Q&A

WESTERN ASSET

Liquidity in the Fixed-Income Market

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Credit Suisse Asset Management
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Janus Capital Management
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In this Q&A, Western Asset Deputy Chief Investment Officer Michael C. Buchanan offers his perspective on reduced liquidity in fixed-income markets.

Q: What are your general thoughts about liquidity in the fixed-income market?

MB: Global investment bank trading desks have experienced a dramatic reduction in the amount of capital they are able to commit to trading fixed-income securities today. This is primarily due to these firms making the determination that, given new bank capital requirements, it is not an efficient use of capital to inventory the amount of bonds they held prior to the financial crisis. As a result, liquidity across all fixed-income asset classes is less than what managers such as Western Asset enjoyed pre-crisis. In an effort to optimize the use of what capital sell-side firms have, most have implemented practices that concentrate their efforts on those clients deemed integral to their capital markets business. These clients are typically the largest money managers by AUM, of which Western Asset is one. While liquidity remains a challenge for market participants, Western Asset certainly benefits from being in a highly select group of managers that broker/dealers view as high priority.

Q: Why has liquidity declined?

MB: The decline in liquidity across fixed-income asset classes is a result of regulatory changes. Various bank regulatory reforms—most notably Basel III, Dodd-Frank/Volcker Rule legislation—and other market regulatory modifications have improved bank transparency, bolstered bank capital and improved bank liquidity, all necessary improvements designed to reduce the possibility of another financial crisis. However, they have also had the unintended consequence of reducing the ability to buy and sell bonds without affecting the asset's price. The Basel III reform mandate has forced banks to increase their common equity base as a percentage of their risk-weighted assets, which has resulted in a meaningful reduction in fixed-income inventory. Dodd-Frank regulation eliminated the ability of the banks to engage in proprietary trading and maintain investments in hedge funds. Proprietary trading and hedge funds were active participants in the trading of fixed-income markets. By closing these lines of business, the regulation reduced the number of players bidding and offering securities on a daily basis, making periods of heightened volatility more violent from a mark-to-market perspective. Market regulatory modifications include a proposal by the European Commission to implement a tax of 1–10 basis points (bps) on transactions in all classes of fixed-income instruments. If finalized as proposed, it would clearly act as yet another disincentive for market-makers to commit capital to the investment community, further reducing liquidity in the market.

Q: What, if any, steps are you taking in portfolios to maintain a sufficient level of liquidity?

MB: We manage a wide variety of portfolios against many different benchmarks (in the case of separately managed institutional portfolios) or peer groups (in the case of retail mutual funds). Regardless of whether a portfolio experiences daily inflows or outflows (i.e., mutual funds) or not (i.e., institutional separate accounts) we maintain a level of liquidity that is measured by risk management on a regular basis. Maintaining portfolio liquidity for mutual funds is of significant importance, and as such, we have been increasing the use of instruments such as cash, T-Bills, ETFs and derivatives to provide additional liquidity. Across all vehicles, we are utilizing the primary market more frequently as new issues price, more often than not, at large concessions to secondary issues, and the new issues actively trade with minimal bid/offer spreads. We are also employing derivatives via indices/tranches that provide a liquidity enhancement while maintaining exposure to the given asset class. In those cases when we consider an issue for investment, we often value the on-the-run investment opportunity more than an off-the-run opportunity on a relative value basis. (On-the-run securities are the most recently issued bond or note of a particular maturity. Off-the-run securities are the bonds and notes issued before the most recently issued bond or note of a particular maturity). For off-the-run securities, which are less frequently traded, our trading team is demanding a greater liquidity premium to take on these positions in this newly hyper-regulated environment.

Q: Do you run tests on portfolios to measure liquidity?

MB: Yes. Western Asset's Risk Management Team has developed a proprietary model with the intent of developing a benchmark-relative measure of liquidity under stress. The model's methodology starts with repo haircut levels based on studies published by the Federal Reserve Bank of New York and the International Capital Markets Association. Western Asset's trading desks provided further criteria to classify securities not covered by repo haircuts. The model makes various adjustments to the scale based on characteristics such as issued amounts, bond age, years to maturity, and the number of contributed pricing sources. All these factors are then brought together to provide a liquidity level from 1 to 5 for each security, with 1 being the most liquid and 5 being the least liquid. The sum of the total market value in each liquidity bucket is compared between a portfolio and its benchmark. We are then able to assess the portfolio's general level of liquidity versus its stated benchmark. We perform these tests regularly on our funds and accounts with daily or otherwise heightened liquidity demands.

Q: Is illiquidity during "risk-off" periods a greater concern now than in the past?

MB: Given our increased use of more liquid substitutes in our portfolios, especially in our mutual funds, illiquidity in "risk-off" markets (like we experienced at the end of June 2015) is not as much of a concern now as it was in the past. During "risk-off" markets, correlations on spread products historically rise regardless of sector or issuer fundamentals. From Western Asset's perspective as value investors, "risk-off" periods may be viewed as opportunities to create positions or increase exposure at valuations that are often very attractive.

Q: Which fixed-income asset classes have experienced the largest declines in liquidity?

MB: The further you move out the risk spectrum the larger the decline in liquidity. High-yield, bank loan and emerging market (EM) sectors have experienced the greatest declines, while the declines in US Treasuries (USTs) and agency MBS sectors have been less apparent. Other developed governments and investment-grade credit fall somewhere in between. In the case of USTs and MBS, bid/offer spreads have not changed much for the on-the-run issue/coupons, but the amount on which dealers will make markets has declined from $1 billion pre-crisis to $250 million today. For high-yield, bank loans and EM market-making, the bid/offer spreads have widened and the amount on which dealers are willing to make a market has declined meaningfully. The biggest reduction in liquidity has been experienced by off-the-run issues in the credit market and non-current coupon bonds in the MBS market. For example, an off-the-run issue on a 10-year bond for an investment-grade issuer trades at a 10–20 bps discount to that issuer's on-the-run issue, versus a 5–10 bps discount that was available pre-crisis.

Q: What is the impact of reduced liquidity on fixed-income investors?

MB: For pension plans, insurance companies, foundations and other institutional investors that maintain separate accounts with fixed-income managers, the impact of reduced liquidity really depends on the investment manager's style. For those institutional investors whose investment manager's investment style is predicated on frequent trading strategies to generate more than a marginal amount of performance, they are likely to experience challenges going forward. Alternatively, managers whose investment style is based on taking a long-term approach supported by disciplined fundamental research should benefit from the increase in liquidity premiums currently in the market. For those whose fixed-income investment firms have a large portion of their AUM in mutual funds, elevated subscription or redemption activity could present some new challenges. Under current market conventions, unchanged since the crisis, mutual fund redemption orders are typically paid in 1–3 days with 7 days being the latest permitted under SEC rules. For certain funds with concentrations in less liquid sectors, it could be a challenge under difficult market conditions to meet very large redemptions without negative impact to NAV and performance.

Regulations have had some unintended consequences, one of which is reduced liquidity in fixed-income markets. Regulators have engaged investors in discussions on this topic. For example, FINRA and the Bank of England's Prudential Regulation Authority recently met with various market participants on the subject, soliciting feedback as well as attempting to work toward possible solutions. Western Asset has indirectly been involved and provided input for these meetings while also engaging with various government agencies, including the SEC and Treasury, on the topic. While it's certainly a concern, we don't think we are likely to see a significant liquidity-related crash given the supportive fundamental backdrop existing in the market today as well as increased asset manager tools and precautions cited previously. So while liquidity has declined, our belief as of now is there is sufficient liquidity to transact in the market and execute strategies across all fixed-income asset classes.

Q: Do you expect liquidity to improve?

MB: Certainly there will be periods when liquidity is improved and times when it will be challenged, but overall the trend is that liquidity will continue to decline. J.P. Morgan estimates that there have been 46 new banking regulations, both global and domestic, that have been or are scheduled to be implemented. Of these, a little over half have been implemented to date, resulting in more regulations designed to improve bank balance-sheet capitalization. These changes will more than likely have the effect of further reducing market liquidity. For example, under Basel III requirements, banks' Tier 1 capital ratio (common equity/risk-weighted assets) requirement will increase from 8% as of 2015 to over 15% by 2019. This will most likely force banks to raise more common equity and further reduce their inventory of fixed-income securities.