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Liquidity ERM: Ignorance may not lead to bliss

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Minimizing risk for fixed income portfolios requires a proactive approach that assesses stressed market conditions.

When preparing for one of his early fights, boxer Mike Tyson was peppered by the media with pre-fight predictions, many of which believed the unbeaten fighter had finally met a formidable foe. "People were asking me [before the fight], 'What's going to happen?,' " Tyson recalled years later. "They were talking about his style: 'He's going to give you a lot of lateral movement. He's going to move, he's going to dance. He's going to do this, do that.'

"Everybody has a plan until they get hit in the mouth," Tyson responded, just days before he knocked out his challenger in his trademark flurry of punches.

The notion — planning adequately for adversity — is one whose applications extend far beyond the boxing ring. For John Schaefer, president of AAM, a Chicago-based investment advisor that manages fixed-income portfolios for insurance companies, his company's plan would be tested in 2012 when Hurricane Sandy began forming in the western Caribbean sea.

"Three years ago today, Hurricane Sandy was formed," he told a group of attendees at the Sixth Annual Plante Moran Insurance Conference, held October 22, 2015, in Chicago. "We did our own internal ERM (enterprise risk management) work, and when it came to disaster recovery, we planned to go to Wisconsin in the event of a disruption. That was the place where we believed our business could operate with minimal disruption."

The reality, as Schaefer discovered, was far different, as the storm's 115 mile-per-hour winds ravaged 24 U.S. states along with Canada and the Caribbean, inflicting 233 deaths and causing more than $75 billion in damages. "When Sandy hit, most companies, like ours, realized that their disaster recovery plans were not good," he said. "While we thought our plan would work well, after Sandy, we learned that the reality is far different."

The lesson was a valuable one for Schaefer and AAM, whose portfolio performance relies on a meaningful ERM plan. "Every ERM plan is only as good as the risks that you've captured. If you're missing something, you may find yourself in a 'reality' situation, like we did with [Hurricane] Sandy. And that applies especially to the liquidity [the ability to transact quickly without exerting a material effect on prices] of bonds," he said, which play a vital role for insurance companies.

According to Schaefer, fixed income holdings like bonds represent the majority of assets for both property and casualty (52.5 percent) and life (70.0 percent) insurance companies. "As your number one asset, if something materially changes to impact it, you need to factor it into your ERM plan," he said. Otherwise, should a catastrophic event occur that forces insurance companies to sell their assets to accommodate a spike in claims, the degree to which those assets are liquid may prevent it from promptly compensating its customers. And whereas stocks trade freely and easily, bond trading is far more restrictive.

"For the S&P 500, there are 500 stocks at a market capitalization of $19.4 trillion," Schaefer explained, compared to 11,561 bonds at $3.3 trillion. "Quite simply, bonds don't trade that much … While the average New York Stock Exchange stock trades 3,800 times a day, the most liquid corporate bonds trade just 65 times a day … You don't have market makers lined up with offers [when you're looking to sell]." And the structure of the bond market is entirely different from the stock market. While the former includes buyers and sellers, the latter is comprised of dealers who buy and sell their inventory.

Despite this distinction and its implications, the insurance industry is not focused on liquidity, Schaefer said — to their detriment. Citing a 2015 IASA (Insurance Accounting and Systems Association) investment survey that asked companies to rate their bond portfolio risks, credit risk ranked highest, followed by duration, yield curve, call risks, and finally, liquidity. Such a diminished emphasis on the liquidity of bonds may be setting insurers up for a post-disaster surprise.

When looking at the growth of debt alongside the bond inventories among brokers and dealers, the liquidity challenges become apparent:

- Debt issuance growth: From 2000-2014, the growth of bonds outstanding went from $87 trillion to $199 trillion. "That's the amount that's available to be traded," Schaefer said.
- U.S. fixed income holdings: In the U.S. during that same period, debt has gone from

$17 trillion to $40 trillion. “There is a tremendous amount of debt that needs to be traded,” Schaefer observed.

- U.S. dealer inventory: U.S. corporate bond dealer inventories have plunged over the past seven years, the result of increasing regulatory burdens. “They’ve gone from $250 billion going into the 2007 crisis, down to about $50 billion today,” Schaefer said, “That has a tremendous impact on our market; dealers don’t want to buy bonds for their own investory and are not likely to have them to sell either.”

The end result is a drop in turnover, with bonds trading far less frequently. Whereas the average U.S. Treasury bond turned over 35 times in 2006, the turnover was just 15 times in 2014. At the same time, the pool of buyers and sellers has contracted, with just 2 percent of asset management firms executing half of all trades. “If you’re in that camp, it’s something to be aware of going forward,” Schaefer said. “You’re going to have difficulty finding those counter parties.”

Portfolio implications

Noting these trends and characteristics, Schaefer highlighted these key portfolio implications:

- The total return opportunities in fixed income portfolios will be increasingly generated from yield rather than opportunistic trading.
- Bond maturity and cash flow profiles of fixed income portfolios are critical components of an ERM framework to meet liquidity needs.
- Cash and equivalents and the highest rated government debt remain preferred asset classes to achieve liquidity needs.
- Building meaningful position sizes across portfolios is difficult for large institutional fixed income managers and selling individual positions may not be possible, especially in stressed market environments.
- Over a market cycle, investment performance will accrue to the providers of liquidity from the forced sellers. “You want to be positioned so that you’re not standing in line

with all of the other sellers and forced to sell when they do," Schaefer said. "You won't be able to do it quickly and at market price."

- Credit lines from banks including the FHLB system should be evaluated as part of an ERM framework. "Think about having a liquidity facility set up in the event that you need cash quickly. The alternative is raising the money from a portfolio, which comes at a cost when others are trying to do the same," Schaefer said.

As Tyson warned his doubters, it's not the strength of the plan when you're ahead that counts, but the one that addresses adversity and risk. It's not a one-and-done proposition, either, but one that merits ongoing attention in order to be relevant and effective. "Think things through now while things are calm," Schaefer said. "And along the way, update your plans."