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Is your liquidity just a mirage?

A close look at fixed income as a portfolio anchor calls for a review of liquidity factors

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Recent events in the absolute return fixed income investment landscape bring renewed focus to the role of this investment style in portfolios. Our view has long been that absolute return fixed income can provide an alternative to traditional bond funds but should not compromise on the fundamental role of fixed income: to provide liquidity and capital preservation within a broader investment portfolio. In recent years we have seen evidence of "reaching for yield" among some absolute return investors, with significant allocations to high-beta credit sectors, private credit, and increased allocations to complex securities. Many of these strategies have worked particularly well over the past decade of "easy money" central bank support but might be significantly less suited to an environment of higher volatility and less accommodative monetary policy.

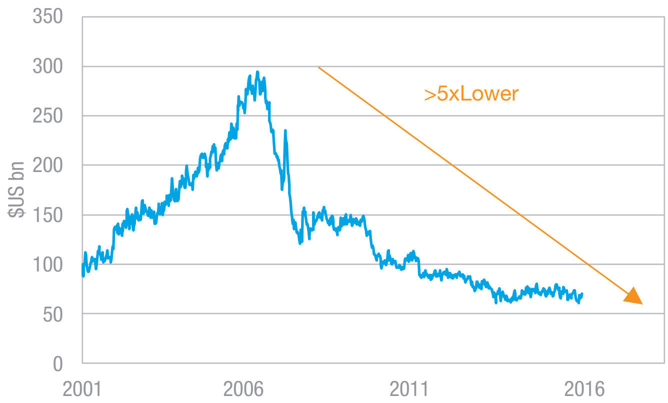
There has also been evidence that investors are again forgetting the value of liquidity. Liquidity is one of the pernicious problems facing fixed income investors. Ignoring liquidity costs will in most market environments generate small, consistent positive returns, at the risk of significant losses during stress: just when the protection of fixed income is needed most.

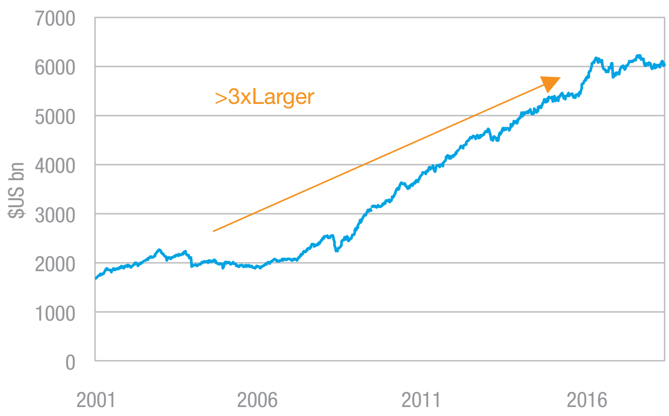
Divergent performance in recent months (and fund closures in specific cases) indicates that some investors have stretched too far to generate returns in a low yield, low spread environment. It is paramount for investors that this allocation is fit to do its job at times when the rest of their portfolios may be under pressure. As such, we think now is a good time for investors to reflect on the capital preservation characteristics of fixed income, and in doing so, ask whether their portfolios' liquidity may actually be a mirage.

How markets behave with abundant liquidity

In our experience, long periods of positive asset performance and market stability tend to encourage investors to reach for one of the few sources of yield remaining: the liquidity premium. This appeared most notably in the years leading up to the financial crisis, when credit markets paid almost no attention to liquidity, and has been increasingly evident in recent years as the reward for taking credit risk has fallen sharply. We have seen a gradual erosion of liquidity in the market, ranging from increasing interest in private credit, to growth in complex products, to renewed use of leverage among investors and the growth in structured deposits. Investors' focus on liquidity has waned over the past decade of loose monetary policy despite credit market growth and dealer balance sheet sizes indicating that liquidity is likely to be flightier than ever.

US dealing inventories (Corporate & ABS); USD credit outstanding

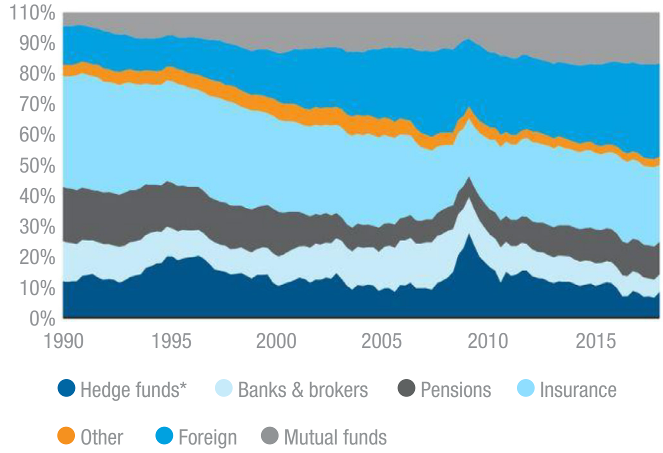




Sources: US dealer inventories (Federal Reserve Bank of New York, Macquarie); US-dollar credit outstanding (Bloomberg, Macquarie)

The buyer base in credit markets has also gradually become less diverse, in our view, and with a shorter-term focus. The increased holdings by mutual funds, exchange-traded funds or ETFs (generally offering daily liquidity), and foreign buyers all point to a lower allocation to long-term, hold-to-maturity type buyers. ETFs in particular have exploded in popularity in most asset classes in recent years, including in markets such as high yield and emerging markets that have historically offered lower liquidity.

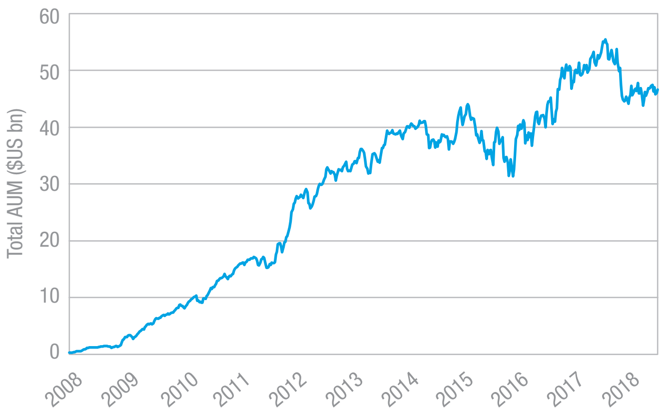
US corporate bonds outstanding by owner



Sources: Citigroup and Macquarie.

*Although described as 'household' in flow in of funds, series likely dominated by hedge fund

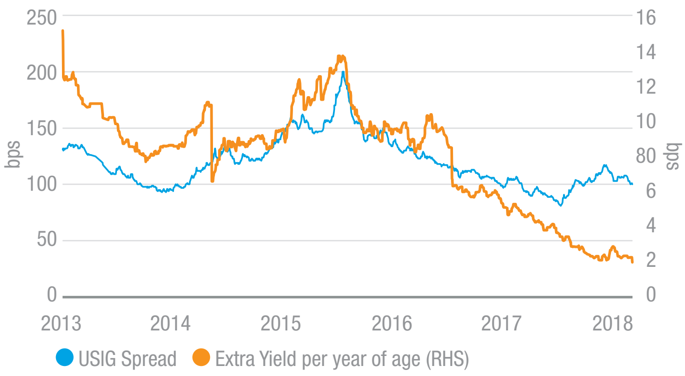
Growth in US high yields ETFs



Sources: Bloomberg and Macquarie.

The result is that the reward for taking liquidity risk continues to fall. Using our global relative value model, we can estimate the extra yield paid to investors for buying "off the run" securities (those that are not the most recently issued), which have tended to be less heavily traded and less liquid. As we witnessed it, the extra yield for buying "aged" securities (based on issuance year) remained relatively static into late 2017 (even as overall credit spreads tightened) but has recently fallen significantly as investors have sought out the last remaining pockets of extra yield.

The disappearing liquidity premium | US investment grade (IG) spreads and additional yield



Source: Bloomberg.

Liquidity is an integral part of long-term fixed income performance

Our belief that liquidity is key to fixed income performance is supported by research that our team first performed more than a decade ago on liquidity in credit markets, and which we updated in 2014 with confirming results. This research showed us that liquidity management is key to performance in credit investing, and that compensation for liquidity is a more important consideration than credit risk when buying investment grade securities.

Less-liquid securities come with a number of features that can be perversely attractive. Their lower liquidity often brings a modest illiquidity premium, but they bring a secondary, less obvious feature: their pricing is marked less reliably as they are thinly traded, meaning that illiquid securities can actually appear more stable than a comparable liquid holding, simply because the security has not been traded. But illiquid securities are likely to perform worse in times of market stress (when capital preservation really matters), so the “stability” of marked prices is illusory. To compound the issue, investors will naturally sell what they can (not what they necessarily should) in times of stress, so when it comes to eventually selling the illiquid holdings, the cost of sourcing liquidity can be severe.

So ignoring liquidity can generate apparently consistent alpha but at the risk of significant losses during stress – the classic “picking up pennies in front of a steamroller.”

Simple steps to managing liquidity

We continue to maintain our underlying philosophy of capital preservation in all the fixed income styles we manage, which includes a significant focus on liquidity. This focus on liquidity involves a total portfolio approach combining the desired risk profile with expected liquidity requirements. A portfolio is constructed with both return targets and liquidity profile in mind as each new security is added.

In the current market environment, that means gradually moving up in quality as tighter spreads reduce the value on offer, reducing allocations to higher-beta sectors such as high yield and emerging markets, and generally building and favouring liquidity. This can be done by increasing cash holdings, moving to portions of the market with proven liquidity through the cycle, and other similar changes. Generally low spreads indicate to us that there is limited return for risk on offer, and we believe the value of liquidity has again become increasingly underestimated by most investors.

Not every holding in a managed fund has to be highly liquid, but with many funds offering daily liquidity, even a relatively small holding of illiquid securities can become problematic in the case of investor outflows. Portfolio managers will naturally look to sell more-liquid holdings to fund outflows, and this in turn tends to increase the level of illiquid holdings remaining. What can investors look for as potential indicators of future liquidity problems? We believe significant weightings to lowly rated or unrated securities, heavily structured securities, use of leverage, or overly complex holdings can offer warning signs that a manager is relying on liquidity premiums to increase returns.

Conclusion

Investors are attracted to the absolute return investment style because of the specific role they expect it to play in their portfolios. It is important to understand the nature of the strategies that managers are using to generate returns, as this will help them understand whether the strategy is suitable for their purposes. Instances where traditional return-generating strategies are being replaced by what is essentially trading illiquidity for incremental increase in return, should be a warning signal.

Liquidity and a focus on capital preservation are key to fixed income investing, and adequate compensation for risk is paramount to long-term fixed income performance and making sure that you are receiving your expected absolute return. Make sure your expected liquidity is not a mirage!

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IMPORTANT RISK CONSIDERATIONS

Investing involves risk, including the possible loss of principal.

Past performance does not guarantee future results.

Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer's ability to make interest and principal payments on its debt.

The strategy may also be subject to prepayment risk, the risk that the principal of a bond that is held by a portfolio will be prepaid prior to maturity, at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate.

Securities in the lowest of the rating categories considered to be investment grade (that is, Baa or BBB) have some speculative characteristics.

An investment in the agency MBS series is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

The Bloomberg Barclays US Corporate Investment Grade Index is composed of US dollar-denominated, investment grade, SEC-registered corporate bonds issued by industrial, utility, and financial companies. All bonds in the index have at least one year to maturity.

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The Bloomberg Barclays US Aggregate Index is a broad composite that tracks the investment grade domestic bond market.

The Bloomberg Barclays Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets.

The Bloomberg Barclays US Treasury Index measures the performance of US Treasury bonds and notes that have at least one year to maturity.

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