Perspectives

Liquidity Management: More Critical than Ever

Key Takeaways

- Post financial crisis of 2008, the municipal market has experienced a number of transformative changes due to a reduction in bond insurance, declining institutional participation, and investor uncertainty.
- Liquidity risk arises from the mismatch between the liquidity of the product and that of the market. And this mismatch becomes greater during periods of dislocation.
- Today's new level of volatility presents opportunities for those who manage liquidity properly.

Insights from MacKay Municipal Managers

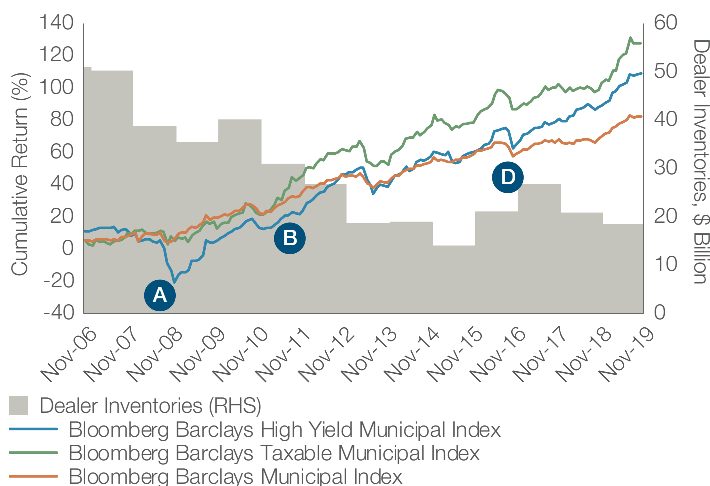
The municipal bond market has long been fragmented, complex, and less liquid than other fixed income markets. In a market like this, active management can capitalize on the numerous inefficiencies created by those conditions. Notably, the municipal landscape has shifted since the financial crisis of 2008, making one feature of an actively managed approach — liquidity management — more necessary than in the past.

A New Municipal Market Landscape

A number of transformative changes have occurred in the municipal bond market since the financial crisis:

1. **A reduction in bond insurance.** In the wake of the crisis, the exit of certain bond insurers has left the majority of issues uninsured. Historically, the attributes of insured bonds contributed to their better relative liquidity. Whereas investors could once select from a larger pool of insured bonds designed to provide additional protection from default, investors must now seek in-depth credit analysis. As a result of the smaller percentage of insured bonds coming to market, investors potentially have to own less liquid bonds when constructing portfolios.
2. **A decline in institutional participation.** New regulations, tax changes and competing investment products have led broker dealers to reduce the amount of capital they commit to municipal trading. In addition, the tax reform legislation of 2017 has caused commercial banks to also reduce their exposure to the municipal market. As a result of this reduction in institutional involvement in the municipal market, the relative liquidity of the municipal market has been negatively impacted.
3. **Investor uncertainty has increased.** Ongoing individual investor migration to the intermediate portion of the municipal yield curve suggests an increasing concern with market risk. Uncertainty over rising interest rates and municipal credit conditions have driven this "flight to quality" trade. However, while experienced municipal managers recognize that uncertainty contributes to illiquidity, it can also generate opportunities to capture value.

Events over the last ten years illustrate this new volatility: market reactions to a widely circulated prediction in 2010 of imminent and widespread muni defaults, headlines regarding the finances of Detroit and Puerto Rico in 2013, and the Presidential election 2016 were all severe. The technical selling pressure following these events produced significant drawdowns (and opportunities through active management).



Past performance is not indicative of future results. It is not possible to invest in an index. Events referenced on timeline are not necessarily the sole cause of market declines during the periods highlighted. Sources: Bloomberg Barclays Capital and U.S. Federal Reserve, as of November 2019.

- Broker-dealer inventories have declined significantly, from $50 billion in 2007 to $18 billion in November 2019.
- New issues wrapped by insurers have also declined significantly, from 60% in 2007 to less than 10% in 2018, making credit analysis increasingly important for investors.

Why Liquidity Management?

This new municipal bond landscape can be navigated best via active management, and one of the core pillars of an active approach is liquidity management. Liquidity risk arises from the mismatch between the liquidity of the product and that of the market. And this mismatch becomes greater during periods of dislocation.

MacKay Municipal Managers™ Believe That Liquidity is Best Managed by:

- **Omitting mutual fund leverage —** In our opinion, leverage should not be employed in municipal bond mutual funds. We believe it contributes to portfolio illiquidity in a "daily-access" vehicle and may add interest rate sensitivity to the portfolio. This may be of particular concern when added to a high yield municipal fund where the client objective is to gain exposure to lower-rated, higher-yielding credits while minimizing rate sensitivity.
- **Maintaining a cash cushion —** Whereas before the crisis, a municipal mutual fund could operate comfortably with 1% cash, we believe today that reserve should be 3-8%. A slightly lower yield resulting from a large cash position is a reasonable price to pay to avoid becoming a forced seller during a dislocation, plus, an active manager will be well-positioned to capitalize along the way.
- **Limiting non-rated bonds —** Fund managers should also limit their holdings of non-rated bonds. Because not all buyers are willing to buy these issues, non-rated issues effectively reduce liquidity.
- **Limiting obligor exposure —** Municipal fund managers should also place limits on the allocations they make to individual obligors. These caps force the fund to diversify across more names, which reduces the chance of having to be a forced seller of any particular one.
- **Opting for callable bonds —** Managers should also consider bonds with coupon and call structures. In effect, call option characteristics can lower a bond's duration, limiting its downside in a difficult market. These bonds hold up better in a dislocation as they are easier to sell, which therefore helps to boost a fund's liquidity.

The reduction in market liquidity presents risk to municipal bond investors because it can produce significant market dislocations. But there is also an upside: today's new level of volatility is largely a result of technical factors, not fundamentals. As a result, it also presents opportunities for those who manage liquidity properly, and therefore avoid becoming forced sellers during a drawdown.

Municipal securities risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers, and the possibility of future tax and legislative changes which could affect the market for and value of municipal securities. Such uncertainties could cause increased volatility in the municipal securities market and could negatively impact the Fund's net asset value and/or the distributions paid by the Fund. Securities purchased by the Fund that are liquid at the time of purchase may subsequently become illiquid due to events relating to the issuer of the securities, market events, economic conditions, or investor perceptions.

Liquidity risk is the risk that certain securities may be difficult or impossible to sell at the time that the seller would like or at the price that the seller believes the security is currently worth. The Fund may not be able to pay redemption proceeds within the allowable time period because of unusual market conditions, unusually high volume of redemptions, or other reasons. To meet redemption requests, the Fund may be forced to sell securities at an unfavorable time and/or under unfavorable conditions.

Past performance is no guarantee of future results, which will vary. All investments are subject to market risk and will fluctuate in value.

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Definitions:

Active management is the use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund's portfolio. Active management strategies typically have higher fees than passive management.

The **Bloomberg Barclays Municipal Bond Index** is an unmanaged index that includes approximately 15,000 municipal bonds, rated Baa or better by Moody's, with a maturity of at least two years.

The **Barclays Municipal High Yield Index** is an unmanaged index consisting of non-investment grade, unrated or below Ba1 bonds.

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