BBH Strategy Insight

December 2015

Sorry, the Trader Has Stepped Away

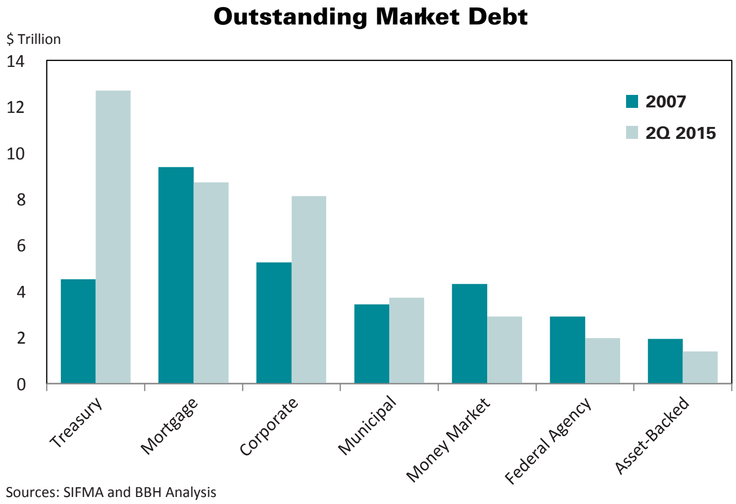
If you have traded bonds for a living, you have often heard this excuse for why a broker-dealer cannot or will not give you a bid. Excuses are particularly prevalent during periods of market stress. Liquidity is the lifeblood of capital markets. When capital flows are constrained, markets and economies can both suffer. History is replete with examples, both here and abroad. Sometimes a lack of liquidity affects only an individual issuer or a subsector. At other times, broad market sectors are impacted such as during the Financial Crisis of 2008-09. In an ideal world, investors should be able to transact in large volumes, on short notice, and with little impact to prevailing prices or yields. Domestic large capitalization exchange-traded equities come the closest to this ideal. U.S. Treasuries are best in the bond market, with credit-oriented sectors trailing significantly.

Many could argue that bond market growth, innovations in security structuring, and the proliferation of exchange-traded products have benefited market liquidity. Despite assurances from oversight agencies, concerns about market liquidity have grown and represent a key ongoing risk factor in the bond market. The broker-dealer community would like us to believe that post-crisis regulatory changes dried up liquidity, conjuring romantic notions of a highly liquid past — memories we do not share. Although this commentary will focus on the realities of limited liquidity in the Municipal bond market, its concepts should be readily applicable to the broader taxable bond markets. For reasons related to its basic market structure, Municipals have never been renowned for their liquidity. Furthermore, additional developments since the Financial Crisis have further siphoned Municipal liquidity. In this commentary, we will explain our thinking about liquidity and our strategy to successfully navigate increasingly choppy markets.

In the over-the-counter bond market, highly liquid markets typically have the following characteristics:

- High level of outstanding debt with large individual issues
- High quality with easy substitutability of issues
- Deep pools of ownership capital
- High trading volumes with narrow bid-to-ask spreads
- Large number of market makers

It is easy to see why U.S. Treasuries are the gold standard in terms of liquidity as they satisfy every item on the list. Behind U.S. Treasuries, government agency mortgage-backed securities, federal agencies, investment grade corporates, asset backed securities, and high yield corporates would round out the dollar-denominated taxable markets. How does the Municipal bond sector rank? On the basis of the criteria listed above, not well.

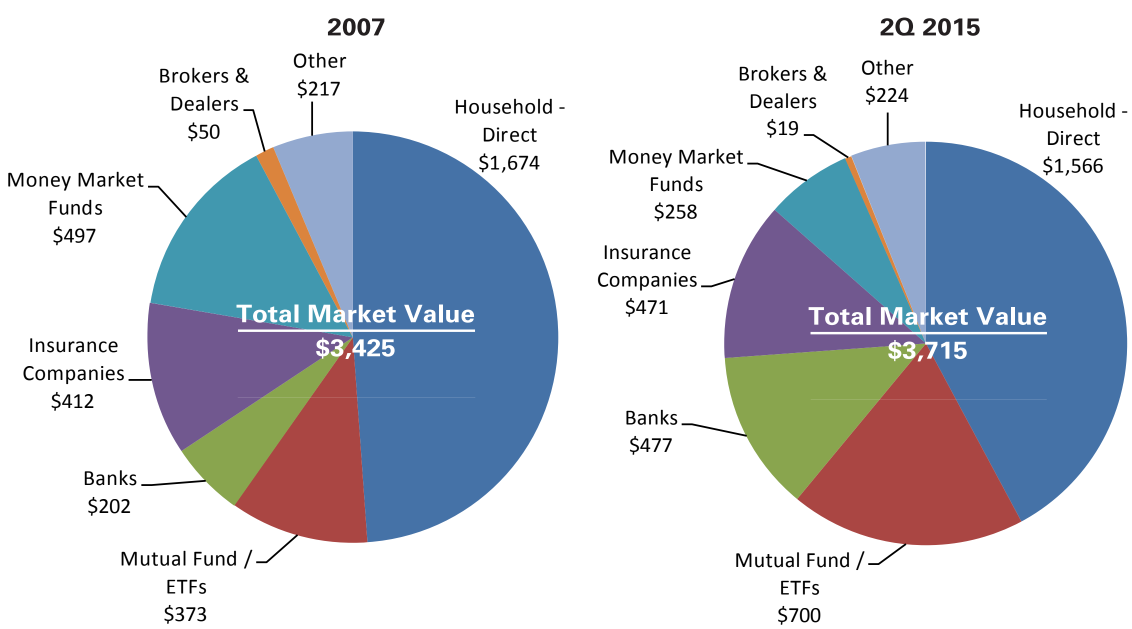


Sources: SIFMA and BBH Analysis

Within the U.S. bond market, municipals are the fourth largest sector at $3.7 trillion. The Municipal market is famous for its fragmentation despite its size. With dozens of bond structures (many of which are less than transparent), tens of thousands of issuers, and over one million cusips, municipals are anything but homogenous. It is a market of nuance, individuality, and small individual issues. Once pervasive, bond insurance was an effort to bring homogeneity to the Municipal market. At its peak, just prior to the financial crisis, nearly 60% of new issue volume "benefited" from bond insurance and enjoyed top-notch ratings.[1] Back then, credits were viewed with a large degree of substitutability because of their insurance wraps, helping liquidity. Not so today. Many bond insurers suffered impairments during the crisis and the worth of their municipal policies declined, leaving many investors exposed to credit risk they probably never contemplated. Currently, less than 10% of new municipal issuance is covered by insurance and investors are much more sensitive to the underlying credit risk of their bonds.[2]

Whereas the major taxable bond sectors enjoy strong support from a range of deep domestic and international capital pools, including sovereign wealth funds and pension funds, Municipal bond ownership is dominated by the U.S. household sector both directly and through mutual funds. While still dominant, direct household ownership of municipals has been declining since the Financial Crisis, while long-term funds and institutional sources of demand, such as banks, have picked up share. Back in 2007, households directly owned about 50% of the then $3.4 trillion Municipal market with banks and insurance companies at a *combined* 18%, or about $600 billion. Today, the direct household ownership share has declined to 42% while banks and insurance companies each own between 12%-13%, for a total of $950 billion.[3] Importantly, long-term mutual funds have experienced rapid growth over the same period with aggregate assets nearly doubling from $370 billion to $700 billion. On balance, these trends have helped liquidity, at least in buoyant markets. When banks and funds are in purchase mode, new opportunities become tougher for us to identify but we generally find it easy to sell holdings. Conversely, market liquidity often dries up during periods of redemptions and rampant forced selling as occurred in 2010 (Meredith Whitney-induced credit fears) and 2013 (taper tantrum, Detroit bankruptcy, and Puerto Rico distress). As contrarians, we often find these periods rich in opportunity.

Municipal Market Ownership Breakdown ($ Billion)

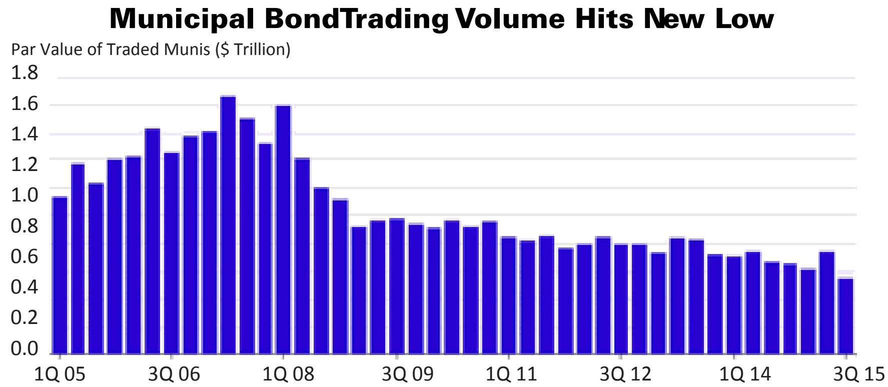


Sources: SIFMA and BBH Analysis

Many broker-dealers trade municipals, however, the vast majority are retail focused, charge high fees and transaction costs, and execute small volumes. The large broker-dealers enjoy the greatest market share, but offer much less liquidity than they did prior to the Financial Crisis. First, there has been a significant consolidation.

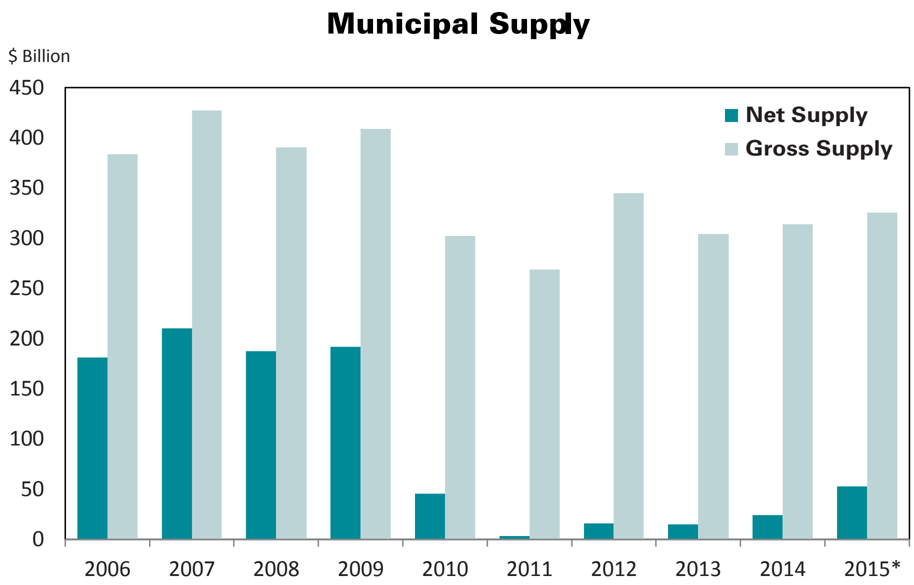
- Bear Stearns into JP Morgan
- Merrill Lynch into Banc of America
- Wachovia into Wells Fargo

[1] Sources: The Bond Buyer and Thomson Reuters
[2] Sources: The Bond Buyer and Thomson Reuters
[3] Source: Federal Reserve



Sources: Municipal Securities Rulemaking Board and BBH Analysis

Second, higher capital requirements have raised the cost of balance sheet intensive business activities, such as market making, as opposed to brokering and underwriting. As a result, large trades are often executed in parts and take longer to complete than in the past when dealers were more willing to use their balance sheets. Across all major bond sectors, including Municipals, dealer inventories have declined significantly as have trading volumes. Municipal trading volumes have typically tended to be low relative to other bond sectors, a reflection of the prevalent buy-and-hold strategy employed among household owners of municipals. This type of passive strategy helps minimize taxes and transaction costs, but it also drains the market of available float, impinging upon overall liquidity.



* as of October 31, 2015
Sources: Thomson Financial Services and BBH Analysis

Healthy market growth from net new supply often stimulates liquidity. Unfortunately, this has not occurred as the aggregate size of the Municipal market has stagnated for the past five years. Municipal supply ramped up before the Financial Crisis. This was followed by a supply boost in 2009 and 2010 which was courtesy of the Build America Bond program, created as part of the American Relief and Recovery Act. Since then, fiscal restraint has driven a building backlog of infrastructure projects and voter appetite has waned for traditionally popular projects such as education. It makes sense that debt issues were postponed amid tepid revenue growth and widespread economic uncertainty. Issuance in recent years has been heavily tilted toward refinancing to take advantage of historically low interest rates, leaving *net* new supply near zero. This has been helpful for issuers in terms of the debt service savings, but not for market liquidity

It is easy to get caught up in the negatives of low market liquidity. In particular, we fear it in the event we need to sell because of credit deterioration or when we are forced to meet a redemption request. But beyond these reasons, we generally view low liquidity environments in a positive light because they are often volatile with prevalent opportunities. In our view, there are three keys to successfully investing in less liquid bond markets: 1) Discipline; 2) Patience; and 3) Good clients. There are many bona-fide investment strategies. At BBH, we are value investors and our approach is straightforward:

A. Consider credits we believe to be fundamentally solid under a wide range of circumstances and economic backdrops.
B. Purchase a limited number of those credits at yields that offer attractive return potential when viewed at over a multi-year horizon, if not maturity.

Value investing in bonds confers the important advantage of contractual maturity dates. In other words, to realize the value we have identified in our securities, we are not required to sell them. Instead, we can own the bonds for years and earn their collective benefit in the form of income. We simply cannot rely on another investor or broker-dealer overpaying for bonds and we never want to be in the position of a forced seller for credit reasons, especially under poor market liquidity conditions.

We have observed time and again that bond market valuations are frequently disconnected from an issuer's underlying fundamentals. Beyond these disconnects, credit valuations are often unjustifiably volatile. Cash and liquid reserves provide valuable flexibility for us to take advantage of future opportunities, even if they are years out. We recognize that many variables are outside of our control and are impossible to forecast reliably. However, discipline, selectivity and patience remain firmly in our grasp.

While too often unsaid and unwritten, we know that the long-term nature of our client relationships is vital to our success. We seek to partner with clients who understand and appreciate our approach and who provide us with a stable source of capital. Deploying capital during periods of illiquidity, market stress, and forced selling (by others) has consistently and repeatedly benefited our investment results. This allows us to act as effective contrarians, creating a virtuous feedback loop and hopefully satisfied clients.

It is ironic that after seven years of unprecedented Federal Reserve policy accommodation, trading liquidity has declined. In Municipals, liquidity has always been challenged given its multitude of issuers, predominant household ownership base, and relatively low level of trading activity compared to other major bond sectors. Following the Financial Crisis, the growth of mutual funds, broker-dealer consolidation, more onerous capital requirements, and rising credit risk have pressured liquidity further. We believe our process and team are well suited to capitalize on this trend. All else equal, *lower* market liquidity raises the probability of *greater* market volatility, whether it is from selling related to mutual fund redemptions, interest rate normalization fears, concerns about the next big bankruptcy, or some other reason. Greater market volatility gives us better chances to identify and invest in undervalued securities. We cannot know when the next attractive opportunity or bout of market volatility will emerge, but until then, we will wait patiently armed with our investment criteria, reserves, and our reliable capital base.

Gregory S. Steier
Head of Tax-Exempt Portfolio Management

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