

In praise of inconsistent liquidity

An institutional public debt perspective

November 2015

There has been a good deal of focus on developments in corporate bond market liquidity over recent years. The credit crisis, and the regulatory response to it, has sharply reduced the willingness of dealing banks to take positions onto their own balance sheets, leaving many banks effectively reduced to acting only when another end investor can be identified. Corporate bond markets have always been prone to bouts of illiquidity, but there is little doubt that there has been a general reduction in the ability of investors to trade.

Some markets have suffered as issuers and investors have switched into other markets internationally to meet their funding and investing needs – and also as some investors have switched into less active investment styles. Moreover, in the recent past concerns have developed that the flood of retail money into corporate bonds over the past ten years might reverse, bringing the liquidity issue into sharp focus.

But does falling market liquidity pose a problem for institutional clients? The answers depend on what sort of liquidity a pension scheme, insurance company or sovereign wealth fund actually requires. Our experience shows that lower liquidity can result in very positive outcomes for clients.

Liquidity and pricing

We have noticed a widely held assumption that this drop in liquidity makes corporate bonds a less attractive asset class and that it makes successful active management more challenging. Suggested remedies include a move from domestic opportunities towards the greater liquidity of the dollar market, a focus on the liquidity provided by new issues, or greater use of the credit derivatives market. Others advocate abandoning the search for greater liquidity in favour of a more passive strategy.

Most of this concern is based on the assumption that a liquid two-way market is an unquestioned positive for the investor. Our own experience has been very different, with periods of supposed illiquidity tending to be marked by significant trading activity and attractive investment opportunities. Conversely, deep liquid markets offer almost limitless opportunities to trade, but will also tend to offer few genuine mis-pricings and so little opportunity to select bonds that offer rewards in excess of the risks available. Clearly, we need to explore the impact of reduced liquidity further.

Standard assessments of market liquidity proposed by market participants suffer from two related weaknesses. Firstly, they generally assume the level of market liquidity and the investor's need or desire to access it to be independent of each other. This assumes the investor decides whether to buy or sell assets first, and then takes the decision to market to see if it can be executed. In this model, for liquidity to be useful, it must be relatively uniform and it must offer the chance to buy or sell. Patchy liquidity or "one-sided" liquidity, offering only the chance to either buy OR sell, is not considered useful because it may not match the independent investment decision that has been taken.

The second weakness of liquidity assessments is that they tend to focus on a generalised level of liquidity in the market. This is helpful to those who wish to quantify the level of liquidity, and its changes, but in reality liquidity is volatile. In addition, when liquidity is assumed to be low, it is very often not uniformly low but unbalanced, with significant liquidity available on one side of the market but not the other.

To assess what really matters to long-term institutional investors we need to consider what liquidity their fund managers need access to. A completely illiquid market may have advantages, and many longer term pension fund and insurance company investors are happy to lock money away for long periods if sufficiently

rewarded. If all else is equal then some liquidity can be useful. Cashflow requirements can be hard to predict, competing opportunities can crop up elsewhere, and there can be value in active management of existing assets. The question is to what extent these operations require the sort of generalised, ever present, two-way liquidity that forms the focus of current attention.

The obvious conclusion is that different types of activity require different levels of liquidity. Are there some investing activities that actually benefit from a drop in liquidity?

Opportunistic value investment

It is helpful to divide investing activity into that which is unavoidable and that which is opportunistic. There are some cashflow activities, such as investing inflows and paying out pensions which are clearly not optional. These activities are largely independent of market conditions, and any drop in liquidity will make them more expensive and harder to achieve.

However, active management is necessarily opportunistic, and it has a very different requirement for liquidity. The patient investor needs liquidity only when they want access to it. This liquidity does not need to offer the ability to buy and sell, but simply to buy or sell depending on the preference of the investor. At M&G the desire of our institutional public debt fund managers to trade is not independent of liquidity, but actually rises as liquidity falls. This is something exploitable – as results in all market conditions attest.

A value driven investor who tries to identify situations where the market has strayed away from fair value is more likely to find that value when liquidity falls. As a result, periods of low liquidity are likely to throw up more opportunities for a value investor to trade. That investor still needs the liquidity to get the trade done but, again, many situations identified as low liquidity are in fact characterised by the imbalance between bid and offered side liquidity. When a value investor wants to buy a cheap bond that offers significant reward for the risks there is usually ample ability to buy in significant size. In fact, the very weight of bonds on offer is typically what is driving the price to an attractive level. The key behaviour is the willingness to buy while the market is still falling, and this separates the value investor from the momentum investor.

As an example, many investors will remember the troubles at BP in the immediate aftermath of the Macondo oil spill. When the company's bonds fell sharply in value, and in our view over-reacted to the crisis, selling the bonds was well-nigh impossible and liquidity was thought to be very poor. However, an investor prepared to take a positive view was able to buy as many bonds as he or she desired. Conversely, when the news flow stabilised, and the bonds recovered, the company was able to sell a significantly over-subscribed bond issue, and liquidity was felt to have returned to the market. Sadly the return of liquidity had, as is so often the case, coincided with removal of any interesting value investment opportunity.

There are two further issues to consider. Firstly, the investor might need liquidity in order to sell one asset to fund the opportunistic purchase of another in stressed conditions. Although a purchase may be easily facilitated, a sale might not. The best solution to this issue is for the investor to run a small level of liquid assets to avoid the need to sell illiquid bonds for funding in a falling market. However, if necessary it becomes a matter of weighing the expense of selling against the advantage of the cheap offer.

Secondly, the opportunistic buyer may need some liquidity to exit a trade profitably. The answer here is largely about timing. A real value investor will be prepared to hold a cheap asset for the long term, even to maturity. However, in reality, cheap assets will often start to trade better when panic subsides and a degree of liquidity returns. The value investor will often find they are taking profits precisely because the market has returned to a more balanced technical position. Indeed, the exit may well be provided by another period of low liquidity, the difference being that offered, rather than bid side, liquidity has dried up.

Administrative value investment

Less opportunistic, more administrative transactions do require access to liquidity and falling liquidity presents challenges. However, the impact of these transactions can be reduced when trustees and their advisers work in partnership with fund managers to balance these cashflow requirements with prevailing



market conditions. Where possible, inflows and outflows can be matched with available liquidity in the market when known in advance. While this isn't always possible, where more routine flows can be managed this way, the impact of falling liquidity will be lessened. The key is to avoid selling and buying in the relatively rare cases when the whole market is trying to do the same. It would also be sensible to treat investments in the corporate bond market as relatively long term in nature.

The overall impact of lower or, more accurately, less consistent liquidity can be assessed by balancing the advantage from greater opportunity with the cost of unavoidable transactions. The obvious conclusion is that the impact of lower liquidity can be greatly reduced by ensuring that the greatest proportion of trades are opportunistic. This involves adopting a value management approach that responds to market conditions, and trying to avoid flows into and out of the asset class at inopportune moments. We can then balance the positives of enhanced value opportunities against the negatives of greater frictional costs on non-opportunistic trades.

Liquidity needs are a function of investment style

An investor who is not driven by value would have a very different requirement. If an investor makes decisions independent of market levels and conditions, perhaps based on a perceived ability to predict macroeconomic or fundamental developments or if they are a momentum driven investor, liquidity is crucial. This liquidity must be there at all times to facilitate trades, and must be "two way" because the investor will often be buying a rising market or selling a falling market. It is no coincidence that it is these investors who have mourned the lack of liquidity hardest, often exiting corporate bond markets completely. These investors have also been the strongest champions of employing corporate bond new issue markets and derivatives to enhance liquidity, or indeed moving to the more liquid dollar market. A perceptive value investor might well note that the enhanced liquidity of these areas is balanced by a paucity of obvious value driven opportunities.

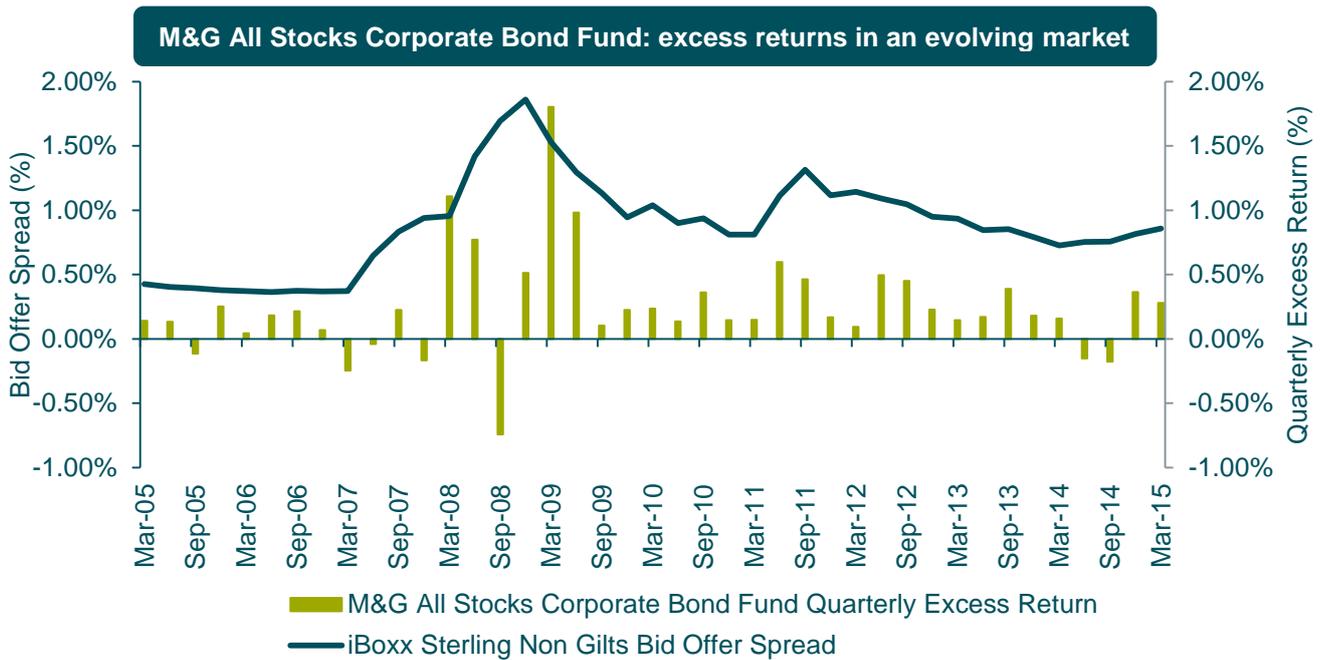
In summary, the need for liquidity is heavily related to the investment style of the manager – so an important consideration for clients is to evaluate whether their manager's style will be helped or hindered by current conditions. Of course, management style is not often applied with complete orthodoxy. Even a committed value manager will sometimes want to trade in the same direction as the rest of the market. In these situations, the manager relies on the ability to obtain such liquidity as is available, perhaps using counterparty relationships and specialist dealing expertise in local corporate markets. There is no doubt that falling liquidity will be an issue in these circumstances, but the important point is that while these situations do arise, they are dwarfed by situations where a value investor is trading against the general market direction. It is also interesting to note that while bank balance sheet capacity has been reduced, what little remains does seem to be closely targeted at more volatile situations where investors are more likely to want to trade – something that liquidity mourners appear to overlook.

Inconsistent liquidity, consistent performance

The chart below compares relative performance of one of our longest-running pooled corporate bond funds to prevailing market conditions. This illustrates the approach taken by M&G's fund managers to managing public credit throughout the cycle, as well as allowing comparisons to be made pre and post the financial crisis. The fund's outperformance of the market benchmark does indicate strongly that performance is better in times of high volatility and associated lower liquidity. Conversely, the more liquid markets in operation prior to the credit crisis were challenging in terms of attaining outperformance targets. This example asserts that under our style of management, the benefits of greater opportunity outweigh any issues on trading costs.

To complete our assessment we need to compare this enhanced ability to produce active returns with the greater frictional costs of entering or leaving the asset class. The key obvious variable here is timescale. If credit investment is viewed as a long term investment, perhaps ten years or more, the increase in initial and final transaction costs can be spread over ten years of enhanced active returns. There is no scientific way of measuring the two figures – both are variable and dependent on investor behaviour. However, given the levels that we have observed as liquidity has declined, we have no hesitation in concluding that a long term credit investor has in fact been well served by the reduction in liquidity in return terms.





Source: M&G, M&G All Stocks Corporate Bond Fund, iBoxx Sterling Non-Gilts index Bid Offer Spread, as at 30 June 2015. For illustrative purposes only. This fund is part of the M&G Pooled Pensions fund range which are funds provided under an insurance contract issued by Prudential Pensions Limited and is available to UK exempt approved pension schemes only.

In conclusion, liquidity and its much lamented decline have not been general or consistent. While an active manager would struggle in a market that offered generally poor liquidity, they may well benefit from a market that offers patchy and often unbalanced liquidity. In fact, history shows that large institutions with traditionally large allocations to credit become providers of liquidity in such circumstances – indeed, insurance companies have done well here time and time again. The key to taking advantage of lower liquidity is to be more opportunistic, both in manager style, but also (and this applies more to pension schemes) in any administrative transactions that have any flexibility.

The lower liquidity environment also suits the longer term value investor in credit as an asset class. These approaches accept and celebrate new market conditions, and are far likelier to succeed than trying to force an investment style on the markets by using slightly more liquid derivatives, new issues or overseas markets. Liquidity in these areas is still lower than it was, and they rarely offer the same sort of value opportunities as the less liquid cash markets.

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