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# INSIGHT

TRADING SECRETS

# Why a Liquidity Crisis Is Heading to a Market Near You

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Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing over $170 billion in fixed income assets, including over $85 billion of fixed income mutual fund assets under the TCW Funds and MetWest Funds brands. Prior to joining TCW, Tad served as Chief Investment Officer for MetWest, an independent institutional investment manager that he cofounded. The MetWest investment team has been recognized for a number of performance related awards, including Morningstar's Fixed Income Manager of the Year. Mr. Rivelle was also the co-director of fixed income at Hotchkis & Wiley and a portfolio manager at PIMCO. Tad holds a BS in Physics from Yale University, an MS in Applied Mathematics from University of Southern California, and an MBA from the UCLA Anderson School of Management.

Capital market theory posits that price always balances supply and demand, more or less guaranteeing deep and continuous markets for securities. In other words, if capital markets were a machine, prices would rapidly adjust to reflect any newly disclosed information, and ready buyers and sellers would reveal themselves at the new and improved price levels. But, thankfully for those of us working as active asset managers, markets are anything but mechanistic. They do have a mood, or if you will, a zeitgeist. This is hardly news to anyone involved with real world, as opposed to textbook, investing. Markets always have–and always will–cycle between fear and greed, between rip-snorting bull markets and gut wrenching collapses. Should it really surprise anyone that liquidity waxes and wanes, in sync with the tides of investor emotion?

It should not. Markets do not operate independent of human action–they are the product of, and therefore reflect human decision-making. Liquidity crises should not be understood as bizarre out-of-body experiences: they are built into the very DNA of the market.

## The Timeless Time-Varying Information Demands of the Investor

Consider: When times are good and money can be made pretty much effortlessly, investors get careless. Or, maybe a better way to characterize investor behavior is that buyers come to believe that the only mistake they can make is to *not* invest. But it is also more complicated than that, because investing is a human activity that takes place in a socially constructed context.

Suppose you go to a buy a house in a red hot real-estate market. As a buyer, negotiation is not an option. When you show up at the property, so do a half-dozen other buyers. "Not negotiating" in this context means that you do not get to ask for a price discount, nor do you get to ask if the roof needs replacing, nor whether the foundation needs repairing, nor whether the neighbors play loud music into the wee hours. The home is being offered to you–and the other six buyers–"as is," no questions asked, and only offers at or above the full listing price will be accepted. While this might be a crazy way to make the largest purchase in your life, if that apartment has become too small for your growing family, exactly what choices do you have? And even if one disciplined buyer says "no can do," another, less disciplined buyer, will happily pay the full offered side price.

Now suppose you are a credit manager and you are looking to add exposure in an overheated risk market. Say, like 2017, where every day is Groundhog Day. Corporate bond prices only escalate, spreads only narrow, and even if you want to be a disciplined investor, all that you hear and see is starting to give you a serious case of the FOMOs, fear of missing out. You watch as even the dodgiest, most leveraged issuers in the high yield and leveraged loan space bring their debt to market as "drive by" deals. With so much cash burning so many holes in so many pockets, it stands to reason that the yield on offer is not negotiable, nor is the credit agreement and, no, the company definitely does not have anytime today or any day to answer any due diligence questions. Well, you did say you wanted to invest, didn't you?

Let's fast forward a few years. That real-estate market is no longer red hot. In fact, from one end of the neighborhood to the other, there are nothing but "For Sale" signs in every front lawn. And now, you too need to list your house for sale. Obviously, you won't get your full listing price. Not only that, you won't get to ignore buyer questions about the roof, the foundation, or the neighbor. In fact, you feel lucky to have even a single interested buyer, and so you'll entertain any and all questions he might have. But getting answers to the questions takes time. And some of your answers turn out to be incomplete and unsatisfactory. "No problem," says the buyer, "I will incorporate all unknowns into my price." The result? The buyer's bid comes in well below your offered price. This disagreement over value introduces friction, i.e., illiquidity.

Meanwhile, let's check-in on the credit markets which have also transitioned from greed to fear. The credit buyers–no longer haunted by FOMO–have sobered up. That cash they thought was burning a hole in their pocket now feels like a safety blanket. Where once the sole question was "how many bonds can I buy?", now there are many questions. Questions about the borrowing company's accounting, its leverage, its business, its management, the debt covenants, and so on. Each time an answer fails to satisfy, the buyer's bid gets "backed up" and worst case assumptions start to fill the vacuum of incomplete information. The gap between where a company thinks it ought to be able to issue debt collides with the new market reality of lender skepticism. Yes, now the debt markets have also become "illiquid."

Whether we are analyzing housing, credit, or indeed any market for which investors "demand" different levels of information at different times of the cycle, we can see that liquidity eventually becomes problematic. Markets are maximally liquid during the greed phase because investors will invest with limited information. Give me a rating and a yield, and I'm done, or mostly done. Alternatively, when fear governs the markets, investors have nothing but questions, and each time these questions get answered, more questions arise in their wake. ***The information requirements to invest in a credit bear market mushroom, opening up an information "gap" between sellers and buyers, resulting in illiquidity.*** Regular offer side prices won't motivate a sale and bid side prices are way, way below the offer side.

### The Debt Markets Have Already Gone (Mostly) Dark

If democracy dies in darkness, so does liquidity in that embodiment of economic democracy, i.e., the capital markets. When information is scarce, investors must color in between the lines. That which is not known nor well quantified must be assumed or modeled. The door is therefore open to different investors reaching quite different conclusions about the underlying value of an asset leading, of course, to illiquidity.

More so perhaps than any other in history, this cycle is the wellspring of the theories and actions of the central bankers who, in their infinite wisdom, determined that they could model interest rates better than markets could price them. Central banks have flooded the system with what they call "liquidity" but which are actually nothing more–nor less–than electronically conjured "loanable funds." Under the banner of "doing whatever it takes," trillions in loanable funds were created so that now $17 trillion in global debt is priced to yield less than nothing.

The magic trick of inverting economic logic with negative rates results from the capacity of the central banks to create unlimited quantities of loanable funds at no cost. Trouble is, while loanable funds can be created without limit, the things that can be purchased with these funds is finite. But, "free money" not only makes loans cheap, it also erodes the capacity of lenders to ask for such reasonable terms as traditional loan covenants and basic financial disclosure.

Traditionally, leveraged borrowers had this choice: borrow in the high yield bond market and live by the disclosure and reporting standards of the public debt markets. In the alternative, if management preferred to adhere to a lesser standard of disclosure, the company could issue in the (private) loan market and subject itself to a battery of covenants designed to limit the ability of management to engage in risky or lender unfriendly actions. Thanks to the central banks, borrowers this cycle no longer had to choose: they could obtain cheap loans without agreeing to restrictive covenants nor providing on-going financial disclosure.

Hence, not only have the debt markets ballooned in size, but the growth has come disproportionately from those segments of the debt market where financial disclosure is poor:

| Market Size (Billions) | 2008 | 2019 | |
|---|---|---|---|
| Leveraged Loans | $605 | $1,212 | ~80% of loan issuers have no public securities, limiting financial disclosure |
| High Yield Bonds | $857 | $1,278 | ~62% of issuers have only 144(a) bonds |
| *144(a) High Yield* | *$106* | *$660* | *144(a)s grew from 12% of HY market in 2008 to 52% currently* |
| Private Debt | $246 | $638 | Not traded, limited or no financial disclosure |
| Total | $1,708 | $3,128 | |

Source: JPM, Bloomberg Barclays, Prequin

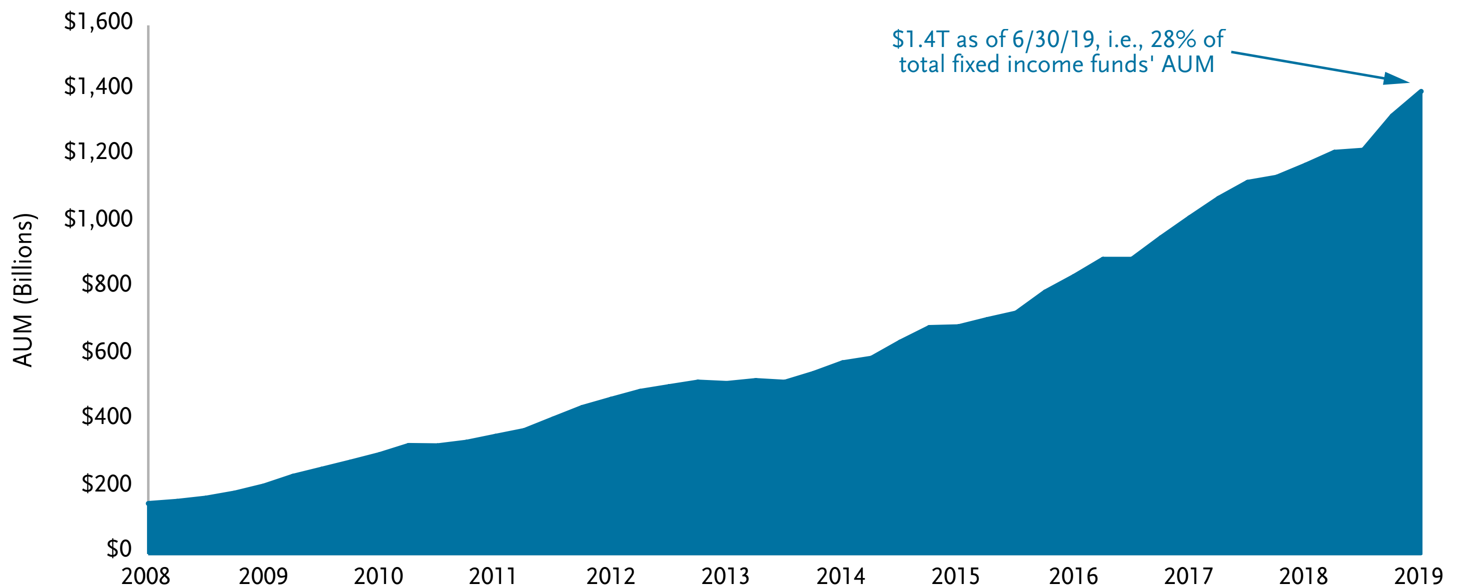
While a paucity of financial disclosure is not problematic during a bull market for credit, it is a defining feature of a liquidity crisis during a bear market. Human beings are naturally inclined towards fear–even panic–when they are unable to obtain the information they deem critical to their (financial) survival.

### Passively Managed ETFs/Mutual Funds

There is yet another feature of this cycle, that while not wholly unique will likely play a major supporting role in the next liquidity crisis: the passive fund. Passive funds are the epitome of the low information investor. On any given morning, the passive fund will experience either an inflow or outflow. Will it then examine industry specific news or credit metrics? Does it care about relative price movements? No! The passive fund is either buying everything in its "index" or selling everything in its "index." It provides credit to all its counterparties, no questions asked.

Thus far, in this cycle, passive funds have exploded in size (see graph). Anyone wonder what might happen should passive funds become large net sellers of credit risk? In that event, these indiscriminate sellers will have to find highly discriminating buyers who–you guessed it–will be asking lots of questions. Liquidity for the passive universe–and thus the credit markets generally–may become very problematic indeed.

**Passive Fixed Income Funds (Including ETFs)**




Source: Morningstar, TCW

The rapid appearance and growth of the trading activity referred to as "portfolio trading" speaks volumes as to the influence of passive funds. This recent development represents an algorithmically enhanced means to facilitate an investor's ability to trade into or out of a "portfolio" of credits. The improved trading efficiencies represented by portfolio trading have substantially displaced the "old" method wherein a fixed income trader hit multiple "direct" lines to the Street and solicited bids (or offers) for a single, specific credit. This innovation, we surmise, relies on the observation that when passive funds buy or sell, they do so "en masse." That is, when the passive fund trades, it must buy or sell that portfolio of securities that matches its index. It is not in the business of targeting single issuers. Hence, the rise of portfolio trading suggests to us that passive funds have, heretofore, played an outsized role in the supply of market liquidity.

## Conclusions

Capital markets are reflections of human nature. So, until the robots take over, fear and greed will remain in the DNA of asset markets and result in bouts of liquidity wherein "anything goes" alternating with periods where "nothing" is believed. As such, while holding a portion of your net worth in such dull investments as cash or Treasuries forgoes some bragging rights, history suggests that it could be among the most important allocation decision you make in a late cycle environment. ■

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