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Firms alter bond portfolios as liquidity concerns mount

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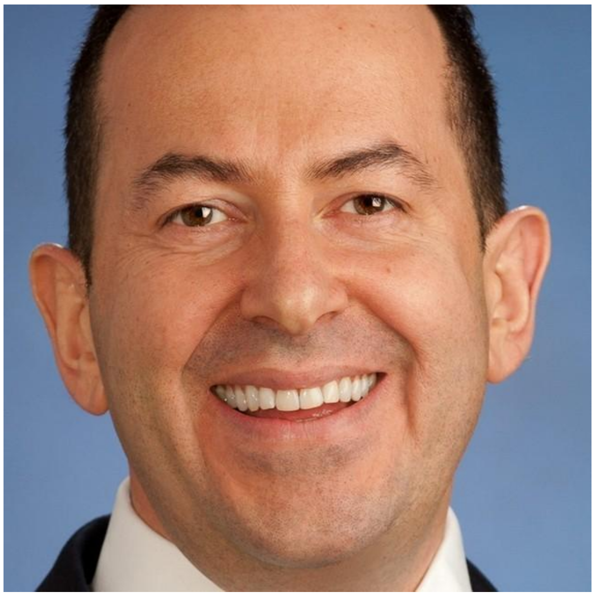

Goldman Sachs Asset Management's David Curtis: 'There is less concentration of money, of participants, of liquidity, but more concentration of strategies.'

Lack of liquidity in the global bond markets has pushed money managers to alter the composition of portfolios, as concerns mount over an impending crunch in the fixed-income market.

A number of factors have resulted in these moves.

Volatility has returned to the bond markets. From April 27 through June 11, the Merrill Lynch Option Volatility Estimate index has spiked 23 percentage points, to 87.7. The index measures volatility on U.S. Treasury options.

Over that same time, 10-year U.S. Treasury bonds rose 46 basis points to 2.37% and 10-year German bund yields exploded more than fivefold, to 0.88%.

An anticipated U.S. interest rate rise later this year, and ongoing uncertainty over Greece, could lead to market shocks, said John Stopford, London-based co-head of multiasset at Investec Asset Management, which has $115 billion of assets under management. "If we are concerned about liquidity now, (that worry will be) more so in July and August as markets naturally become fewer (in) participants, and there are fewer risk takers."

Participants in the market already are cause for concern. "There is less diversity of participants in the bond market," said David Curtis, London-based head of U.K. institutional business at Goldman Sachs Asset Management, which has $1 trillion of assets under management. After the 2008-'09 financial crisis, regulators imposed increased capital requirements on the investment banks and broker-dealers that traditionally had provided liquidity. "Therefore asset managers are more noticeable as a group because of their combined size. And typically, asset managers behave more similarly as well. So there is less concentration of money, of participants, of liquidity, but more concentration of strategies."

Some sources worry the bond bubble has become increasingly fragile because of these elements.

"What keeps me awake at night? Liquidity," said Adam Ryan, London-based head of diversified strategies team and a portfolio manager at BlackRock (BLK) Inc. (BLK), which has $4.8 trillion of assets under management, and $1.4 trillion in fixed income globally. Lower liquidity "is a key reason why, certainly in my portfolios, we have very little exposure to high yield. That is not a view around the default cycle picking up, but that liquidity in fixed-income markets is something that does concern me."

Concern is also mounting in traditionally more liquid assets. "When we have low volatility in the markets, (lower liquidity) is less problematic," said Cosimo Marasciulo, head of government bonds at Pioneer Investments in Dublin. "In addition, more recently in the European market, even government bonds and assets that trade easily are becoming more of an issue." The firm has $242 billion in assets under management, with e126 billion ($138 billion) in fixed income.

"As a result of more exaggerated price movements, we reduced our risk budget to government bonds in some of our portfolios," said Donal Kinsella, London-based fixed-income investment director atHenderson Global Investors Ltd., which has £89.4 billion ($135.9 billion) of assets under management, £21.7 billion of which is fixed income. Across bond investment, and particularly in less liquid areas such as high-yield bonds, investment executives have become more sensitive to ease of trading into and out of positions, and the size of bond holdings. Trading decisions are "not taken lightly," he said.

Time factor

Some money managers are taking longer to enter positions, and opting for longer holding periods.
Moves in yields are extending further than normal, said Jim Caron, managing director and portfolio manager with global fixed income at Morgan Stanley (MS) Investment Management, New York. "We have to build that into the overall valuation structure — we may choose to wait for higher yield, or for the bond to cheapen a little further." MSIM has $406 billion in assets under management, with $65 billion in fixed income. His team also assigns higher risk premiums to compensate "for what may be a less liquid environment," and holds more cash for buying opportunities.

Lower liquidity is "causing us to lengthen the time horizons of our trades somewhat," becoming more fundamentally oriented rather than "tactical and technical," said Michael Lillard, Newark, N.J.-based chief investment officer at Prudential Fixed Income, which has $560 billion of fixed-income assets under management. "We are going into positions planning to hold them for a longer period of time."

As well as holding some bonds for longer, Olivier Monnoyeur, lead portfolio manager, high yield, at Fischer Francis Trees & Watt in London, is also buying bonds that have a "very high chance of getting called in a short period of time," giving a constant stream of cash returning to the portfolio. He has started using total-return swaps, representing about 6% of the flagship e1.25 billion ($1.4 billion) Parvest Bond Euro High Yield fund, which are offset by cash. "Should we see outflows, at a time when it would likely be hard to sell bonds in the wider market, I can use the cash for investors looking to redeem their position, or I can sell the bonds." He also uses single-name credit default swaps and bullet bonds, whose face value is paid at once, at maturity.

Russell Investments has introduced or increased weightings to "managers who are good at rotating their exposures," or use options to make money from volatility, said Adam Smears, London-based global head of fixed-income research. Russell has $271.5 billion in AUM, of which $61 billion is fixed income.

BlackRock (BLK) is making more use of exchange-traded funds in multiasset portfolios as “a liquidity buffer,” said Justin Chrisofel, New York-based director and portfolio manager. “(ETFs) offer more liquidity in fixed-income exposure than investing in the underlying bonds themselves,” he said.

Managing the bubble

Strategy size and constraints can cause problems. A large fund needs a wide mandate, particularly where an asset class investment universe is short on names, said Fraser Lundie, co-head of credit in London at Hermes Investment Management, which has £30.1 billion of assets under management. “In a world of declining liquidity, and with (government bond yields) as low as they are, it has never been more important than today to be able to operate without constraints in mandates and narrowness.”

While liquidity has increased in some asset classes, such as investment-grade bonds, GSAM still keeps strategy capacity in mind. “Certain strategies we are looking at carefully, and I'm sure there are certain points that, if we reached them, we would close some of our funds (to new inflows,)” said Mr. Curtis.

Some are less concerned, with Nick Gartside, London-based managing director and international chief investment officer of fixed income at J.P. Morgan Asset Management (JPM), citing high bond issuance in 2015 so far and the estimated $100 trillion global bond market. While “liquidity should be on every investor's radar screen,” JPMAM, which has $1.8 trillion of assets under management, and $359 billion in fixed income, has not had to shift any portfolio allocations, he said.

But regulators' focus also has increased on bond market liquidity, questioning money managers about the management of portfolios in normal and stressed environments.

Managers say they already have an eye on stress testing. And Mr. Lillard at Prudential Fixed Income said the firm is looking to expand the tools used to stress test bond portfolios in terms of liquidity, from a risk management perspective. “We think that is appropriate given that we do have less liquidity in the marketplace,” he said.

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