

# Solving the problems of LIQUIDITY and VOLATILITY IN FIXED INCOME

*The challenges and risks in fixed income markets, including LIQUIDITY AND VOLATILITY, were discussed at a roundtable hosted by Investment Magazine.*



Chris Baker principal, Mercer

AT THE ROUNDTABLE, the role of exchange-traded funds (ETFs) in helping address the liquidity challenge and manage risk in fixed income was examined. Investors shared their experiences of using ETFs for short-term trades, tilting in portfolios and transitioning between managers.

We live in a new era of fixed income investing, with low yields and increased volatility, coupled with a lack of liquidity. Investors are reacting by being underweight core fixed income, looking further up the risk spectrum and looking at new ways to gain the desired exposures. The roundtable discussed these challenges, and heard that StatePlus and Sunsuper are both underweight core fixed income, and looking to high yield and private debt to generate returns.

The impact of Dodd Frank and Basel III is important to highlight, says Bigos.

"So the challenge clients are facing is: where to access the liquidity when they want it? Primary market is one source and the issuance is there as borrowers take advantage

of low borrowing costs. Just recently we've seen increased issuance in investment grade and high yield, but those deals were on average three times oversubscribed," she says.

"We're conscious of taking more risk, some liquidity risk, in the search for higher returns. That said, we're not abandoning core fixed interest all together, we need that liquidity," says Richard Dinham, head of research at StatePlus.

For Sunsuper the current environment prompts the question: "why own fixed income?" and portfolio analyst, Andrew Fisher says really the only rationale is that it diversifies equities.

"Now when you start to question whether the diversification is going to be there, and the cost, we naturally have less. So we have less fixed income and within fixed income we have less duration," he says. "We've lost confidence that the diversification will continue to behave the way it has in the past."

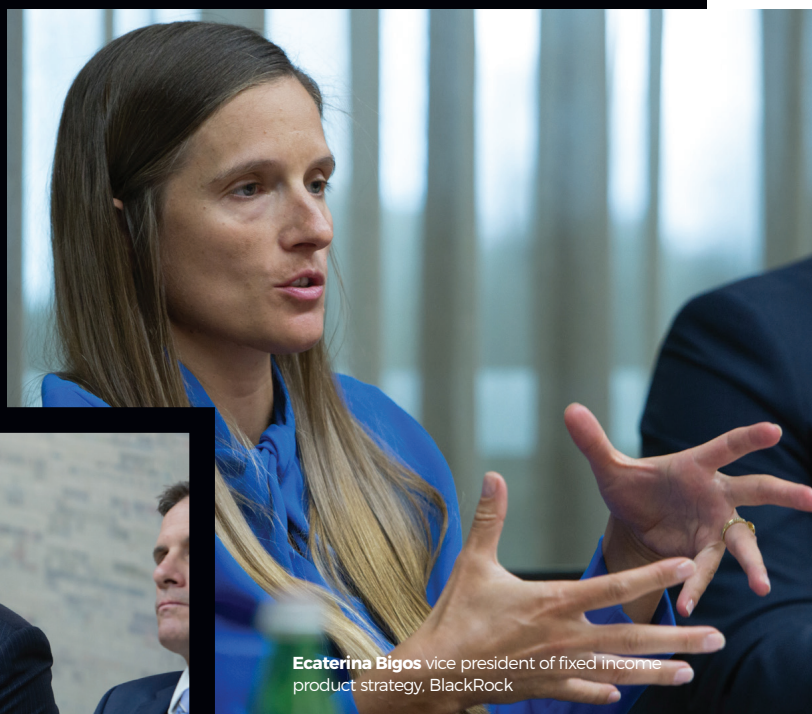
Craig Vardy, portfolio manager at BlackRock, says tighter regulation is commonly blamed for shrinking dealer

balance sheets and the decline in traditional market-making activity. Lower risk appetite from banks and profitability have been nearly as important as regulation for lower liquidity. "So when you think about liquidity, you're probably thinking about two main elements. There's a size element to it, and also a timing element. So how much do you need to trade, and how long have you got to trade that?" he says. "The bid/offer spreads haven't really changed but the quantity has changed."

David Foodey, co-head of program trading in the Asia Pacific, and co-head of cash execution in Australia at Deutsche Bank, says the bank has tripled the amount of capital it holds and the amount of risk it holds has halved.

Ecaterina Bigos, vice president of fixed income product strategy, BlackRock, gave an overview of more than \$60bn flows into fixed income ETFs this year, which have gone primarily into exposures such as investment grade, high-yield credit and emerging markets.

Morningstar has a lower allocation to



**Ecaterina Bigos** vice president of fixed income product strategy, BlackRock



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fixed income than it might in a “normal” environment, and Brad Bugg, head of multi-asset income at Morningstar says cash is the only asset class that can protect capital with 100 per cent certainty.

“In terms of breaking down fixed income, we’re probably heavily underweight traditional government bonds. We are starting to take more of a look at the local currency emerging market space. The yields are a lot higher there, and if we are in a slower growth environment around the world, it probably means they’re going to have lower interest rates going forward, so hopefully there’s some potential for diversification as well.”

But while the diversification benefits of fixed income may be less, George Lin, senior investment manager at CFS, says he is struggling to find anything that diversifies equities, especially when cost is a consideration. While the argument for diversification may not be as strong, he says the purpose of fixed income will be dictated by the fund’s circumstance

and also include liquidity, or generating return and a bit of income.

### FINDING LIQUIDITY

“It certainly is a challenging environment,” says Chris Baker, principal at Mercer.

Importantly, Mercer considers the liquidity aspects, and the defensive nature of fixed income, by splitting up more credit-heavy strategies versus smarter composite style mandates from the core bucket.

And while liquidity has been most pronounced in the core bucket, Mercer is also concerned with how liquidity has impacted other buckets.

“I guess people are surprised at the liquidity issues in high yield and the market’s really changed over the past few years,” he says.

### OPPORTUNITY TO PROVIDE LIQUIDITY

The issue of liquidity was one of interest to the group, and Dinham queried how





Craig Vardy co-head of fixed income, BlackRock

it is possible to provide greater liquidity in an ETF than what is available in the whole underlying market.

Bigos explained that the exchange trading element and the ETF design are key differentiators.

Fixed income ETFs essentially provide a means to trade bond exposure on exchanges, which are well-established all-to-all trading venues. The additional layer of liquidity provided by the secondary market for ETF shares allows ETF investors to trade shares of the ETF without the need for any transaction in the underlying securities held in the ETFs.

But as Bugg pointed out at the roundtable, the industry has been concerned about liquidity in fixed income since 2008/2009.

Vardy says the key around managing underlying bond liquidity now is that it can take time to trade positions.

"Ask the question of what's your size, what's your timeframe in terms of getting in and out. It can be done, it just takes time," he says.

"Changes to the bond market structure have not kept pace with changes to market participants and the overall growth in the number of bonds outstanding. Going forward, it will help to see a reduction in the number of distinct bonds per issuer. We believe this could occur via a greater use of benchmark issues by larger issuers," Bigos says.

According to Bigos, the market dynamics

such as issue size and the frequency of issues, of varying maturities complicates matters.

When it comes to ETF design in addressing this challenge, ETFs track representative of the universe benchmarks, well diversified across issuers, maturities, ratings and industries. Additionally, liquidity of an ETF is defined through its inclusion rules. For example for the BlackRock high yield ETF a minimum issue size per bond and a minimum amount outstanding per issuer is required before it is included in the index. Another component to consider is portfolio management, and in most cases BlackRock delivers index risk and return with a subset of securities, in doesn't fully replicate the ETF.

"This means, importantly in market distress, or when we're looking to redeem out of the ETF on client orders, we only have to sell a representative basket of the full portfolio," Bigos says. "If there's a bond that is difficult to sell, we'll just not sell it. We're not going to be forced sellers into the market," she says.

#### HOW DO INSTITUTIONS USE ETFs?

Bigos gave examples of how investors internationally are using ETFs, in particular as overlays to help clients navigate current volatile markets.

"One client used ETFs on top of their core asset allocation in order to tilt the duration to the desired level," she says. "ETFs allow

investors to keep their core over long term, but at the same time be nimble to navigate current markets to tactically position their portfolios over short to medium term."

Steve Strain, transition manager at Mercer, says that when investors are looking to switch to new funds within the same asset class, but have not identified the new manager, they can use ETFs as an interim parking vehicle.

"Investors can park the money, and it is safe and flexible and you don't have to be an expert in the field. It will keep you safe for a while. It can take months to appoint a new manager and we've found in the past that managers will be willing to accept the funding through an ETF, and they'd incrementally sell it down into their portfolio at their leisure."

Fisher, who says Sunsuper has used ETFs in transitions, cautioned that if an investor is going to use an ETF in transition then to make sure that transition is not too long, as it can be expensive.

Foodey added that if an investor is going straight passive then it is cheaper to go into a passive index fund, especially if an investor has size on their side. But on a short-term basis, ETFs are very practical, he says.

"In high yield I don't think we can do better than an ETF. It's all about the access, fees, entry and exit costs, and trading volume. It's probably the easiest place to get volume away in high yield in a relatively short space of time. And we're more likely to use high yield as a tactical play," Strain says.

Bugg says that Morningstar used iShares Interest Rate Hedged High Yield Bond ETF (HYGH) a hedged high yield bond ETF, earlier in the year when the spreads were out.

"We thought they were attractive. We didn't like the total yield on offer, so we just really wanted to isolate the credit spread. HYGH was a really good option in that environment, and it gave us a couple of months to go and find a manager who could provide a short duration quality option because we don't want to be running a sort of a passive exposure in high yield over the longer term."

ETFs are not a substitute to active security selection. There is, however, a potential benefit to allocating a portion of a fund to an ETF that offers liquidity and can be traded and repositioned quickly to capture strategic opportunities. ✕