EYE ON THE MARKET

Liquidity Risk: Déjà vu All Over Again

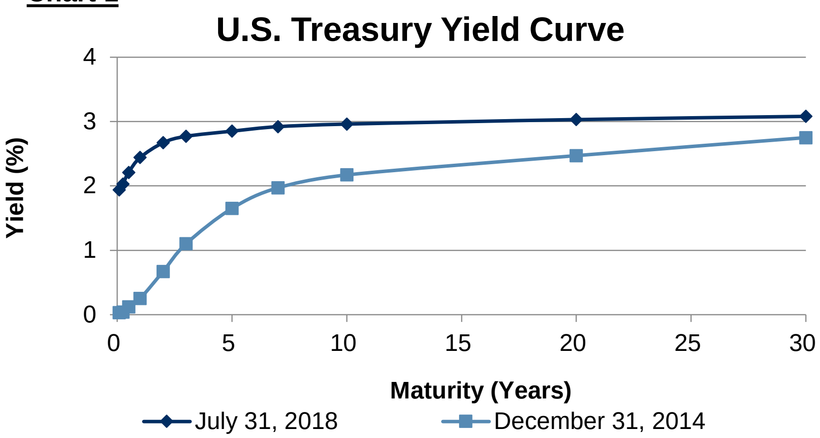
Peter Greenberger, CFA, CFP®, Director, Mutual Fund & 529 Plan Product Management

As the mid-summer doldrums are upon us, Eye on the Market ("EotM") took time to catch up on some reading. One article that caught the attention of EotM was published in the *Wall Street Journal ("WSJ")* on July 22, 2018, entitled "Prolonged Slump in Bond Liquidity Rattles Markets." The piece focused on the concerns portfolio managers had about liquidity in the fixed income market. Readers of EotM have come to know that a key focus of ours is to help investors understand risk. Looking back, we realized that this exact topic was addressed in our inaugural commentary written on January 26, 2015.

IT'S ALWAYS THE SAME IT'S JUST A SHAME THAT'S ALL

Our major concern back in 2015 was focused on liquidity risk in the U.S. fixed income markets, however we currently see increasing risks in Europe and emerging markets. Liquidity risk is becoming a greater concern today, as the U.S. Federal Reserve began raising short-term interest rates while other central banks around the world are starting to wind down accommodative policies.

Chart 1



Source: St. Louis Federal Reserve and Raymond James

Investors have been struggling to find yield in high quality bonds since the financial crisis of 2008, causing many to take on additional credit and and/or equity risk in order to generate growth and yield.

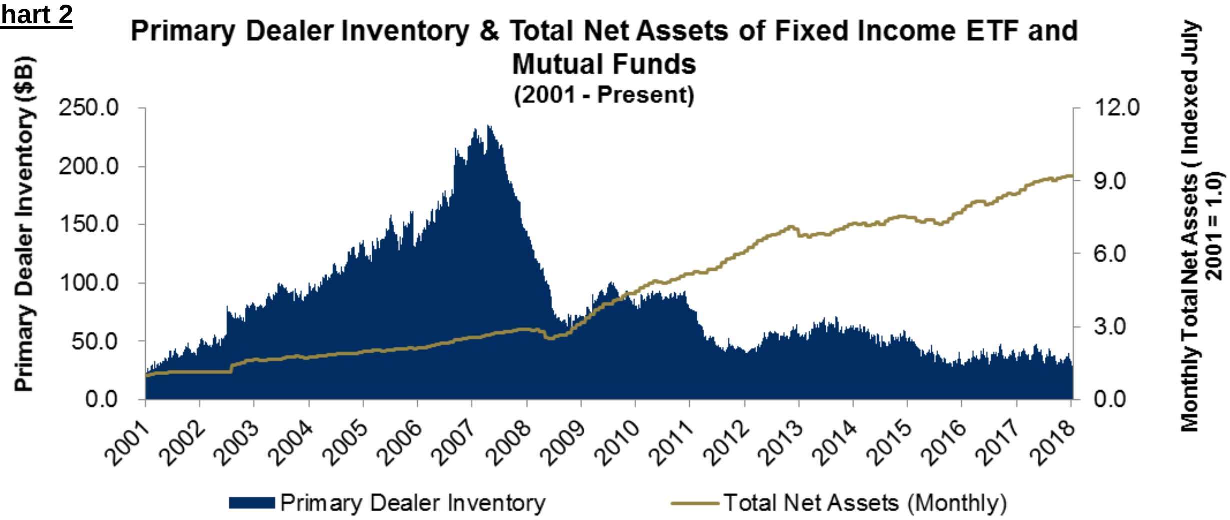
As a point of reference, Chart 1 shows just how different the yield curve currently looks relative to the end of 2014. As of December 31, 2014, the 10-year U.S. Treasury was yielding 2.17%, and is currently hovering around 3%. Even more remarkable is the change in the shortest maturities, as they have climbed from at or near zero to roughly 2% today.

Liquidity is limited in fixed income markets such as high yield, bank loan, and emerging market debt, leaving investors' principal potentially vulnerable during market stress. One way of measuring liquidity is by evaluating the spread between the price a buyer and seller are willing to accept/pay for a given security. If the spread is narrow, the market for the security is liquid. If spreads are wide, then buying and selling these securities can be much more challenging. In the event that a seller chooses to exit a less liquid position, she may have to accept a discounted price or she may not be able to find a buyer at all.

LAND OF CONFUSION

Prior to the financial crisis, institutions that served as primary dealers would step in and buy securities from those selling, until a willing buyer could be found. Given regulatory changes since then, as well as a heightened focus on limiting balance sheet risk, many of these firms have drastically reduced these business lines. As Chart 2 illustrates, lower inventories coupled with increased flows to fixed income mutual funds and exchange traded funds ("ETFs") resulted in a significant imbalance between primary dealer supply and outstanding assets held by packaged products.

Chart 2



Source: New York Federal Reserve, Morningstar Direct. All Dealer Inventory data is as of July 18, 2018 while Fund Total Net Asset data is as of June 30, 2018. Total Net Assets represent monthly totals for the following: Bank Loan, Corporate Bond, High Yield, Intermediate-Term Bond, Multisector Bond, and Short-Term Bond categories as defined by Morningstar for both ETFs and Mutual Funds.

As of June 30, 2018, there was approximately $2.66 trillion in assets held in fixed income-oriented mutual funds and ETFs. At the same time, there was only $26.7 billion held by primary dealers in inventory, down nearly 48% from the $50 billion that was held in inventory when EotM first addressed this three and half years ago. The gap between assets and inventory is not a problem in and of itself, but it further highlights the growing challenges fixed income markets could face if a liquidity event were to occur.

IN TOO DEEP

The easiest way to describe how this can be negative for investors would be to think of musical chairs. As the game goes on and on, there are fewer chairs left until only one remains. If there were a significant move to sell – think lots of players - the mismatch would likely result in certain less liquid bonds being deeply discounted before the market would clear – think of this as only a few chairs remaining. As the *Wall Street Journal* article indicated, this has become acute in European and emerging market bonds of late. For the investor that needs to sell, he does not want to find himself without a chair once the music stops.

INVISIBLE TOUCH

Given less accommodative central bank policy in the form of rising U.S. interest rates, fewer primary dealers, and a high level of risk-based assets being held by investors, fixed income investors should remember why they have allocated to the asset class in the first place. EotM believes now is not the time to take on undue risk, especially as liquidity is becoming more challenged.

For those investors seeking a fixed income portfolio that is designed to generate income, preserve capital and/or buffer against equity market risk, Mutual Fund Research ("MFR") currently has five strategies that would meet this criteria. Additionally, there are other managers that MFR thinks highly of that also merit consideration. These are all reflected on Chart 3 below.

Chart 3

Return and Risk Statistics for Funds Referenced in the Report

			Total Return			Sharpe Ratio			Maximum Drawdown		
Highly Recommended Funds	Ticker	Inception Date	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year
American Funds Bond Fund of Amer F2	ABNFX	8/4/2008	(1.06)	1.55	2.33	(1.23)	0.29	0.66	(2.52)	(2.84)	(2.84)
Dodge & Cox Income	DODIX	1/3/1989	0.16	2.72	3.09	(1.04)	0.75	1.07	(1.34)	(1.80)	(2.00)
Hartford Total Return Bond I	ITBIX	8/31/2006	(0.14)	2.30	2.80	(0.82)	0.56	0.84	(1.95)	(2.79)	(2.79)
PIMCO Total Return I2	PTTPX	4/30/2008	(0.58)	1.66	2.33	(0.96)	0.32	0.60	(2.37)	(3.11)	(3.11)
Wells Fargo Core Bond Inst	MBFIX	10/31/2001	(0.97)	1.45	2.38	(1.15)	0.25	0.67	(2.38)	(3.18)	(3.18)
Baird Aggregate Bond Inst	BAGIX	9/29/2000	(0.76)	1.89	2.81	(1.02)	0.42	0.84	(2.21)	(3.03)	(3.03)
BlackRock Total Return Instl	MAHQX	9/24/2007	(0.82)	1.79	3.11	(1.19)	0.40	0.95	(2.05)	(2.79)	(2.79)
Western Asset Core Bond I	WATFX	9/4/1990	0.06	2.59	3.44	(0.58)	0.62	1.01	(2.22)	(3.14)	(3.14)
BBgBarc US Agg Bond TR USD		1/1/1976	(0.80)	1.49	2.25	(1.00)	0.27	0.65	(2.28)	(3.28)	(3.28)

Source: Morningstar Direct & Raymond James.

SIDE NOTE

On July 13, 1985, Live Aid, a dual-venue concert, took place to raise funds to help relieve an ongoing famine in Ethiopia. The concert took place simultaneously at Wembley Stadium in London and John F. Kennedy Stadium in Philadelphia, PA. Top artists from all genres of music performed including U2, Dire Straits, Madonna, and Phil Collins. In fact, Phil Collins was the only artist to perform at both venues as he flew from London to the U.S. to perform.