

High yield liquidity: in at the deep end

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In a 2015 memo, Howard Marks, of Oaktree Capital, defined liquidity as ‘**the degree to which an asset or security can be bought or sold in the market without affecting the asset’s price**’. He explained that it is not a fixed attribute, but instead ‘**entirely situational**’, and that it is a function of size and the direction of the market at that specific time.

These elements make liquidity difficult to forecast. Since the specific nature of the future ‘situation’ is not yet known, there will not always be a reliable availability of liquidity. Nevertheless, despite the challenges of applying it, the definition provides useful insights when assessing the availability of high yield liquidity.

Consider the recent market correction that resulted from the COVID-19 pandemic and the associated governmental containment measures. Even during this difficult period, the high yield market continued to function appropriately because price discovery occurred continuously and risk was consistently transferred between market participants. In that sense, liquidity **was** reliable.

There was of course a price to pay for this liquidity and the asset price was ‘**affected**’. However, beyond the lower bond prices achievable, which were to be expected, there was a secondary and perhaps less appreciated cost.

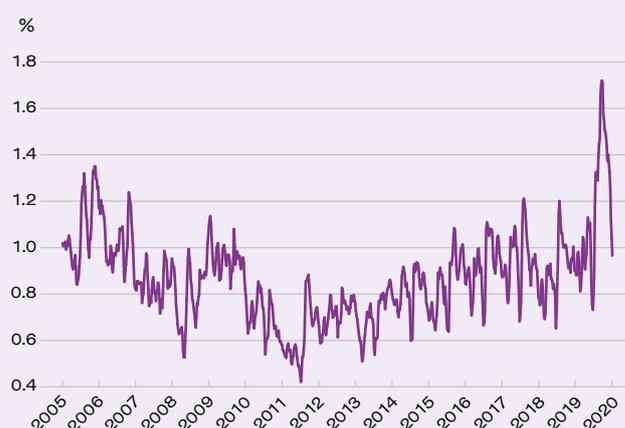
What is the volatility of an asset you can’t sell?

The downside to the availability liquidity in the high yield market was heightened volatility. Some of the bonds perceived to be most liquid were disproportionately volatile. Illiquidity, while seen as an unattractive attribute, can in fact work to dampen mark-to-market volatility. Available liquidity and volatility can be two sides of the same coin.

Raising cash in the high yield market

The US is the largest, and historically most liquid, part of the global high yield market. Back in 2012, trading volumes dropped markedly, halving from 2010 as a percentage of the market.

Figure 1: Trace HY trading volume, pct of outstanding

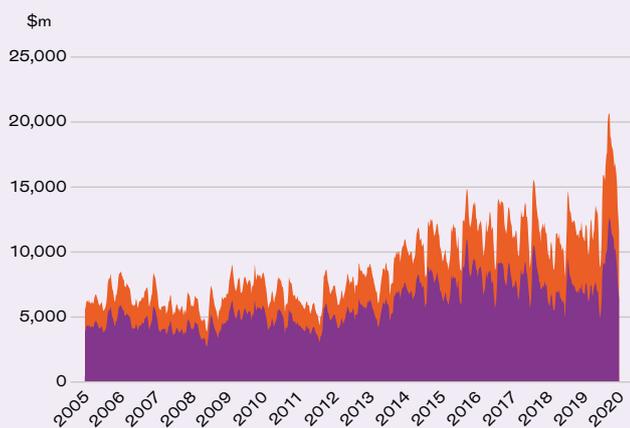


Source: BofA Merrill Lynch Global Research, TRACE FINRA, 31 July 2020
Average trading volume based on a 30 day moving average
144A trace volumes are estimated pre 2015

Past performance is not a reliable indicator of future results.

Despite growth in the overall market size, absolute volumes declined. While there is disagreement on the exact reasons for this, it coincided with the implementation of new regulations restricting banking activity (namely the Volcker rule).

Figure 2: Trace HY trading volume, absolute



Source: BofA Merrill Lynch Global Research, TRACE FINRA, 31 July 2020
Average trading volume based on a 30 day moving average
144A trace volumes are estimated pre 2015

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Much of the market chatter at that time centred around the potential for lower ongoing levels of liquidity, especially during a sharp selloff. However, trading volumes subsequently recovered steadily as new vehicles entered the market and new trading techniques became popularised.

Bank of America Merrill Lynch cites one for the main reasons for this as the emergence of exchange traded funds (ETFs). Referring to the US high yield market specifically: **‘Trading in major High Yield ETF shares consistently represents around 15% of overall High Yield Trace bond trading volume, and peaks at over 25% around market reversal points’**. As at May 2020, US High Yield ETFs stood at less than \$50bn in AUM or 3% of market size. Thus the influence of ETFs is far in excess of their relative size within the high yield market. From this perspective, ETFs have become the marginal buyer or seller in the market.

ETFs allow for passive investment into high yield assets. These vehicles have attracted new capital and new investors into the market, and stimulated trading activity. They also have specific eligibility criteria, with a focus on higher-rated larger-scale issues; traditionally the most liquid bonds.

From mid-February to mid-March high yield ETFs experienced consistent outflows, contributing to the sharp selloff in the market. Investors who were perhaps not fully committed to the long-term prospects of this sub asset class withdrew their capital. This resulted in a disproportionate amount of selling of ETF underlying holdings versus comparable bonds. The liquidity required was sourced from ETF eligible bonds; the type of positions that buyers felt comfortable purchasing.

To substantiate this claim, we examined the volatility characteristics of bonds, from the perspective of those included within ETFs. What can be seen is that despite the same

underlying credit risk, there were different levels of volatility. If a bond was held by an ETF, it experienced higher volatility than a bond with similar attributes that was not included. The underlying data showed that there were numerous transactions of these bonds, in a variety of sizes. Simply put, the higher level of volatility in certain large-scale bonds was due to their categorisation as having a higher level of available liquidity.

As it is the larger issues that provide the liquidity when required, it is worth assessing, from the perspective of currency and regions, where those large issues are located.

Here we use \$1 billion face amount as the hurdle, as at July 2020. We split the ICE BofA BB-B Global Non-Financial High Yield Constrained Index by currency. The important point to note is that over 19% of US dollar-denominated issues are over this threshold (407), approximately 11% (52) of euro issues are, while sterling has only one issue above one billion in size. This is a clear indication of where large-scale liquid issues are located. A similar picture emerges if we split the same index by region. The US has 20% of its issues over this threshold (306), the emerging markets have 14% (87), and Europe has approximately 14% (56). It is clear that the US and US dollar bonds have the lion’s share of this pool of liquidity.

The changing shape of the high yield market

Two other key factors have contributed to the improved depth of liquidity in the market: the increase in the total scale of the market and the increase in average issue size. The global high yield market was around \$229bn in size at the end of 1999. By the end of 2007 it had nearly tripled to \$627bn. Since that point it has more than tripled in size again, to \$2.0trn.

Over that same time period there has been a straight line increase in the average issue size from \$234m in 1999, to \$430m in 2007, to \$720m as at the end of July 2020.

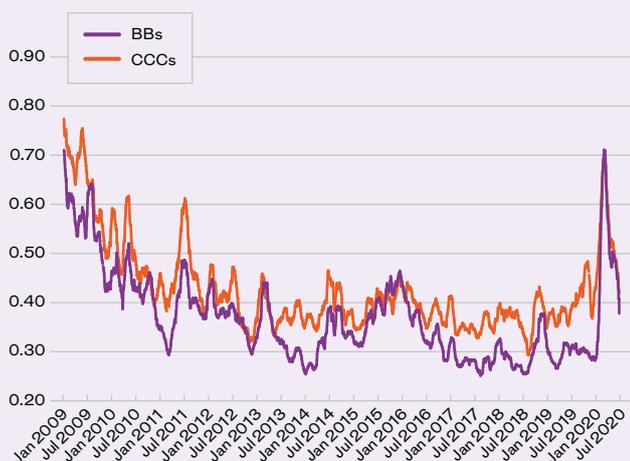
Figure 3: ICE BofA BB-B Global Non-Financial High Yield Constrained Ave Issue Size



Source: RLAM, BofA Merrill Lynch Global Research, 31 July 2020

Past performance is not a reliable indicator of future results.

Figure 4: Effective bid-asks, \$ price points, 30d average



Source: BofA Merrill Lynch Global Research, 31 July 2020

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Central banks in a crisis

On 23 March this year, the US Federal Reserve announced its unprecedented plans to purchase under the new Secondary Market Corporate Credit Facility (SMCCF). It would buy bonds directly, as well as shares in ETFs. As with the global financial crisis (GFC) of 2008-09, it was again the central bank which was required to backstop risk assets. However, unlike during the GFC, high yield trading volumes actually increased during the worst of the crisis.

Despite the much quicker selloff in March compared with the GFC, the effective bid-ask spread of traded positions was no worse. There was a similar cost to raise cash, but in much larger volume; with size being a key component of our original liquidity definition. This increased volume can be seen in figures 1 and 2. The motivation behind the Federal Reserve's actions is likely to have been multifaceted. One consideration, given the swiftness of the decline in bond prices, may have been concern about how long the price of liquidity could be maintained.

In the six week period following the Federal Reserve's announcement, there was \$12bn of inflows into ETFs; the most on record. It could be argued that the importance of ETFs, both directly in the market and indirectly as an indicator, was what led the Federal Reserve to take this step.

As a result of these large swings in the direction of flows, the volatility experienced by ETF bonds was disproportionately high. It is interesting to note that the volatility of lower-rated credit versus higher-rated credit was much lower in this market selloff, as compared with the GFC. CCC rated holdings, for example, remain underrepresented in ETFs due to their eligibility criteria.

Investment structures versus their underlying assets

For long-term investors, while getting compensated to bear short-term market volatility may be an attractive proposition, it is vital that investment vehicles reflect the underlying liquidity of their assets.

Earlier this year, several funds from different asset classes imposed restrictions on investor redemptions for this very reason. In March, high yield funds that focused on less liquid parts of the European high yield market also imposed restrictions as the assets could not be sold to meet redemptions.

As high yield investors, this is something we are always conscious of when selecting investments. The last stage of our investment process is assessing the technicals of an investment instrument. This means factoring in the likely liquidity and volatility over time and assessing the correctness of fit for the investment strategy.

One step change we have seen this year is the number of fallen angels entering the market. These companies provide new and deep capital structures to be mined for value. Large bond issues sizes in these companies are, of course, included in ETFs for their attributes, and may be called upon in future as a new source of liquidity. This undoubted improvement in the mix of high yield investments should improve the overall liquidity situation further over the next few years.

Conclusion

We believe that substantial parts of the high yield market performed admirably in providing liquidity to fund investors' cash needs during the particularly difficult period of the COVID-19 pandemic selloff.

This period is now the benchmark for assessing available liquidity in the market, superseding previous crises in relevance. The assets which were the source of this liquidity bore a disproportionate amount of volatility and the pool of these types of assets has increased in size with the recent fallen angels.

We also acknowledge that large parts of the market did not do as well and were weeks away from causing a real crisis. This was undoubtedly a key reason for the scale of fiscal and central bank intervention we experienced.

All this leads us to envisage a high yield market that can experience higher mark-to-market volatility, but that has a higher average credit quality and contains a deeper level of liquidity than many might expect; albeit unevenly spread across the market.

As the recent crisis has just shown, pricing liquidity in distressed market conditions is among the most difficult challenges investors ever have to face, but equally it is among the most important.

This crisis has just highlighted the value of this.

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All data is correct at 31 July 2020 unless otherwise stated.

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