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Liquidity crunch endangers strategies focused on credit

With little trading, market structure "out of balance'

BY CHRISTINE WILLIAMSON | MARCH 21, 2016

Lingering illiquidity in credit markets, especially for high-yield bonds, has pushed hedge fund strategies like leveraged relative value and long/short credit onto the endangered species list.

The liquidity crunch is so acute, especially for corporate bonds rated B or lower — the very place long/short credit managers prefer to discover their best alpha generators — that very little trading is going on.

With 99% of the corporate bond market held by pension funds, sovereign wealth funds, insurers, money managers and mutual funds, "there is higher demand for trading, but the market structure is out of balance with the demand," said Constantinos Antoniades, global head of fixed income at electronic trading venue Liquidnet Inc., New York.

"The kind of classic leveraged relative-value strategy that was once pretty popular just isn't working now. You have to be really excited about a credit opportunity to invest right now," said Adam Blitz, CEO and CIO of hedge funds-of-funds manager Evanston Capital Management LLC, Evanston, Ill.

Evanston Capital manages $5 billion.

Unintended consequence

The unintended consequence of the Volcker rule provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act and Basel III that forced banks to close proprietary trading desks, reduce risk assets and maintain higher capital reserves was to dry up the credit market's primary source of liquidity.

Bank prop desks were the counterparties that credit hedge fund managers turned to most often because they maintained the inventory of credit securities on the bank's books in a warehousing function.

With that function long gone, "a lot of trades just don't happen. It's very inefficient. The market isn't supposed to work this way," said an executive from a large credit hedge fund firm who requested anonymity because of concerns about moving the market.

Regulators made a trade-off when it came to regulating banks, the source said, increasing capital requirements to reduce risk while creating an extreme liquidity shortage and rendering markets much more inefficient.

“Regulation has had a meaningful impact on the markets,” agreed Craig Bergstrom, partner and chief investment officer of hedge funds-of-funds manager Corbin Capital Partners LP, New York.

Even as the size of the high-yield market rose significantly in the past 10 years, “far less is in the hands of market-makers and dealer inventory is much lower than it's ever been,” Mr. Bergstrom said.

Corbin Capital manages $4.6 billion.

“Nothing is trading. You have to make an appointment to trade these days. You used to be able to just pick up the phone any time and make a deal,” said William J. Ferri, group managing director and head of UBS Hedge Fund Solutions, New York.

A few of the casualties of the credit market's illiquidity problem have been fairly spectacular, sources said, pointing in particular to the implosion last year of credit manager Claren Road Asset Management LLC, one of the most institutional and respected hedge fund firms.

Other firms that manage relative-value or long/short credit hedge strategies said they are coping by scaling down or closing these strategies, at least for now, or evolving to master new market conditions.

The regulations that changed old-style trading practices are here to stay, Mr. Ferri said, noting that managers have no choice but to accept less trading.

“The solution? Your job is to adapt,” he stressed.

UBS' hedge funds-of-funds business managed $34 billion as of Jan. 1.

Small-batch trading

One adaptation strategy that's been forced on hedge fund managers is small-batch trading, said Aaron Dalrymple, head of credit, at alternatives investment consultant Cliffwater LLC, Marina del Rey, Calif. “As it's getting harder to trade, the average trade size has lowered to $10 million or $20 million, but in fact, it's really much easier to make a $5 million trade these days,” Mr. Dalrymple said.

Executives at multistrategy credit hedge fund manager Whitebox Advisors LLC, Minneapolis, clearly saw that the difficulty with long/short credit was that the strategy required a lot of leverage in order to produce decent returns, said Paul Twitchell, an Austin, Texas-based partner and head of non-corporate credit and macro.

Because liquidity is so tight, Whitebox's investment team made a conscious decision to lower leverage because of the danger of being forced to sell a security at the wrong time.

The firm has not run a dedicated long/short credit strategy for some time because of the difficulty of trading, but it still is managing to trade in high-yield and other credit instruments.

“We decided that we want to be liquidity providers, to selectively buy interesting credit, but it requires patience. We are making money by sitting back and waiting until the right thing comes along,” Mr. Twitchell said.

“We reinvent ourselves constantly. You have to in order to adapt to changing markets,” he said.

Whitebox manages about $4 billion in single and multistrategy hedge funds.

In the absence of market-making prop desks, Whitebox and other hedge fund managers are expanding their networks of buyers and sellers to source potential investments.

Cliffwater's Mr. Dalrymple agreed with Mr. Twitchell about the importance of sourcing networks, but he cast his comments a little differently: “Trading is an underrated skill in credit investing. Part of it is an art. These days, you need to know who owns what, how to get what you want and who wants what you have, especially when it comes to distressed bonds.”

Homegrown networks

There have been signs that market participants are starting to trade with each other, using their homegrown networks, Mr. Dalrymple said.

“The most obvious community to tap to make deals — big deals — and to provide liquidity through their purchases are pension funds and endowments with yield targets they've been struggling to meet,” said the unnamed hedge fund source.

“This community is beginning to realize that credit is a place they can go to get (higher) yields, but there's nervousness and investors aren't sure if the market really is at the bottom yet,” the source said, noting that institutions are “nibbling around this. It's going to be a very slow process of acceptance, given the variables.”

Liquidnet, which launched a dark pool for trading fixed income six months ago, has seen strong interest from investors and already has attracted 155 firms with 325 users, Mr. Antoniades said, including more than 30 of the 50 largest U.S. corporate bondholders.

Most of Liquidnet's current fixed-income clients are traditional money managers along with some hedge funds and sovereign wealth funds. n

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— Contact Christine Williamson at cwilliamson@pionline.com | @Williamson_PI