ADVISOR PERSPECTIVES

What We're Doing to Manage Liquidity Risk

September 14, 2015

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In our last post, we urged investors to vet potential asset managers to make sure they understand the bond liquidity crunch. It's only fair, then, to explain what we're doing to manage liquidity risk.

Although it may seem to be, declining bond market liquidity isn't a new phenomenon. Strict capital rules for banks started draining liquidity from the market years ago, and several other factors, including crowded trades and risk-management strategies that make it hard for investors to ride out short-term volatility, have the potential to make the situation worse.

Lately, investors have grown increasingly aware of the decline in market liquidity. But well before this decline became the topic *du jour* in markets, we were shoring up our investment process to help investors stay afloat in less liquid markets and possibly even profit from them.

Here are five things we're doing to fortify our clients' portfolios:

1. Diversifying, diversifying, diversifying.

Isolating allocations into single-sector funds—high-yield, emerging-market and so on—is risky business when liquidity is low. If liquidity dries up in one sector, investors may not be able to trade during times of market stress.

That's why we prefer to take a holistic and dynamic multi-sector approach that taps into a broad range of fixed-income assets. This way, if selling spikes in high yield, investors can quickly and easily move to investment-grade corporates or another sector where liquidity is more plentiful.

2. Avoiding the crowds.

Low interest rates around the world have forced investors to hunt for yield in the same places at the same time. This crowding tends to push asset prices up—in many cases to levels where we no longer think investors are being compensated for the risk they're taking.

We think it's better to avoid the crowd and make decisions based on value, not popularity. The ability to take the other side of popular trades can be a crucial advantage. Should something happen that makes others want to sell, investors who didn't follow the crowd may be in a position to buy attractive assets at a reduced price.

3. Keeping plenty of cash and derivatives on hand.

Swooping in to buy when everyone else is desperate to sell requires cash. Think of those investors who used the "taper tantrum" to buy attractive bonds when everyone else was hitting the Sell button. For providing liquidity when others needed it, they were compensated with higher yields. But first, they had to be in a position to buy.

Sure, cash has yielded next to nothing for the past seven years, and keeping too much of it on hand hasn't boosted returns. But it's critical for investors who want to turn less liquid conditions to their advantage.

To offset the potential performance drag, we use relatively more liquid derivatives to get exposure to "synthetic" securities.

4. Hitting the books and lengthening our investment horizons.

We do extensive credit research into every possible investment and analyze each new bond opportunity as if we intend to hold the bond to maturity. Why? Because we think it's dangerous to assume that liquidity will always be there when it's needed. If we're uncomfortable with the idea of holding a particular security to maturity, we probably won't buy it in the first place.

But if we’ve done our credit homework well, we should end up with a portfolio of sound long-term investments that can weather periods of market turbulence. It’s also important to remember that long-term fixed-income investments provide their own liquidity. As long as the bond issuer doesn’t go bankrupt, investors will earn a steady stream of interest and get their principal back when the bond matures, regardless of daily market fluctuations.

After all, the ultimate form of liquidity is making sure you get your money back.

5. Making strategic allocations to private credit.

Taking the long view also means making selective investments in private credit. This can include making direct loans to middle-market companies and investing in privately originated commercial mortgages, where appropriate. Because these investments are less liquid than more traditional fixed-income assets, they offer considerably higher yields.

But liquidity can disappear suddenly anywhere in the fixed-income market. And remember, the primary role of bonds in a portfolio is to provide income. Investors with long time horizons might want to ask themselves how much liquidity they really need.

If there’s a common thread that runs through all of these strategies, it’s this: take the long view and focus on value. We think that investors who take that to heart will find they don’t have to fear liquidity risk. They just have to manage it.

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