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THE INHERENT COSTS OF LIQUIDITY

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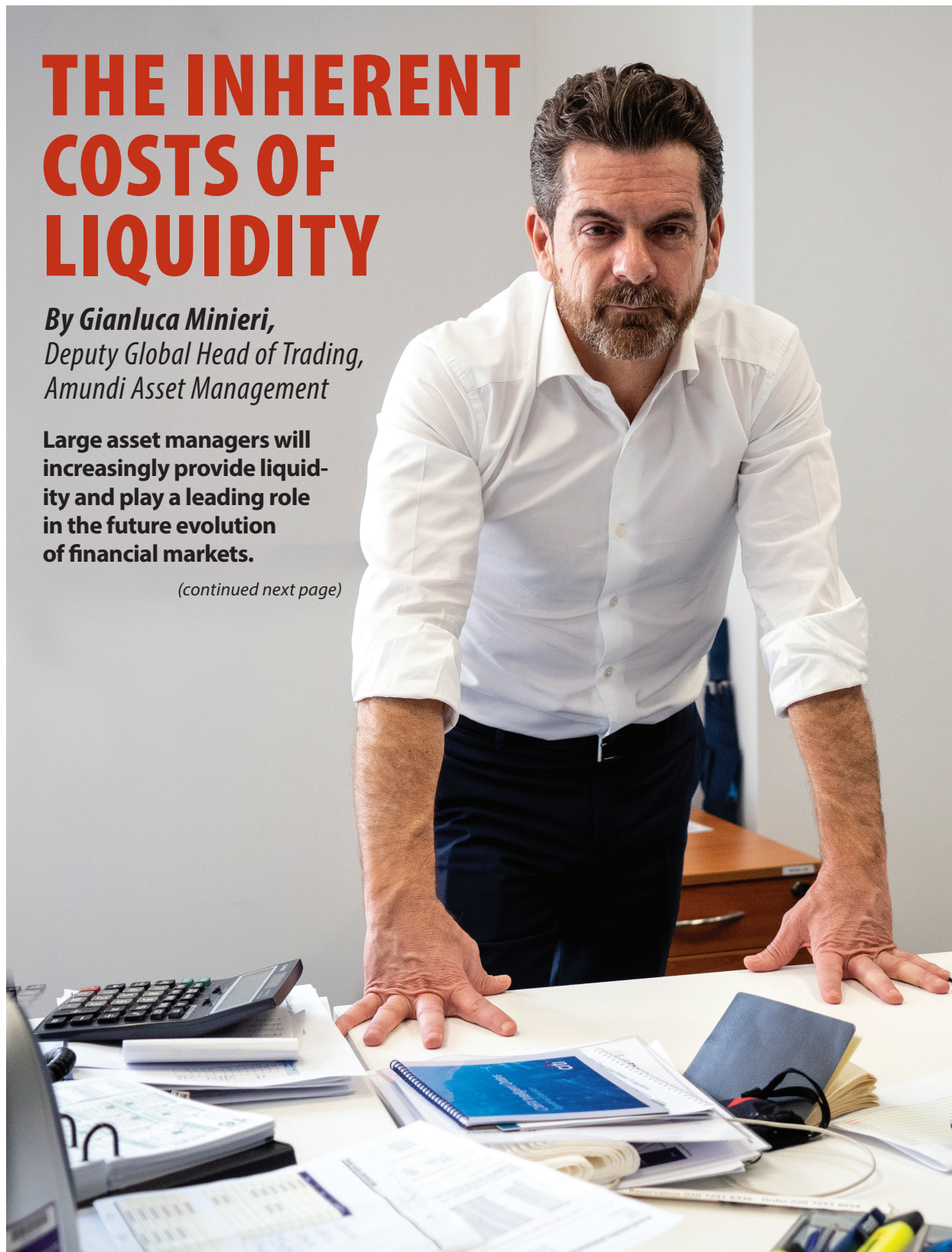


THE INHERENT COSTS OF LIQUIDITY

By Gianluca Minieri,
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Large asset managers will increasingly provide liquidity and play a leading role in the future evolution of financial markets.

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During the past few years, much has been written about market liquidity and the main factors that have had a significant impact on it. These include:

The reduction in market-making activity, due to an increase in capital charges and a reduced risk appetite across investment banks as they adjusted to a post-crisis market environment;

The decline in trading turnover, linked both to the reduced level of liquidity available and to the nature of the asset owners (long-term investors such as asset managers, pension funds, insurance companies)

The record increase in corporate bond issuance, incentivised by low interest rates, which created a gap between the size of the primary market and the size of the tradable secondary market

The growth of the asset management industry

The increased demand for liquid assets due to stricter regulatory collateral requirements.

As a result, there appears to be a consensus that investors have to accept a market environment in which liquidity is characterised by a structural lack of resilience which means that in fast market conditions most of the liquidity normally available might vanish or significantly reduce.

However, this is not necessarily true -- or at least it is not true for all -- because it ignores or underestimates several other factors and constraints that might drive the decisional process of market participants in different directions.

Many asset owners have unrelated investment objectives and constraints, which motivate their behaviour in disparate ways. For example, during the spike in volatility that occurred in the high yield market in December 2015, mutual funds redeemed almost \$10 billion of assets from high yields funds. However, the high yield market did not register negative net flows, for the simple reason that while mutual

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funds were selling, other institutional investors decided to increase their high yield allocations, viewing the sell-off as an attractive buying opportunity.

Hence, while increased liquidity costs might reduce investment returns and generate losses for some, it might generate profit for someone else. The fact that there are winners and losers in the market confirms our belief that what we are facing is market risk, not systemic risk.

Asset managers have to acknowledge that a structural change to market liquidity requires a structural response, a strategic change in the way they manage their business, which entails evolving and adapting governance, strategies, processes and systems.

ADAPT THE INVESTMENT PROCESS: PORTFOLIO CONSTRUCTION, PORTFOLIO MANAGEMENT AND TURNOVER

Investors have to cope with the reality that liquidity is not free. Inherent in the price of every asset is the concept that liquidity has a cost. This cost increases when immediacy is needed and liquidity is scarce. For this reason, liquidity should be included among the factors to consider during the portfolio construction phase. When creating investment portfolios, trading costs, which are a direct function of the liquidity level of an asset, erode the expected alpha. Although liquidity does not qualify as an independent alpha factor, it is nonetheless a key driver of transaction costs and therefore net returns.

Liquidity must also become a major factor to consider when theoretical investment strategies are implemented into live portfolios, as there might be significant differences between transacting on paper and transacting in real markets. This gap is known as “implementation shortfall”.

Moreover, estimates of liquidity are needed to optimize portfolio turnover and ensure that the portfolio's assets remain within liquidity risk boundaries. Indeed, research demonstrate that trading costs and turnover are negatively related to funds' performance. As a result, a sophisticated investment process cannot ignore liquidity.

ENHANCE TRADING CAPABILITIES

Of course, trading has experienced a massive impact from



regulations, technology and automation on various layers. From the back office operations to the dealing desk, new cross-border legislations combined with the rise of automation have brought sweeping changes to what used to be a manually intensive transaction-based operation. From the proliferation of executing venues and electronic platforms to millisecond executions, asset managers have to accept that without the support of a leading-edge technology at the core of their trading system, they will lose in the liquidity game.

Integrated order management systems (OMSs), execution order management systems (EMSs), connectivity to electronic trading platforms, direct market accesses (DMAs), algorithms, smart order routers (SORs) are all tools that traders must have in order to be able to find liquidity effectively and at a competitive price.

However, there is probably a more important factor that might change forever the rules of the liquidity game. If we consider that in fixed income markets, more than 90% of global outstanding bonds inventory is held by buy-side institutional investors, it is easy to come to the conclusion that the asset management industry holds the key to addressing the liquidity conundrum. Those large, dormant asset inventories held by institutional investors are a natural source of liquidity that can be used as the alternative to the greatly reduced capacity of broker/dealers to use balance sheets to facilitate clients' trades.

FROM PRICE TAKERS TO PRICE MAKERS

How can that be achieved in practice? The answer is for

them to shift from a price-taker role to a price-maker one.

Today the trading environment is significantly more disintermediated than before and brokers/dealers are only filling a technological gap between buyers and sellers. Once this gap is filled (and it will be filled) by asset managers capable of embracing technological investments and innovative trading protocols, the reward will be for them to receive the spread instead of paying it, with the potential for significant improvement in

the majority of deals employ the so-called "pot" system", where the issue is priced when sufficient orders have been collected to cover the whole amount of the book. Only at this point, when there is virtually no risk of loss, the new issue is finally launched. Bonds are then allocated to clients of all underwriters by the book-running lead manager.

In other words, deals are no longer launched until they are already pre-placed with investors. Therefore, the underwriting risk has largely been taken away from

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terms of pricing and eventually performance for their clients.

This is not only true in the secondary market. It would also bring benefits to the functioning of primary markets, which are a key source of alpha for portfolio managers.

During the past few years, bond primary markets have gone through significant change in how the underwriting system works. Traditionally, in primary deals, lead managers used to buy the whole issue from the corporate borrower before it had been placed with investors. When this happened, broker/dealers committed substantial regulatory capital to the distribution process. Today

the dealers. On the other hand, asset managers find it increasingly harder to understand how to play a more meaningful role in this market as the rules of engagement of the process of allocation are not always clear and transparent.

An alternative would be for the buy-side to work with the sell-side by joining distribution syndicates and acquiring their positions directly from the issuer. In such cases, the investment bank would undertake only pricing and issue management rather than also providing capital commitment. As in direct buy-side participation in the secondary market, this would allow institutional investors to buy at the syndicate-buying



price (bid) rather than at the syndicate-selling price (offer).

If the buy-side could provide liquidity services successfully, it would have private and public benefits. The private benefit would be to create another source of alpha for clients. The public benefit would be a shift of liquidity provision from highly leveraged firms to unleveraged funds, which would also reduce systemic risk.

THE ROLE OF LARGE ASSET MANAGERS

In fact, asset managers are much better equipped to manage inventories. Brokers/dealers have their trading books highly mismatched from a maturity perspective, since they finance long-term bonds with overnight repo transactions. In contrast, asset managers do not have to re-finance their long maturity inventory every day in the overnight repo

market and therefore do not have to bear the risk of not being able to roll-over repo during a liquidity crunch. They are better placed to provide liquidity to each other than are highly leveraged intermediaries.

The lessons are the following: revisit investment processes, rethink portfolio construction rules, enhance risk management tools, use capital for significant technological developments, adopt a market-maker approach to liquidity provision.

Of course, not all asset managers will be able to sustain the required investments and manage the complexity deriving from such a massive transformational approach. The operational complexity required to enhance the operating model to exploit liquidity as an alpha source would be far too demanding for small-to medium-size asset managers.

Besides, the role of technology will continue to grow in importance within the asset management business, which will inevitably favour the bigger players due to the capital-intensive nature of these type of investments.

In practice, only large asset managers will have the capabilities to embark on all these challenging initiatives by leveraging on economies of scale within their organisation. Only the biggest players in the industry will be able to offer their internal and external clients dedicated global integrated dealing platforms, capable of addressing effectively the liquidity demand while at the same time exploiting new alpha source opportunities and actively contributing to the development of a more efficient market structure. ●