

Vantage Point



How to address liquidity as bond markets show greater signs of fragility

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Although liquidity fears during turbulent times are an ongoing problem for fixed income investors, new research suggests few parts of the market now remain safe from thinning liquidity conditions.

A report by Committee on the Global Financial System (CGFS) suggests that bond markets are becoming increasingly susceptible to disruptions – such as sudden stops of liquidity in key segments of the market – and identifies regulatory change and banks' trimming of trading-related exposures as key drivers behind their concerns.

Yet in an asset class that has already faced one extremely high-profile liquidity scare, how can investors shield themselves from a potential nightmare?

Following the launch of the study, William Dudley, CGFS chairman and president of the Federal Reserve Bank of New York, underlined the transitional state of fixed income markets, but observed that recent changes within the sector have not had the desired effect on liquidity.

'So far, the effects of ongoing regulatory, technology and market structure changes do not appear to have had large, persistent effects on the price of liquidity services for most major asset classes, but rather have been reflected in increasingly fragile liquidity concerns,' he said.

Dudley's comments come less than two months since fixed income investors were served a reminder of illiquidity dangers during large sell-offs within the US high yield sector.

Third Avenue Management blocked redemptions from its \$789 million (£541.5 million) Focused Credit Fund towards the end of last year, while it began liquidation proceedings.

Although this is an extreme example of how fixed income investors can be burned during periods of extreme volatility, the CGFS report serves as a timely reminder for investors to remain cautious in the current market environment.

Mark Williams, investment manager at Charteris, says bond markets are showing greater signs of fragility during periods of market stress and he feels the worst may still be yet to come.

'An increasing number of the more astute investors are waking up to the fact that when the interest rate cycle turns, it could become very difficult to get one's money out of a corporate bond fund,' he adds.

'What is really concerning from the bond market's perspective is that the potential is there for volatility to increase in the short to medium term, as opposed to retreating back to levels perceived as regular historically.'

With the liquidity of bond markets currently sitting in such focus, discretionary fund manager Wellian Investment Solutions has compiled a liquidity consideration checklist, to help investors analyse the suitability of fixed income funds – addressing aspects such as diversification and the largest holders of a fund as well as regular flows and dealing with redemptions.

According to Richard Philbin, chief investment officer at Wellian Investment Solutions, although there is no failsafe strategy for analysing liquidity risks, investors need to take a far wider and comprehensive approach when considering bond funds.

'Unfortunately, there is no one golden rule for identifying liquidity issues in fixed income. It is not possible to apply one definitive set of rules stating we will not invest in funds over and above a certain level: rather, identifying illiquidity requires a multi-faceted approach that will help to pinpoint where any potential risks may lie,' he says.

Common sense can also play a key part in avoiding a potential liquidity disaster. James Barber, head of investments at Epoch Wealth Management, explains that in some instances, bigger does not always mean better.

‘When you have a liquidity issue, it is not going to be something that only a large or small fund will face – everyone will have to face the fact there are more sellers in the market than buyers,’ he explains.

‘But clearly, if you have chunks of securities to sell down, that is what you want to be concerned about. We have reduced exposure to strategies that have done well and attracted a lot of assets, because if the tide turns, you need to be mindful of the risks.’

These sentiments are echoed by Williams, who stresses the importance of focusing on the underlying assets of a bond fund when weighing up liquidity risks rather than its size.

‘It is a myth that small funds are illiquid and large funds are not – indeed, more often than not, the opposite is true,’ he says.

‘The liquidity of any fund is determined totally by the liquidity of the underlying assets. For example, a small gilt fund is a lot more liquid than a larger corporate bond fund.

‘However, as with any fund – regardless of its sector – a manager must conduct thorough due diligence on all aspects of a fund, and liquidity risk management certainly falls into that category.’

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