Managing Liquidity Risk

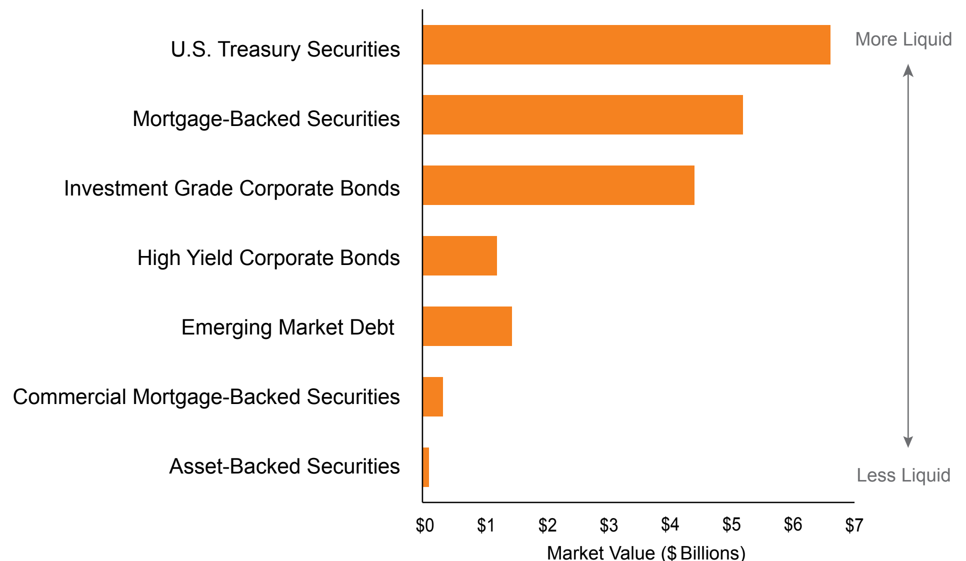
Active Management is the Best Response to the Fixed Income Liquidity Crunch

Executive Summary

- Liquidity crunch is a popular term for the risk that in today's fixed income markets it may become more difficult to sell certain types of securities as quickly as investors wish.
- Liquidity risk is not distributed evenly across the spectrum of fixed income assets – certain kinds entail more liquidity risk than others.
- Investors should consider liquidity risk management when choosing a bond fund.
- This Insight discusses the implications of liquidity risk for bond fund shareholders and examines ways to mitigate this risk through active management.
- Finally, we advocate maintaining an allocation to bond funds in the context of clients' investment goals, and suggest criteria for choosing an actively managed bond fund.

Bond markets have changed since the financial crisis of 2008. Central banks have taken extraordinary measures to keep interest rates low to spur economic growth. The supply of corporate bonds has increased as issuers have taken advantage of historically low rates. At the same time, investors seeking higher yields have taken on greater credit and liquidity risk. Regulatory changes intended to reduce the risk of another financial crisis have made it more difficult for banks and brokerages to act as intermediaries between buyers and sellers. When interest rates finally begin to rise, if many investors try to exit their bond positions at the same time, they could have trouble selling them – the so-called liquidity crunch. It's important to note, however, that not all fixed income assets have the same sensitivity to liquidity risk. Figure 1 illustrates the distribution of liquidity risk by market value and shows that large segments of the fixed income market are more liquid than others.

Figure 1. Liquidity Risk is Not Equal: Fixed Income Asset Classes Arranged From Highest To Lowest Liquidity



Source: Barclays, Voya Investment Management. U.S. Treasury, U.S. mortgage-backed securities, government-related securities, commercial mortgage-backed securities, asset-backed securities and U.S. investment grade corporate bonds are represented by sectors of the Barclays U.S. Aggregate index. U.S. high yield corporate bonds are represented by the Barclays U.S. High Yield index. Emerging market U.S. dollar denominated bonds are represented by the Barclays EM USD Aggregate index. Data as of December 31, 2015.

Lower Liquidity

A combination of more stringent capital requirements, banks' lower tolerance for volatility and a looming Federal Reserve interest rate hike has constrained dealer liquidity (Figure 2). Increased financial regulation and other structural changes have raised the cost of maintaining inventories of financial assets. As a result, traditional liquidity providers such

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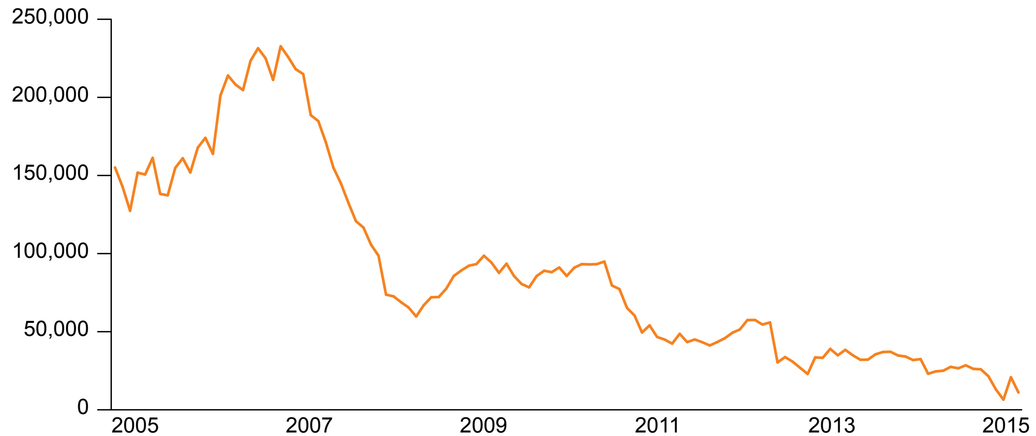
as broker-dealers and banks have become more risk-averse, making individual bonds more difficult to trade for some sectors of the market. Dealers' ability to provide liquidity during significant market moves has been impaired as firms' ability to use their balance sheet has diminished significantly. If volatility increases other market participants may step in to provide liquidity, but only at higher cost.

Figure 2. Traditional Sources of Bond Liquidity Have Been Drying Up
Primary Dealer Holdings of Corporate Bonds ($Millions)



Source : Bloomberg, Voya Investment Management. Data as of December 31, 2015.

Financial advisors and their clients should look for bond funds that deal with liquidity risk as part of their active management toolkit – along with interest-rate risk, credit risk and currency risk, where appropriate. The goal throughout the fund management process ought to be to provide clients with an investment vehicle that they can rely upon to help them achieve their savings goals.

How Can Bond Funds Mitigate Liquidity Risk?

Accepting risk is necessary in order to obtain return potential. Effective fund managers therefore are not risk averse but risk aware; able to focus their efforts on decisions where they can add value through research while minimizing exposure to more random, systematic risks. The criteria described below can be useful for determining how effective a bond fund might be at delivering its potential benefits to investors.

Liquidity risk doesn't affect all bonds equally — exposure must be actively managed.

Diversification

Many diversified bond funds include positions in U.S. Treasury securities, agency debt and agency mortgage-backed securities (MBS) – the most liquid parts of the market. Does the manager favor higher quality or larger issue size names within corporates? Will the fund manager have a strong enough conviction to hold onto a position if there is a bout of volatility? Active managers with a strong grasp of underlying fundamentals potentially can position their funds with holdings that can withstand adverse periods while retaining sufficient liquidity to meet shareholder needs.

Nimbleness

In a low growth, low interest-rate world, active sector allocation and security selection with an emphasis on finding multiple sources of return are prerequisites for success. By understanding where you are in the business cycle, in any given country or region, a bond fund manager can opportunistically adjust exposures as market conditions and long-term forecasts change. A well-diversified bond fund also should be invested across a broad spectrum of fixed income sectors, industries, maturities, structures and credit ratings. Fund size can be an important factor in this effort: larger funds may be limited to the largest, most concentrated issues to avoid negatively impacting market liquidity. Small-to-mid sized funds enjoy the added flexibility of transacting in a wider range of issue sizes; what's more, their positions generally comprise smaller percentages of total deal size, enhancing their diversification and liquidity benefits.

Risk Management

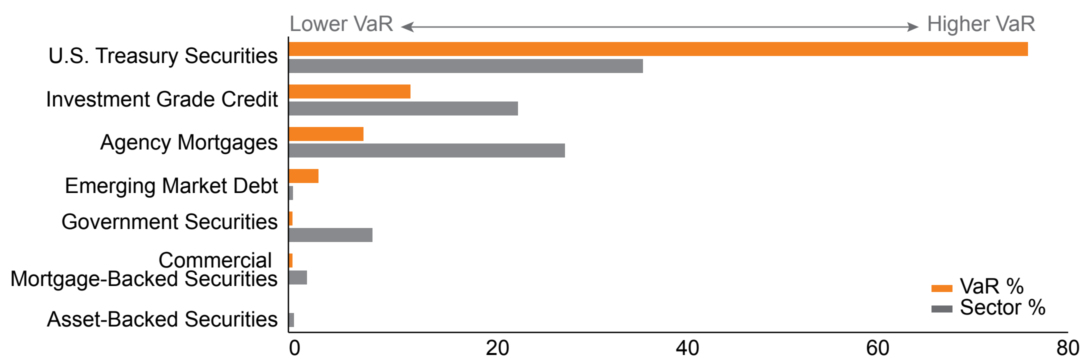
Another desirable feature of bond funds is the potential to generate consistent returns – with acceptable levels of risk — in both up and down markets. Actively measuring and controlling risk is a critical aspect of every stage of fixed income portfolio management. The common factors that drive fixed income returns – duration, yield, credit spread exposure and currency, when applicable – explain most of a portfolio's risk.

A comprehensive risk outlook provides insight into the risk/reward attributes of each investment decision before and after it is made to best navigate the bond market. Look for a bond fund that utilizes analytics such as tracking error, duration, spread duration, yield metrics, leverage and liquidity, stress scenarios and allocation dispersions. For example, a core bond portfolio can be diversified across regions, bond sectors and maturities to reduce risk exposures.

Focus on the long-term benefits of bond funds, not their short-term liquidity profiles.

Figure 3 underscores the importance of active risk management. The Barclays U.S. Aggregate bond index may appear to be well diversified in terms of sector allocations, with approximately 36% in U.S. Treasury securities and cash; but it is much less diversified in terms of risk to principal. Using a value-at-risk (VaR) analysis, 76% of the risk to principal is concentrated in the index's Treasury positioning. The index thus has a bias towards more interest rate risk and less credit risk.

Figure 3. Index-Like Sector Diversification Does Not Ensure Lower Risk to Principal (VaR)
Exposure to Sector and Value Risk Can Differ, Value at Risk vs. Sector Exposure



Sources: Barclays and Voya Investment Management. Data as of December 31, 2015.

Active Management

We believe the best way to limit performance risks down the road is to resist passivity in your fixed income asset allocation now. Active managers can pursue flexible approaches that seek to take advantage of opportunities and market conditions at any point of the business cycle. The benefits of active management potentially include the ability to reduce duration, credit and liquidity risks while maintaining income and diversification benefits. Prudent, bottom-up security selection also could be critical to focusing exposure toward those industries and securities that can benefit from ongoing economic recovery, even with rates on the rise.

Don't Bail on Bond Funds

Investors allocate a portion of their assets to bond funds to obtain benefits intended to enhance their long-term investment goals. That market conditions may change, or that certain asset classes may fall in or out of favor, are not necessarily reasons to alter one's long-term investment plan. Instead, make sure the bond funds you employ are doing the job you intend them to do.

Look for fund managers who continuously measure and manage liquidity risk as part of their active management toolkit – along with interest-rate risk, credit risk and currency risk. Liquidity risk limits should be determined through careful research, in accordance with the managers' views of each particular asset class in the fund portfolio. The total management process should be dynamic, seeking to benefit from prevailing and anticipated market conditions at any point in the business cycle.

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