Fixed Income Focus.

Dealing with liquidity – preparation is key

Liquidity concerns aren't a new issue for bond markets. While it's tempting to look at liquidity as a straightforward technical issue, we think it is more complex than that.

Contribution by Ben Bennett – Credit Strategist

Ben focuses on allocation within the credit funds as well as providing the credit input to macro strategies.

Fixed Income Focus represents the viewpoint of the Active Fixed Income team at LGIM.

Liquidity has always been a concern for credit investors. Since 2008, this has become a bigger issue. Regulatory changes put in place after the financial crisis reduced the amount of inventory that investment banks could hold, hitting market trading volumes. At the same time, we've seen increasing interest in the asset class, partly from pension funds looking for matching assets as well as investors seeking yield in a zero rates world, who have been pushed into riskier assets. Companies have taken advantage of this demand to issue record amounts of debt, much of it used to fund shareholder-friendly activities such as mergers and acquisitions or share buybacks.

WHY DO YOU HOLD FIXED INCOME?

When is liquidity a problem? In our view, it is about the reason for buying credit, rather than just which securities you hold. For the pension fund investor holding credit as part of a matching portfolio or an individual looking for a stream of cashflows to help with school fees planning, liquidity should be secondary to the long-term credit quality of the bonds in the portfolio.

Liquidity is a day-to-day issue. However, at LGIM, most of our fixed income clients are long-term holders of the asset class. We regularly assess portfolio liquidity, both as portfolio managers and also through stress testing by our investment risk teams. It also helps that we have experienced traders and strong relationships with the key investment banks. In addition, we are a significant source of liquidity ourselves – the scale of our active and index bond funds means that we carry out around 25% of our trades by matching buyers and sellers in-house, while ensuring best execution. This is obviously helpful in liquidity terms, and more importantly, saves our clients money.

Figure 1: Bond indices have soared in value even as liquidity reduces

Source: BarCap bond indices

Legal & General
INVESTMENT MANAGEMENT

This type of process planning for poor liquidity is beneficial, but the key is to have portfolios set up for such difficult conditions. And this is where our structural macro outlook is very important.

SYMPTOM OF A WIDER PROBLEM

Liquidity conditions need to be seen in a wider context. In our view, reduced liquidity is a symptom of the economic and market strains that we've been highlighting through the four Ds (debt, deficits, demographics and deflation) for some time[1]. The market has managed to look past long-term structural problems thanks to the sticking plaster of QE. But with falling oil prices leading to increased default concerns – notably in the US high yield market – and the market now confronting the first US rate hike for almost a decade, we are not surprised to find stressed conditions. As we said in our Fixed Income Compass publication at the start of the year, investment grade credit markets were likely to see greater yield volatility with increased tail risks in Europe and emerging markets. Clearly, this also holds true today.

Importantly, our portfolios have reflected this belief. As we have highlighted for some time, we have been cautiously positioned and depending on the portfolio, have typically had material exposure to cash and / or government bonds. This provides some insulation from liquidity conditions and general market weakness. Looking ahead, it also allows us to take advantage of market dislocations. As we saw in the aftermath of 2008, there were great opportunities to buy fundamentally sound bonds at very attractive prices.

So, we continue to be cautiously positioned, with the themes of the four Ds driving the broad allocation within our funds. When dealing with liquidity, it is important to be prepared.

[1]See Fixed Income Compass, March 2015, for a full explanation

Legal & General Investment Management Ltd,
One Coleman Street,
London, EC2R 5AA

www.lgim.com

Authorised and regulated by the Financial Conduct Authority.

M0662