SCS Financial
Strategic Capital Solutions

INVESTMENT PERSPECTIVES

JULY 2015

MANAGING BOND MARKET LIQUIDITY

BY JEREMY L. RAGUS CFA, MANAGING DIRECTOR, GLOBAL ECONOMIC STRATEGIST

Main Points

- Bond market liquidity conditions have deteriorated due to a series of accumulated changes in the financial markets, as volatility has risen
- At the same time, assets in bond investments and global debt-to-GDP ratios have continued to increase
- We believe any market imbalances caused by illiquidity should be short-lived given a benign credit environment, stable fundamentals and the large cash balances of managers looking for opportunities
- Skilled fixed income managers can employ strategies to assess risks and identify opportunities that can add value for bond investors in this landscape

OVERVIEW: Bond market liquidity conditions have deteriorated, and market volatility has increased, since the middle of 2014.[1] These shifts have not been the result of fundamentally changing economic conditions (such as radically different savings rates or a collapse in economic growth) but are instead due to a series of accumulated transformations in the financial markets. This reduced level of liquidity appears to be tied to a number of trends stemming from responses to the financial crisis of 2008 along with continued growth in the size of the world's bond markets. These include discreet changes in the legal and regulatory framework of the markets, the rapid advancement of electronic trading systems for bonds and the increased ownership of sovereign debts, including US Treasuries, by governmental entities as a result of quantitative easing programs. Global debt markets, meanwhile, have continued to grow in size since 2008, in both absolute and relative terms compared to global gross domestic product (GDP)—in spite of brief periods of improvement in the US. Liquidity is certainly a serious consideration for investors today, and we have been vigilant in our efforts to mitigate the impact of illiquid conditions on client portfolios. While there's no way to eliminate the risk, we believe any market imbalances should be short-lived given a benign credit environment, strong fundamentals and the large cash balances of managers looking for opportunities. We do not see bubble conditions like those that led to the financial crisis and are instead cautiously optimistic about the potential for sophisticated investors to capitalize on such periods of reduced liquidity. Skilled fixed income managers can employ strategies, outlined below, to assess risks and identify opportunities that can add value for bond investors in this landscape.

LIQUIDITY'S IMPACT: Liquidity refers to many different things, but the use of the term here refers to the ability and ease with which various participants, whether investors, mutual funds or brokers, can buy and sell securities. Lack of liquidity is generally reflected in a number of ways, including increased times to execute trades, difficulty or inability in executing large orders, or a sudden, large price change when buyers or sellers enter the market. Higher costs of trade execution, typified by lower bid prices upon selling a security and higher offered prices when buying, are another result. For investors, all of these resulting conditions can raise investment costs and negatively impact performance. The Bank for International Settlements (BIS), a highly respected and influential organization that represents the world's central banks in promoting global financial and monetary cooperation, has recently expressed concerns on the subject of market liquidity. While markets may appear liquid and well-functioning, there may be a "liquidity illusion," where markets can become one-sided with either all buyers or sellers.[2] Some signs of reduced liquidity, according to BIS's June 2015 Annual Report include:[3]

- US primary dealer daily inventory positions in corporate bonds have dropped from about $275 billion to around $50 billion
- The average size of US investment grade bond transactions has dropped, as has the number of transactions valued at over $1 million
- The Treasury market is the biggest it has ever been, while at the same time the smallest number of bonds on record are changing hands

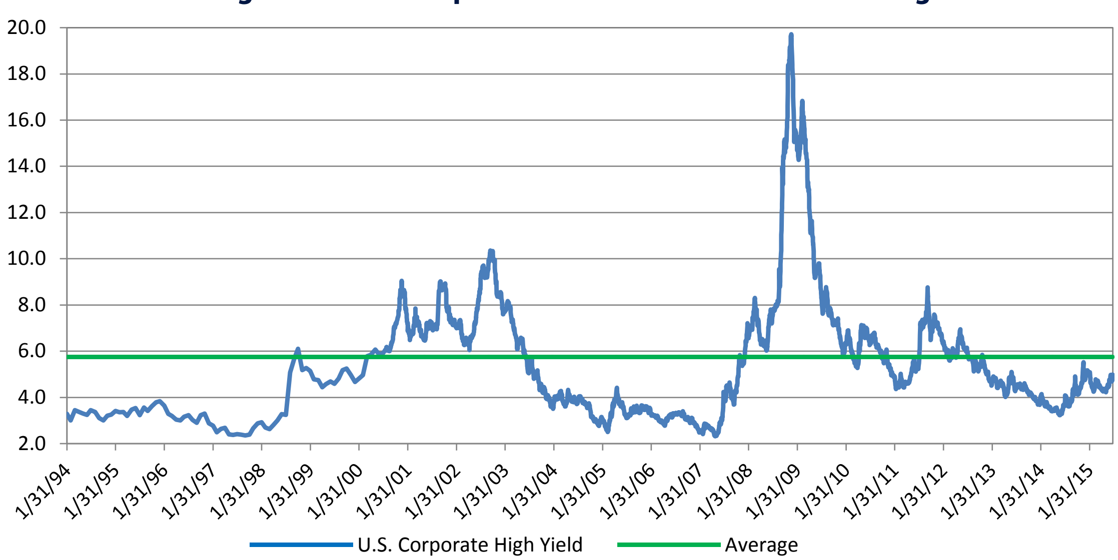
Meanwhile, fixed income assets under management in bond mutual funds are up over $3 trillion since 2009 and the total size of fixed income mutual funds now stands at $7.4 trillion. When fixed income exchange-traded funds (ETFs) are added to the picture, the amount of individual investments in the debt markets is even larger.

Complicating the picture is the fact that debt markets just keep growing, not only on an absolute basis, but on a relative basis compared to GDP, adding more and more leverage to the system. According to a February report by the McKinsey Global Institute, global debt has grown by approximately $57 trillion to $199 trillion since 2007, pushing debt-to-GDP ratios up by 17 percentage points to 286%.[4] Debts have risen across all categories: financial, government, corporate and household, with the fastest growth in the government sector at 9.3% during this time period.

INVESTMENT IMPLICATIONS: One of the first signs of change in bond liquidity came on October 15, 2014 when the yield on the 10-year US Treasury fell by 36 basis points in just a few minutes—a greater yield decline than had occurred when Lehman Brothers declared bankruptcy in September 2008. Treasury yields recovered in a few minutes but the swing was so severe it triggered an investigation by five different US regulatory agencies, including the Federal Reserve and the Securities and Exchange Commission. The investigation found no single cause for this volatility, but cited a number of contributing factors including: increased use of trading algorithms; higher bank capital requirements; and restrictions on proprietary trading. The investigation also noted there had been a large withdrawal of Treasury and sovereign bonds from the markets as a result of global quantitative easing programs to stimulate economic growth. The Fed now holds $2.46 trillion in US Treasuries, representing about 27% of outstanding securities with maturities of 10 years or less.[5]

Yet it is worth noting that the yield on the 10-year closed at 2.14% on that October day and traded within a narrow range, albeit with volatility, to end the year at 2.17%. While there is less liquidity in today's fixed income landscape, we believe daily market imbalances are generally short-lived as astute real money buyers and sellers take advantage of these swings. Compared to historical averages, corporate borrowers are fundamentally strong, with less leverage and more cash on their balance sheets. For example, within high yield, gross and net leverage are well off their lows for this cycle but still below their long-term peaks, according to a recent report from

High-Yield Credit Spreads are Below the Historic Average



Source: Bloomberg, Barclays. Data from 1/31/1994 through 7/23/2015

Morgan Stanley.[6] Cash and debt levels are modestly above average, while interest coverage remains at an all-time high, due largely to the low interest rate environment, the report found. We believe these markets remain relatively healthy, offering attractive yields to compensate investors for the additional risk—especially in the face of rising interest rates. As outlined in the chart above, high yield credit spreads (a measure of the value within the credit markets) are modestly below the historical average but are still offering a reasonable risk/reward tradeoff. The option-adjusted spread for high-yield credit was 4.74% as of June 30, versus the average of 5.75%, well above its historic low of 2.33% reached in 2007 before the crisis.

Thus, we think any short periods of reduced liquidity can create opportunities for skilled managers who may be able to capitalize on cheaper markets by putting additional capital to work at better prices. Ultimately, we believe this approach leads to better long-term performance. An influx of buyers during these periods may include sophisticated fixed income specialists and hedge funds that factor in liquidity and related risks as part of their security analysis. Consider one recent example from one of our hedge fund managers who capitalized on reduced liquidity in Europe, where heightened regulation has raised concerns about liquidity in sovereign bond markets. Older issuance "off-the-run" Italian sovereigns were trading at a 20 basis points spread to newer "on the run" issuance—a dislocation not seen since the Long-Term Capital Management crisis of 1998. Measuring the success of the trade may take time to realize, though spreads have narrowed since then. Spreads at this level are highly unusual in government bond markets, so the potential for astute managers in less liquid credit markets could be much higher. Highly skilled fixed income managers are also taking a number of steps to mitigate liquidity risk, including maintaining slightly higher cash weightings, opening lines of credit and regularly stress-testing their portfolios for severe outflows and pricing disruptions.

Within SCS portfolios, we have been addressing liquidity with our managers for the past year based on our belief that a temporary liquidity pullback may come as a result of either rising interest rates or credit market concerns. We manage this risk through manager selection, diversified credit exposure and lower duration securities. Our fixed income managers focus on liquidity and actually use its fluctuations to their advantage in many cases. They are targeting less liquid fixed income assets based on spreads that we agree are sufficiently wide so that our clients are more than compensated for reduced levels of liquidity. This risk/reward tradeoff is true for a wide variety of current fixed income holdings in SCS bond portfolios, including asset- and mortgage-backed securities, collateralized loan obligations (CLO debt), high yield bonds, floating rate corporate debt and private credit holdings. We feel that in a benign credit environment, earning a substantially higher fixed income yield than the overall US bond market will substantially benefit our clients—and compensate for the reduced liquidity levels that we are observing. SCS is also maintaining a shorter than benchmark duration in its Core Plus portfolio, which provides a certain degree of "natural" liquidity as short-maturity bonds and loans roll off and can be reinvested profitably when market conditions warrant. We are very confident in our managers' ability to easily meet required liquidity needs across mutual funds, separately managed accounts and our Core Plus portfolio.

CONCLUSION: Reduced liquidity has become an issue in the debt markets now for the first time in many years—for both financial professionals and investors. In all likelihood, the emergence of this phenomenon results from a number of the factors mentioned above, including increased government regulation of banks, reduced capital commitments to bond trading, increased usage of electronic trading platforms and ever growing holdings of high-quality sovereign bonds by central banks and sovereign wealth funds. As always, we are actively managing and monitoring liquidity and other sources of risk and return in our portfolios and will make strategic adjustments based on rigorous analysis of a broad range of market variables, including the risks and benefits presented by less liquid markets. We feel we are positioning our fixed income assets in the best way possible given the changing liquidity environment outlined above, ensuring our managers are able to price in risk and capitalize on opportunities.

REFERENCES

[1] *Bank for International Sentiments 85th Annual Report, 1 April 2014 - 31 March 2015, Basel, 28 June 2015, Pages 36-40*
[2] *ibid*
[3] *All data from BIS report cited above*
[4] *McKinsey & Company, McKinsey Global Institute, "Debt and (Not Much) Deleveraging," by Richard Dobbs, Susan Lund, Jonathan Woetzel and Mina Mutaffchieva, February 2015*
[5] *Federal Reserve Bank of St. Louis, Economic Research, US Treasury securities held by the Federal Reserve: All Maturities as of July 16, 2015*
[6] *Morgan Stanley's Leveraged Finance Insights, July 17, 2015*

IMPORTANT DISCLOSURES