs, is no, given selloff conditions.[7]

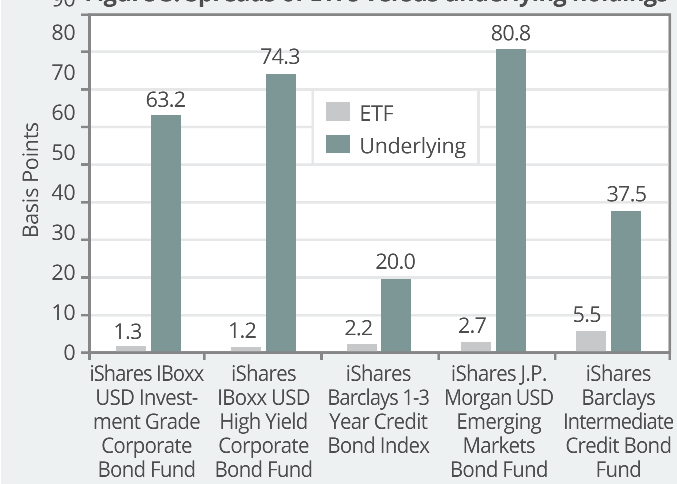
Echoing Stein, Marks points out:

> *"A senior loan ETF can be sold for settlement in three days, whereas if there are tenders of creation units, sales of loans to raise the funds with which to pay for those units may require a week or considerably more to settle. What are the implications of such a mismatch?"*

The ownership picture has changed as well. According to UBS, large institutions, insurance companies, and mutual funds have boosted their holdings of corporate and foreign bonds by 65% since the end of 2008.[8] To this extent, Bill Gross observed in a recent outlook that mutual funds, hedge funds, and ETFs have filled the role that was previously filled by commercial banks themselves, even though the former "are not banks and so not required to maintain reserves or even emergency levels of cash."[9] The implication is that a greater amount of debt is now ultimately held in the hands of the investing public, which is prone to rushes for liquidity in times of panic.

Some consider these concerns overblown. The world's largest asset manager has been leading the charge. Larry Fink, CEO of BlackRock, claimed in a June 5 interview that a bond ETF liquidity dry up is "more of a myth than a reality."[10] And Mark Wiedman, head of the firm's iShares ETF unit, added a month later that ETFs "are contributing to the solution — I think we can say that with 100 percent confidence."[11] Wiedman is referring to the argument that, because of their structure, ETFs actually provide an additional layer of liquidity for traders as they enable them to buy and sell the ETF without transacting in the individual underlying securities. A study by the Investment Company Institute quantifies this. Over the period from January 2013 through June 2014, only 19% of bond ETF trades triggered buying or selling in individual bonds. Figure 3 illustrates how BlackRock's own literature also shows that ETFs have much smaller bid/ask spreads than their underlying holdings.

Figure 3: Spreads of ETFs versus underlying holdings



So, are such concerns justified, or are they without warrant? Arguments from both sides deserve a bit of tempering, and the objective answer probably lies somewhere in between. The explosion in popularity in ETFs has served to concentrate ownership and crowded position-taking in bonds that are now fully priced by most valuations. There is admittedly a transfer of risk from bond dealers to buy-side financial institutions, but it cannot be determined whether end investors in nondiscretionary accounts are more prone to panic than were bank trading desks previously. The maturity mismatch concern is probably a valid one, even if ETFs have continuous price determination throughout each trading day. However, one cannot say that net risk to the financial system has been increased.

The recent August 2015 selloff illuminated several potential issues with ETF trading that caused many equity ETFs to trade at significant discounts to NAV. Contributing factors to extreme volatility at the market's open on August 24 included (1) a glitch within BNY Mellon's SunGard software, which is used to price ETFs; (2) the invocation of Rule 48, which permits market makers to open a stock for trading without indicating a bid and ask; (3) triggering of Limit Up/Limit Down breaks in trading in some equities while ETFs continued to trade. While these issues may be worrying, none of them truly speak to either market liquidity risk or redemption risk for fixed income ETFs in particular.

Figure 3 Source: BlackRock, TRACE

Assessing Brinker Capital's vulnerability, or lack thereof, to bond illiquidity

Brinker Capital employs a rigorous due diligence process with the outside investment managers that are included in our portfolios.

Brinker Capital's process, in part, entails examining the strategy of our outside managers, the underlying composition of their holdings, and their operations in the framework of their vulnerability to illiquidity. While a significant portion of our assets under management are allocated to fixed income products, we feel that those assets are sufficiently protected from unnecessary market liquidity risk and redemption risk.

Our foremost consideration is the tactical and strategic positioning of our outside investment managers. Over the last several months we have engaged in targeted conversations with our largest fixed income fund managers, and they have sufficiently addressed these concerns. Across the array of these managers, here are some common points we took away.

The fixed income managers Brinker Capital partners will strive to consistently:

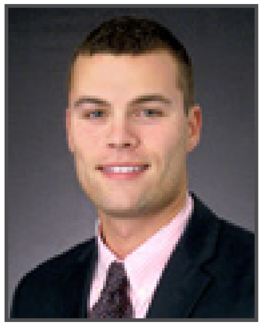
- Avoid exposure to "liquidity traps" by pursuing strategies with low turnover.
- Buy assets that can be held to maturity even if prices temporarily decline or price discovery ceases to take place.
- Hold higher-than-usual cash balances in the 8-20% AUM range, rather than "cash proxies" that may embed counterparty risk.
- Maintain minimal overlap with ETF portfolios and require additional risk premium if a bond the fund looks to acquire is a component of a major bond ETF.
- Rely on selection of "money-good" bonds—those with quantifiable, steady future revenue sources.
- Adhere strictly to self-imposed AUM limits to mitigate reliance on third-party liquidity.
- Show a bias towards high-quality debt, minimizing ownership of securities rated BB or lower.
- Utilize healthy doses of government or government-sponsored securities, assets which have historically remained in demand as liquidity in other lower-quality sectors dries up.[12]

The bottom line

The majority of Brinker Capital's platforms center on strategic, long-term positioning with low turnover. For strategies with high turnover and systematized rules regarding when a firm buys and sells securities — namely, risk parity strategies with highly leveraged bond holdings — fixed income liquidity may be a serious danger, as they participate in periods of heavy selling volume and lock in permanent dislocation in spreads. Given Brinker Capital's positioning, we feel that such selling activity would be reflected in some volatility, but would ultimately not be injurious to account values in the intermediate to longer-term.

The bottom line is that fixed income liquidity, especially its public perception and the regulatory response, is a topic that Brinker Capital intends to continually monitor regardless of our advantageous positioning.

Meet the authors



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BLOG

Who we are

At Brinker Capital we implement great ideas with a disciplined investment approach to consistently offer financial advisors forward-thinking solutions with the goal to achieve better outcomes based on their clients' personal goals.

Great **Ideas** + Strong **Discipline** = Better **Outcomes**™

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