Crowded Trades, Liquidity Problems and Tech Solutions

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by Gershon Distenfeld, Douglas Peebles, Scott DiMaggio, Jeff Skoglund, James Switzer

of AllianceBernstein

Crowded trades have become all too common in fixed-income markets. But running with the crowd is risky, particularly when it comes to illiquid assets like bank loans that may not be easy to sell during a market downturn.

Exceptionally low interest rates have at times over the last decade pushed yield-hungry investors into a handful of sectors with a high income potential—high-yield bonds, emerging-market debt, and so on. In the case of high-yield bank loans, the attraction has been floating-rate coupons, which can help shield these assets from the losses fixed-rate bonds may suffer now that low interest rates are finally rising.

The problem is that most of these higher-yielding assets carry varying degrees of liquidity risk. Liquidity measures how easy it is to buy or sell an asset without drastically affecting its price. Highly liquid bonds such as US Treasuries or German Bunds can be bought and sold easily in rising and falling markets.

Many other types of assets don't fit the bill. Take bank loans: trades can take weeks to settle, and loans don't change hands often. Yet most investors own bank loans through mutual funds or exchange-traded funds, highly liquid instruments that investors can enter and exit at will.

When Does Liquidity Dry Up? When Investors Need It Most

This creates a liquidity mismatch—vehicles that promise "daily liquidity," but invest in assets that can't be traded on a daily basis. That concerns us, because as we've noted here and here, we think bank loans will be vulnerable to large drawdowns when credit conditions become less favorable.

It would be a mistake for investors to assume they'll be able to sell assets quickly—even those that may have appeared reasonably liquid in calmer conditions—without taking big losses. As anyone who buys and sells financial securities for a living knows, liquidity is a mercurial thing. It tends to be abundant when you don't need it and scarce when you do. With the crowding in bank loans and even some other credit markets today, we think it's safe to say that if everyone tries to exit at once, some won't fit through the door.

Why Manager Selection Matters

Investors can certainly choose to avoid a particular sector. We've repeatedly advised as much when it comes to bank loans, where we think the risk outweighs the potential long-term reward.

But it's nearly impossible to avoid liquidity risk altogether. Limiting portfolio holdings to high-quality government bonds and liquid short-term instruments isn't an option for most investors—at least, not if they want to maximize potential returns and a portfolio's earning potential. Most investors will need some level of exposure to less liquid—and at times congested—sectors of the fixed-income market.

That's why it's so important to have a manager who recognizes the importance of managing liquidity risk and has the tools to do it effectively. That's no easy feat today. Liquidity has grown scarcer and more fleeting since the global financial crisis. Dealer balance sheets have shrunk even as the size of the market has grown. Even relatively small events can freeze bond markets.

Plugging into the Digital Future

Thankfully, fixed-income managers who have adopted new technology are able to read markets and react far more quickly in all kinds of liquidity conditions.

Even when liquidity is normal, a bond that seems to be available can disappear moments later, and the appetite for a

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security can fade just as fast. Having a centralized feed of market liquidity information and a combination of machine and human intelligence to monitor that feed gives investment professionals an edge when it's time to grab a coveted bond or unload one that no longer serves the portfolio. That ability will be especially critical during a liquidity crunch, when the first to transact often wins.

Under such scarce liquidity conditions, tech tools that can survey the entire bond market won't serve just one purpose. These same tools will also help investment managers ensure that they're getting the best pricing without having to spend precious hours calling multiple brokers for quotes.

And other digital machines, by integrating the data that traders, analysts and portfolio managers rely on, will help to identify new investment ideas.

The result: instead of following the crowd into a sector, managers can scoop up the hidden gems within it. It may even mean fewer crowded trades to begin with. That would be a healthy outcome for all investors.

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