December, 2015

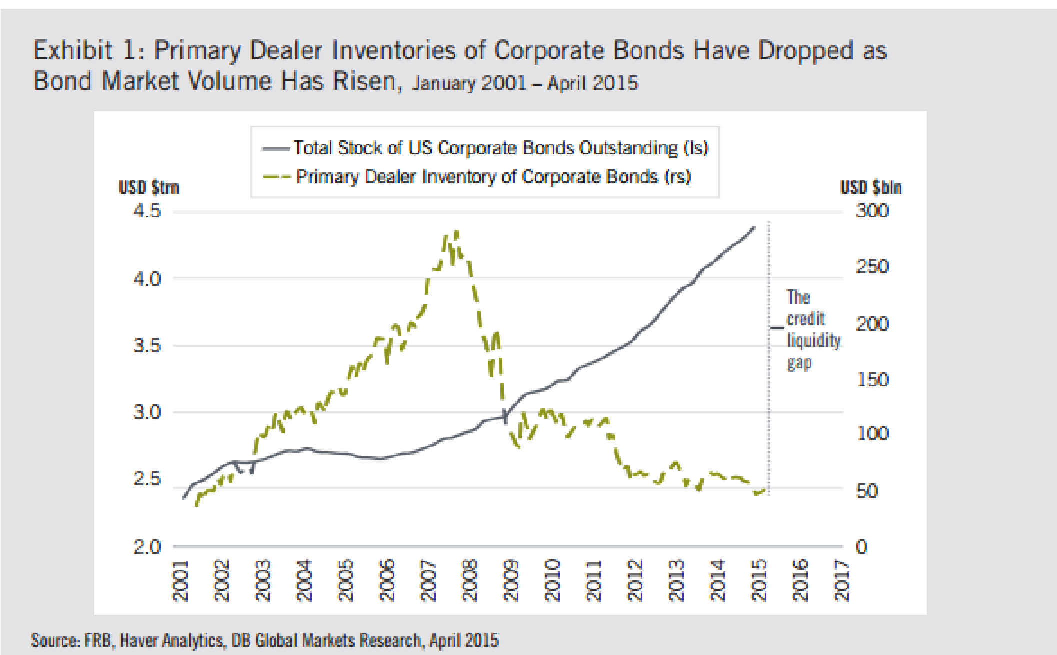
Brothers Grimm: A Cautionary Tale

At Sionna, we go by the philosophy that it is better to know what may be hiding around the corner – this way you don't panic and, in the investing world, you can prepare yourself so you don't react irrationally. We know that markets are unpredictable, however the more informed we are, the better we can rationally respond to unanticipated events. As we turn the corner towards the end of 2015, we are concerned about the possible broad implications of bond market illiquidity. More specifically, we are uneasy about its potential and indirect impact on equity markets, since we have seen the effects before (circa 1987, 2007 and 2008).

Hiding in the Shadows

Globally, banks have become more highly regulated. They are expected to hold more capital, while limiting leverage and exposures. As a result, capital that was previously available to maintain bond inventories and support clients participating in trading bonds, has been greatly reduced. This reduction has occurred simultaneously with a significant increase in appetite, and corresponding issuance, for corporate credit offering enhanced yield and returns to investors, while government bond yields have shrunk.

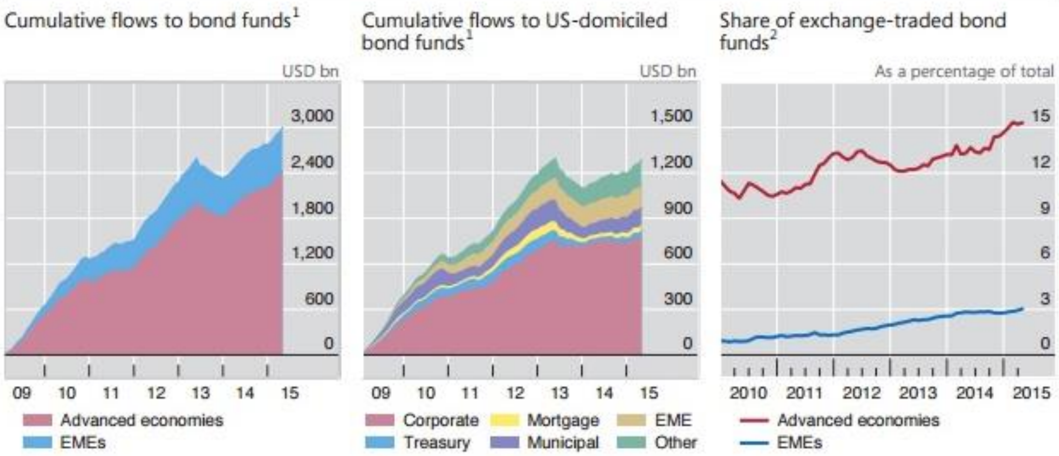
Chart A[i]



Not surprisingly, bond indexes are becoming more volatile. As they change to reflect the market's evolving complexion, higher proportions are being dedicated to lower rated and riskier corporates as well as to longer dated bonds. As indexes get riskier, informed bond managers are wisely shifting away from index-like bond funds towards newly created "unconstrained" and "benchmark agnostic" approaches that aim to be less volatile and less exposed to pain caused by rate increases. Unfortunately, investors are not broadly following this approach. Instead, more and more of them are shifting to "cost conscious" index and ETF investing.

Chart B[ii]

Bond funds have grown rapidly post-crisis



[1] Includes mutual funds and exchange-traded funds (ETFs). [2] The ratio of cumulative flows to ETFs investing in bonds issued by advanced economies (or EMEs) to cumulative flows to both mutual funds and ETFs investing in bonds issued by advanced economies (or EMEs).

Sources: Lipper; BIS calculations.

What is not well understood is that ETFs are not as liquid as most investors believe. ETF prospectuses include a cease trading clause that typically states, "If the securities of a constituent issuer of an ETF are cease-traded by order of the relevant securities regulatory authority or are halted from trading by the relevant stock exchange, the ETF may halt trading in its Units."[iii] During the last several years, ETFs with significant illiquid underlying securities have had to halt trading during major market schisms. It's clear to many that if another Black Monday was to occur, many ETFs could trade at significant discounts to their underlying securities for periods of time.

We are not alone in expressing an apprehension about the fixed income market. Numerous participants in bond funds and bond regulators have shared their concerns on the growing level of bond illiquidity, for example:

"Financial supervisors and central banks should develop pre-emptive strategies to cope with financial instability caused by market illiquidity." — IMF Survey Magazine, September 2015.

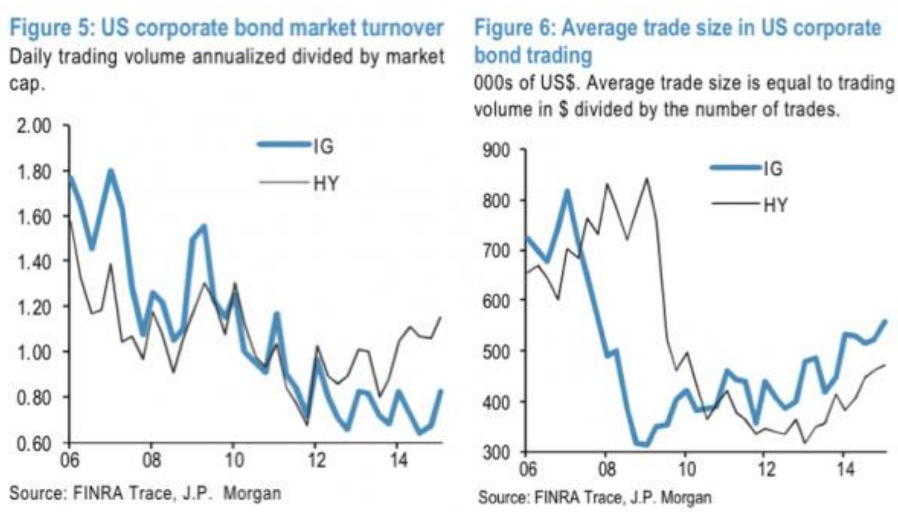
"Under these conditions, a significant – even if temporary – mispricing of assets may ensue, with negative repercussions on financial stability." — IMF World Economic and Financial Surveys, Global Financial Stability Report, October 2015.

Why Sionna's Senses are Tingling

Unlike equities, bond trading is still "over-the-counter" rather than through a formal exchange, and dealers have long played a role in helping buyers and sellers meet across spreads. Traditionally, dealers would step in to support the market by buying slow-selling bonds cheaply with the hope that, over a short time, a willing buyer would emerge and pay a premium to own the illiquid bond. In return, the dealer earned a spread sufficient to compensate them for taking on the risk of trying to offload an illiquid security in a volatile market.

The combination of new regulation and less dealer incentive to take on illiquid inventories has created a market with just a few bonds with good liquidity that can be easily traded.

Chart C[iv]



As a result, a number of bond funds, primarily in Europe, have introduced "swing pricing" and "gating" to deal with the growing illiquidity problem. Swing pricing is structured so that large purchases or redemptions are done at a premium or discount, which protects the long-term investors and punishes the short-term traders. Gating permits the manager to decide at his/her discretion to close the fund and cease trading until sufficient liquidity is available. Bond managers in these funds are hedging their risk of getting gated by shorting equities. Why?

From 1941 to 1981 bond investors lost money and bonds were wittily referred to as "certificates of confiscation." Since 1981, however, bond yields have fallen and bond prices have risen. It's unlikely that many under the age of 65 have ever lost money in a bond investment. It isn't part of the contemporary experience. But as bond yields continue to fall, which they may do for some time, we are approaching the paradigm shift where bonds will once again enter a multi-year period of rising rates. At that time, bond prices will fall and fixed income investors will, for the first time in about 35 years, experience capital losses. Investors may then decide to move out of longer dated, volatile bonds – and the resulting one-way exit may cause significant gating of funds.

This leads to our cautionary tale. If the story plays out as we fear it might, there may suddenly be a brief time where bond illiquidity occurs and bond funds are gated. Uninformed investors will be stunned by the lack of liquidity. Some investors who require cash will be forced to seek liquid instruments. Freely tradable equities will likely become that source and, rattled investors will be willing to sell them at low prices just to raise necessary cash. In the midst of this type of an equity "crash", investors more broadly will wonder if it is a fundamental equity problem – it's not.

Our hope is that by anticipating what may be lurking around the corner, investors will be better informed and able to keep a clear head when forced to consider options. Knowing that the crisis is not fundamental to equities, this scenario would actually create an opportunity to take advantage of buying some compelling values that may emerge. We tend to be better able to resist a fear instinct when we know what is coming. In this case, it is important to resist selling your carefully selected equities and locking in losses – since they may rapidly reverse direction when market normalcy returns, which it eventually always does.

The Sionna Team

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[i] Chart A: Brandes Investment Partners. "U.S. Bond Market: Liquidity Squeeze, Shrinking Bond Inventories and the Brandes Advantage". June 2015.

[ii] Chart B: Zero Hedge. "As SEC Rolls Out Liquidity Risk Plan, Here Are The Bond Funds That may Be Most Vulnerable In A Meltdown". September 2015.

[iii] Horizons. "Exchange Traded Funds Prospectus". August 2012.

[iv] Chart C: Zero Hedge. "As SEC Rolls Out Liquidity Risk Plan, Here Are The Bond Funds That may Be Most Vulnerable In A Meltdown". September 2015.