BlueBay
Asset Management

Avoiding the crunch before it bites

PUBLISHED
November 2019

READ TIME
10 minutes

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Liquidity concerns are on the rise and show no sign of abating. But fixed income investors shouldn't have to give up on alpha in order to maintain good liquidity – careful management can result in a happy medium, in my view.

After a summer flurry of liquidity shocks, investors have rightly pushed the topic to the top of their agenda and are turning a critical eye on portfolio construction, questioning just what their managers are holding.

And this is a good question to ask – investors *should* know what they own.

While liquidity management remains the job of the trusted asset manager, it is important that, besides being comfortable with how their investments' liquidity risk is being managed, they enjoy an adequate level of transparency into their investments: Information is power!

With US/China trade tensions likely to remain on the agenda for some time to come, propped up by a carousel of rotating geopolitical issues, central bank monetary policy plans remain under constant scrutiny. The prospect of tighter global liquidity conditions is a scenario we can't overlook. No fund manager has a magic solution to improving the macroeconomic environment, but they can implement best practice around liquidity management to mitigate risk.

While recognising the importance of having the most sophisticated systems, from my own experience of developing a proprietary model to manage liquidity risk, I strongly believe in overlaying qualitative inputs from portfolio managers and execution traders to complement quantitative liquidity frameworks.

In my view, this type of governance is fundamental in mitigating liquidity risks at source, but once an investment is in play, proactively addressing potential issues becomes critical.

While each bond house has its own approach, there are three elements that I believe are crucial for any risk management framework.

1. Liquidity scoring – once an investment is made, the hard work shouldn't stop. Continuously reviewing a fund's risk profile to assess the liquidity of its underlying holdings is essential to ensure current thinking is in line with the reality of market conditions but, more importantly, to ensure that the liquidity profile is consistent with the fund's liquidity terms. As fixed income investors, we primarily focus on parameters such as credit spreads, position size and number of market-makers, but the approach can be customised to suit any asset class.

LIQUIDITY SCORING IN ACTION – EXAMPLE FUND*

NAV (MM)	USD100
Cash	8%
1 day	75%
2-5 days	14%
5 days to 1 month	3%
>1 month	0%
B/A spread	60c

2. Stress testing – once we have the liquidity score, we can start stressing the fund to see how its holdings would perform in extreme market conditions. For example, what would happen if it faced a redemption shock of 30% or 40%, or how would it look when simulating the conditions of October 2008 as the crisis was deepening? This kind of testing can show up unexpected results and, reverting back to the ethos of 'knowledge is power', this information is crucial for thoughtful ongoing position rationalisation and potential portfolio adjustments.

EXAMPLE FUND UNDER OCTOBER 2008 STRESS SCENARIO*

NAV (MM)	USD100
Cash	8%
1 day	50%
2-5 days	33%
5 days to 1 month	9%
>1 month	0%
B/A spread	86c

*The data in the charts is for illustrative purposes only and is not reflective of any actual fund. It is offered for the limited purpose to help the reader understand type of information used in performing the type of risk assessment identified.

3. Concentration considerations – this will have different dimensions! I believe that a significant holding in any issue, say 10% or more of the total issue size, isn't necessarily an immediate liquidity red flag as there may be some mitigating factors, such as the depth of the total debt outstanding, but it should warrant special attention. The concentration of a position within a fund also needs to be controlled. Ultimately, concentration is important as it could affect the price you trade at or, in a worst-case scenario, your ability to trade at all.

The prospect of tighter global liquidity conditions is a scenario we can't overlook

A side note on illiquids

In my opinion, illiquids shouldn't be tolerated in daily dealing funds! From an active investment decision perspective, my belief is such positions are simply not appropriate holdings for funds in which you have to deal with subscriptions and redemptions on a daily basis. In exceptional circumstances, however, it is possible that a default scenario or debt restructuring event could render a holding illiquid. How much exposure a manager can and will tolerate in such a scenario requires accurate judgement, alongside a robust exit plan. Managing concentration upstream, as discussed above, should limit the scale of such scenario, but it is fundamental to ensure an independent governance oversees the execution of the exit strategy agreed with the investment teams. While such situation is not necessarily a result of an active investment decision, I feel it is nevertheless critical to continuously review and enforce the consistency of the liquidity profile of a fund with its liquidity term.

Miscalculating liquidity can result in substantial losses for clients and tumbling AuMs for managers. The recent media scare stories provide a strong reminder of the reputational risk bond managers carry running daily dealing funds. While strong governance is fundamental in mitigating these risks, proactively addressing potential issues is critical in order to avoid facing them altogether.

A robust liquidity management framework cannot be optional in today's environment of increased volatility coupled with erratic and unprecedented political and policy moves. With continuous enhancement, it can help to ensure the appropriate level of scrutiny is applied to liquidity risk – helping to ensure investors remain ungated and free to flow while managers stay out of the headlines.

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