Sector Monthly

Unravelling Liquidity Risk in Markets

2 October 2015

Key points:

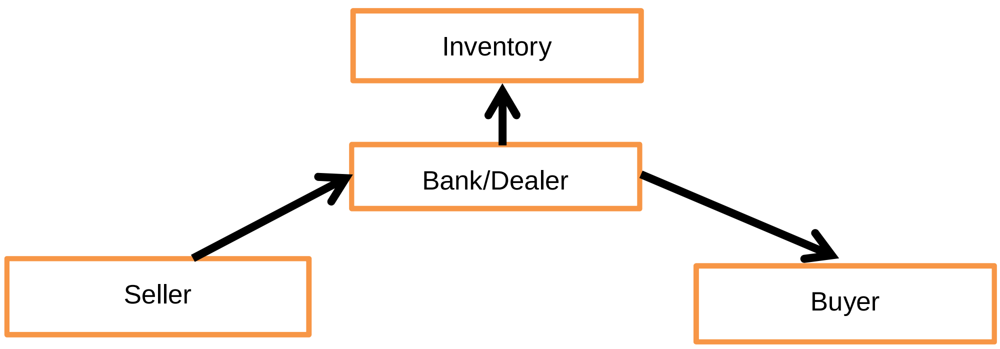
- Liquidity risk has heightened in markets since the GFC. Ironically, changes to regulations to make banks safer for depositors have had flow on impacts and increased risk to investors instead.
- Changes from the US Dodd Frank reforms limiting trading activities and the requirement to hold additional capital has forced banks to curtail their traditional market clearing roles. Previously, investment banks could participate in trades as an agent (ie. finding a buyer/seller on behalf of their client) or as a principal (ie. acting as the counterparty themselves). The inability of investment banks to hold securities on their own balance sheet means they will revert to being mainly agents.
- The banks acted as a liquidity buffer to the market. With this role reduced, the impacts range from increased price volatility, to potentially no liquidity at all, in some markets. This risk has been compounded by flows into ETFs in recent years. Any large outflow or rush for the exit will be painful.
- Liquidity risk is ultimately unavoidable for investors. High quality managers like PIMCO and Schroders mitigate liquidity risk through portfolio diversification, recognise and measure liquidity risk, and ensure they are adequately rewarded for bearing it.

Many market commentators, such as former PIMCO CIO Bill Gross and JANA's own John Coombe, have made mention of liquidity risk being something that keeps them up at night. In this paper we explain what liquidity risk is.

Background

In order to explain what the risk is, it is worth revisiting the world before the Global Financial Crisis (GFC) and the role of the main financial intermediaries in securities markets, such as bond markets. Pre-GFC, investors looking to trade in fixed interest securities would contact the trading or sales desk of an investment bank. The trading desk would facilitate the trade by finding a party on the other side of the trade, whether it is a buy or a sell order. In other words, the trading desk was acting as an agent of the investor to facilitate the trade.

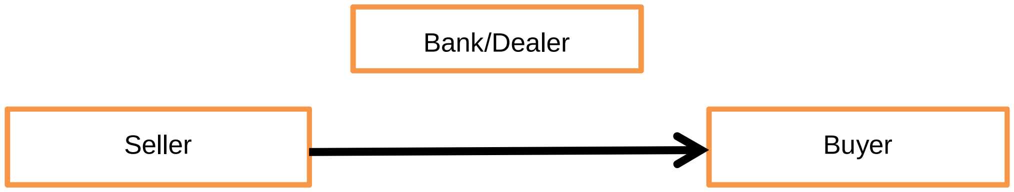
However, in addition to acting as an agent, the trading desk was able to act as a principal. In other words, if an investor was seeking to sell a security, rather than trying to find a buyer, the trading desk had the option to purchase that security and retain it in the bank's inventory for sale at a later date. This activity had a positive impact on the overall market liquidity for investors as in effect, these trading desks had become market makers. For investors looking to sell difficult to move securities with few buyers, the ability of the investment banks to inventory securities meant there would virtually always be a price available at which they could transact (even if it were a particularly unattractive price).



Dodd-Frank and the Volcker Rule

The GFC saw the demise of two large investment banks, Lehman Brothers and Bear Stearns, and saw a number of other major financial firms, such as AIG, have near death experiences. The response to this from regulators was an extensive regime of reforms, led by the Dodd–Frank Wall Street Reform and Consumer Protection Act. One component of this law was what is known as the Volcker Rule (s619 of the Act). The Volcker Rule specifically bans the investment banks from making speculative investments that had no benefit to its clients (read: bank deposit clients), such as proprietary trading or owning or investing in a hedge fund. Regulators had determined that one of the problems with many financial institutions in the GFC was their exposure to higher risk activities such as speculative trading. While the GFC was caused by the interaction of the collapse of the US housing bubble, prevalence of complex high risk instruments such as CDOs, poor governance and risk management, and risk taking behaviour by market participants, the high risk trading activities of the banks were deemed to be magnifying the difficulties facing large financial institutions.

The main impact of the Volcker rule is to curtail the ability for banks to keep securities in inventories or stockpiles. This means that the bank can no longer act as a principal when an investor wishes to trade, but rather is required to revert back to being the agent. Alternatively, where banks continue this line of business, they must hold large amounts of regulatory capital making it an expensive exercise.



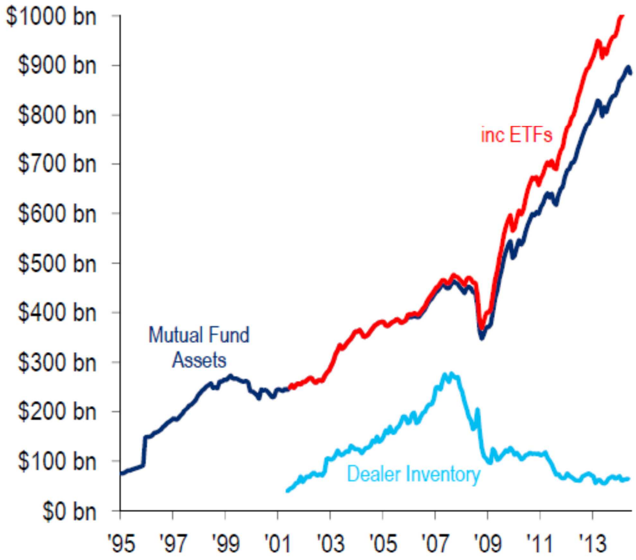
What does it mean for me?

This brings us back to the question at hand. What are Bill Gross and John Coombes talking about when they worry about liquidity risk?

Earlier we talked about how the role of investment banks as principals allowed them to act as de facto market makers. In this role, they had a smoothing effect in markets and their participation in markets meant that prices for securities had a lesser chance of “gapping” (in other words, making large sharp price changes). As a result, the first observation that can be made is that without the smoothing effect, securities prices are potentially susceptible to short sharp volatility spikes.

While increased market price volatility is an interesting aside, the main issue with liquidity risk is that without the presence of the investment banks trading as principals to “buffer” the financial system, investors face the real risk of their not being a willing opposing party to trade with. We saw the ramifications of this during the GFC when the investment banks ceased trading activity, with many funds in the credit, high yield, and hedge fund sector becoming frozen and unable to satisfy redemption requests.

The drawdown in bank activity has also coincided with a period of growth in the amount of ETF and mutual funds owning credit instruments.



Source: Citi Research, Federal Reserve, ICI
Note: As of July 2014

Source: Schroders

Advisors will be familiar with the reasons for this growth in FUM. The chase for yield is a common thematic that has driven activity in a number of asset classes. While the dollar amount of bank inventory has stayed constant since the GFC, as a proportion of the total amount in the market it continues to dwindle. This highlights the risk that the banks will not be able to "smooth" the market in case there are large outflows in the market and there will be significant liquidity issues should a large number of investors seek an exit at the same time.

Extreme liquidity risk – the story of Breaking the Buck

A common strategy undertaken by investors is to remain in conservative funds such as cash funds. While the GFC was an extreme event, lessons can be learnt and one major lesson was that even investors hiding in "safe havens" such as cash funds found that they could not avoid liquidity risk. This is an illustration of how liquidity risk can cascade from a fund specific issue to a system wide issue through a combination of loss of investor confidence, and the failure of market liquidity.

The concept of "breaking the buck" is when a money market or cash fund is unable to sustain its $1 unit price. In the GFC, this was precipitated by some cash funds writing off investments in Lehman Brothers, and then not being able to price or transact in other investments due to the withdrawal of market makers. A cash fund is considered the most "safe" of all investment funds and more akin to a bank account, even though it is not (a bank account is regulated by the bank regulator and has the benefit of prudential safeguards such as capital backing). As a result of this perception, any reduction from a $1 unit price has the potential to cause investors to lose confidence and seek to redeem their investment. When this occurs on a large scale, it may make difficult for the fund to sell enough assets to satisfy any redemption requests.

While the impact of "breaking the buck" is an extreme case, the same feedback loop effects can present in other liquidity risk situations, namely the risk of being unable to transact or value securities, the impact this has on fund unit pricing and the ability to service unitholder redemptions, and ultimately the spillover of this into investor confidence.

How do fund managers manage liquidity risk?

Ultimately liquidity risk is an unavoidable consequence of investing. Managers such as PIMCO and Schroders manage liquidity risk by factoring it into their investment decision making. In other words, financial securities considered at higher risk of illiquidity are held in smaller allocations and/or are required to generate a higher return before being considered for investment. Diversification across markets, sectors, issuers, and maturities also plays a role. While this structure does not alleviate liquidity risk, it does serve to ensure that there is an appropriate portfolio construction framework to manage the risk, and that there is adequate consideration of reward for risk that is borne by investors.

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