



There is no Free (Liquid) Lunch | November 2015

The topic du jour in the corporate bond world is liquidity, or more specifically the lack thereof. Despite significant growth in the size of the market, it has become increasingly more difficult to buy and sell corporate bonds without moving prices.

Many are quick to point the finger at the Volcker Rule and Dodd-Frank and the restrictions they place on banks. Implicit in these theories is the assumption that prior to the new regulations, bond dealers were always willing to deploy capital to facilitate investors who want to buy or sell securities.

Seasoned investors who experienced the Asian financial crisis (1997), the Russian debt crisis (1998), the dot-com bubble (2000), the Great Recession (2008), and the European debt crisis (2011) might contest that point. In these times of stress, dealers were actively trying to reduce their inventories, making it easy to buy corporate debt but nearly impossible to sell without taking significant price concessions.

To understand why, it helps to take the perspective of the bank dealer. As with any business, the primary objective is to generate profits, with the difference being the dealer's profits are subject to 'mark-to-market' accounting practices. Thus, during benign markets, when corporate spreads don't move much, the bond desks are quite happy to provide liquidity in an effort to profit from the bid/offer spread. Furthermore, they are willing to hold inventory and earn the interest. In periods of stress, 'mark-to-market' losses make it difficult for traders to withstand large price drops, even though the odds of a default and incurring a permanent loss remains remote.

Taking into consideration the aforementioned crises, we feel that the liquidity provided by the banks has always been a mirage that is prone to evaporate under certain conditions. This is just the nature of liquidity, as the behavior of banks is both rational and acceptable for any profit seeking entity.

So what has been the impact of new regulation?

The increased cost of capital and compliance has curtailed some trading strategies and has reduced the bond dealer's pain threshold. One response to these challenges has been to improve the quality and stability of the earnings by shifting from a pure liability driven trading model to one that incorporates more order based or agency trading. Furthermore, even in moderately stressed markets, those dealers carrying large inventories become highly motivated to sell quickly and mitigate losses. This rush to the exit can easily lead to further downward pressure on security prices and draw in other sellers as well.

Is it all doom and gloom? The optimists within us say there is always an opportunity in a problem.

The first step is acceptance. Liquidity has changed, and we must adapt to the new environment. A good start would be for investors to demand higher credit spreads for new issues (from all issuers) in order to compensate for the increased cost of trading. Given the recent widening of credit spreads, we believe this move is already afoot.

Also, as part of our process of acceptance, we need to understand that trading larger amounts of bonds will necessitate some flexibility and creativity. We cannot simply rely on dealers to be the sole providers of liquidity. Instead, investors themselves need to be a part of the solution.



Those with capital to allocate can work with the banks to step in whenever there is a motivated and time sensitive seller. In such cases the buyer is in a position to demand a healthy price concession. In the past, the yield on illiquid securities would compensate the dealers enough for them to use their balance sheet to hold them. In the current environment, they are more open to partnering with clients in unstable markets, creating interesting opportunities for investors to capitalize on.

The last part of acceptance is placing an increased emphasis on understanding the underlying liquidity of securities. Factors to consider include the number of investors who can own the security, whether a concentrated holding is controlled by one investor, the frequency with which the issuer accesses the market and the number of market makers active in the security. Using these and other variables, it is useful to group securities into buckets depending on the time required to liquidate in various market environments. In doing so, we can better match our liquidity needs.

So while the environment is new and the problems different, the old lessons still apply. Liquidity after all is like a taxi, never there when you truly need it. Regulatory changes have effectively reduced the number of taxis available, thus we must be more creative and thorough in our thinking. We must be careful to match our liquidity needs with the types of securities we invest in. And for those with patient capital or the ability to allocate to illiquid instruments, there can be interesting opportunities to explore and profit from.

Regards,

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