Three Ways to Manage Fixed-Income Liquidity Risk

September 4, 2019

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Liquidity risk grabbed headlines this summer on the heels of several high-profile fund implosions. The hunt is now on to find ways to manage market liquidity risk and to protect portfolios against liquidity crunches.

Most investors blame stricter banking regulations for the relative liquidity squeeze since the global financial crisis. Before 2008, banks held vast inventories of bonds and traded them regularly, making a profit for themselves and making a market for other investors. This kept price fluctuations in check and was especially valuable in times of stress when investors could count on the banks to be a willing buyer when everyone else wanted to sell.

Post-crisis rules designed to make banks safer also discouraged risk-taking. As a result, banks beat a hasty retreat from the bond-trading business. They simply aren’t big buyers and sellers of bonds anymore and no longer provide ample liquidity to the markets. As a result, bonds are vulnerable to wider and more violent price swings, and investors may have to take big losses if they need to sell assets in a hurry. In other words, regulations have effectively transferred liquidity risk from banks to bondholders.

There are also less obvious causes that have the potential to worsen any liquidity crunch. Low government bond yields have forced yield-hungry small investors to crowd into the same trades. Another driver is caution by large institutional investors, who are less willing to ride out short-term market volatility. So, while regulatory changes have reduced the supply of liquidity, these trends have drastically increased the potential demand for it.

With volatility in fixed-income markets rising, investors can’t afford to take liquidity risk lightly. We believe investors can help protect their portfolios by ensuring that their bond managers adhere to three essential practices:

1) Establish a rigorous governance framework.

The first safeguard against risk is better governance. For liquidity risk, that means portfolio managers must constantly monitor security prices and allocations to different security types. Prices that are out of line with comparable securities, or “stale” prices that stay static for long periods, can be telltale signs of risks, including liquidity risk.

An effective governance process should feature daily internal price variance checks and reviews of exception reports. On a less frequent basis—say, every five days—those price reviews should be cross-checked with external vendors. And monthly, the governance team should analyze and discuss the pricing and liquidity data with the portfolio-management team. As part of these reviews, managers should evaluate portfolio liquidity against stress tests using different scenarios.

Liquidity reviews are most effective when viewed through different lenses—for instance, comparing internal assessments with third-party specialists that have proprietary methodologies. These comparisons offer a further, objective assessment of the liquidity profile of a portfolio’s fixed-income assets.

2) Deploy innovative technologies.

Forward-looking bond managers have already transformed research and trading, upgrading from highly manual approaches to digitized, automated processes. Research findings can now be automatically accessed and filtered, and orders to buy or sell that might have taken many hours to prepare can be compiled using digital assistants—chatbots based on computer algorithms.

In fast-moving bond markets that are fragmented across many small puddles of liquidity, this technological leap is already creating a significant edge. That edge will become even more important when liquidity is further stressed.

3) Implement risk-aware portfolio construction.

In current markets, avoiding concentration risks that can lead to liquidity traps is paramount. In less-liquid parts of the bond markets, trading costs can be high and may rise steeply for larger trades. By holding a more widely diversified basket of securities, investors can trade more flexibly and cheaply.

A risk-aware portfolio construction process should feature a rigorous approach to controlling cost and risk by minimizing individual exposures and diversifying across multiple issuers. Good management control systems should provide at-a-glance access to this information.

Sophisticated portfolio construction techniques aim to reduce both risk and cost. For example:

•Trading in derivatives such as credit default swaps may be a cheaper and more liquid approach to implementing an investment idea than trading the underlying security.

•Bonds with optically attractive yields may be less liquid. It is important to evaluate whether the yield on a given security adequately compensates for the liquidity risk.

•Diversification can help achieve a portfolio's overall risk and return objectives, for instance, by holding cash and/or highly liquid government bonds for flexibility.

Investors with limited risk appetites may benefit from dynamically managed, risk-aware portfolio-management approaches. For instance, strategies that combine the stability of government bonds with the return-generating properties of corporate credit may capture attractive yields while reducing liquidity risks. Balancing exposures to different economies and industries with varying risk and liquidity characteristics helps create a more efficient overall risk/reward profile. And while government bonds may offer little income, they can enhance the liquidity of the overall strategy.

In contrast, we believe that risk-conscious investors should approach bond ETFs with care. Bond markets are too vast and diverse to replicate precisely, so ETFs typically use sampling methodologies to create representative exposure to their chosen underlying markets. This may make them vulnerable if large redemptions trigger sell orders where there is no liquidity—particularly in higher-risk markets such as high-yield or emerging-market corporates. Frequent rebalancing can also hit ETFs' returns, especially during periods when trading costs are high.

We believe that investors should take liquidity risk very seriously and ensure they have all the resources necessary to manage it. Implementing and refining these three practices for managing liquidity risk takes time, money and deep resources. Not every asset manager is up to the task. And managers who don't take the right precautions when it comes to liquidity probably won't be able to keep their clients from getting snared in a liquidity trap.

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