Tyron Green

Why is liquidity important?

Tyron has seven years' experience in the investment industry. He joined the fixed income team as a Credit Analyst in 2013 and serves on the PSG Asset Management Credit Investment Committee.

Liquidity is currently a key theme of the global economy
Liquidity in the instruments that we hold in our funds is always an important consideration, but recently it has really become top of mind. We can all recall how many investors were trapped in illiquid assets in 2008/2009 and avoiding that pitfall is one of our roles as stewards of our clients' investments. Liquidity is one of the key global themes at the moment, with concerns about a potential stalemate as funds try sell their assets to fund investor redemptions.

Both quantitative easing and regulatory changes have affected liquidity since 2008
There are a number of aspects that have impacted liquidity since the financial crisis in 2008/2009, one of which is quantitative easing from the United States and the other central banks pushing down global yields. In South Africa, the real repo yield over the last 20 years has remained low, resulting in investors seeking higher yields through investing in property, corporate bonds and other fixed income securities. This has seen significant inflows into fixed income and multi asset funds, driving demand for higher yielding corporate bonds.

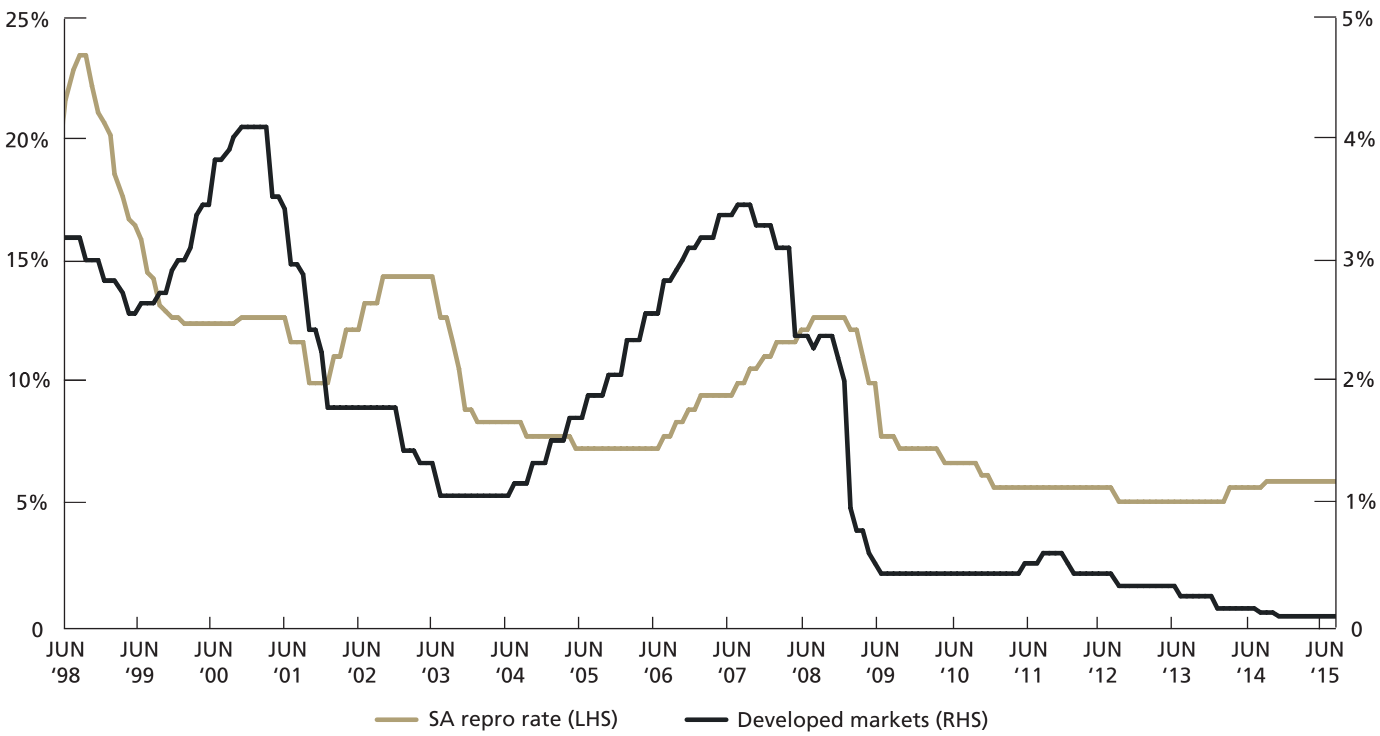
Graph 1 shows the repo rate in South Africa (left-hand axis) as well as a developed market composite of the Federal funds rate (USA), the European Central Bank refinance rate (Europe) and the Bank of Japan benchmark interest rate (equally weighted) since the middle of 1998.

As can be seen from the graph, domestic and global yields are at the lowest points they've been in a very long time.

Graph 2 shows that South African fixed income and multi asset funds saw inflows of R334 billion (over 300% growth) since 2008.

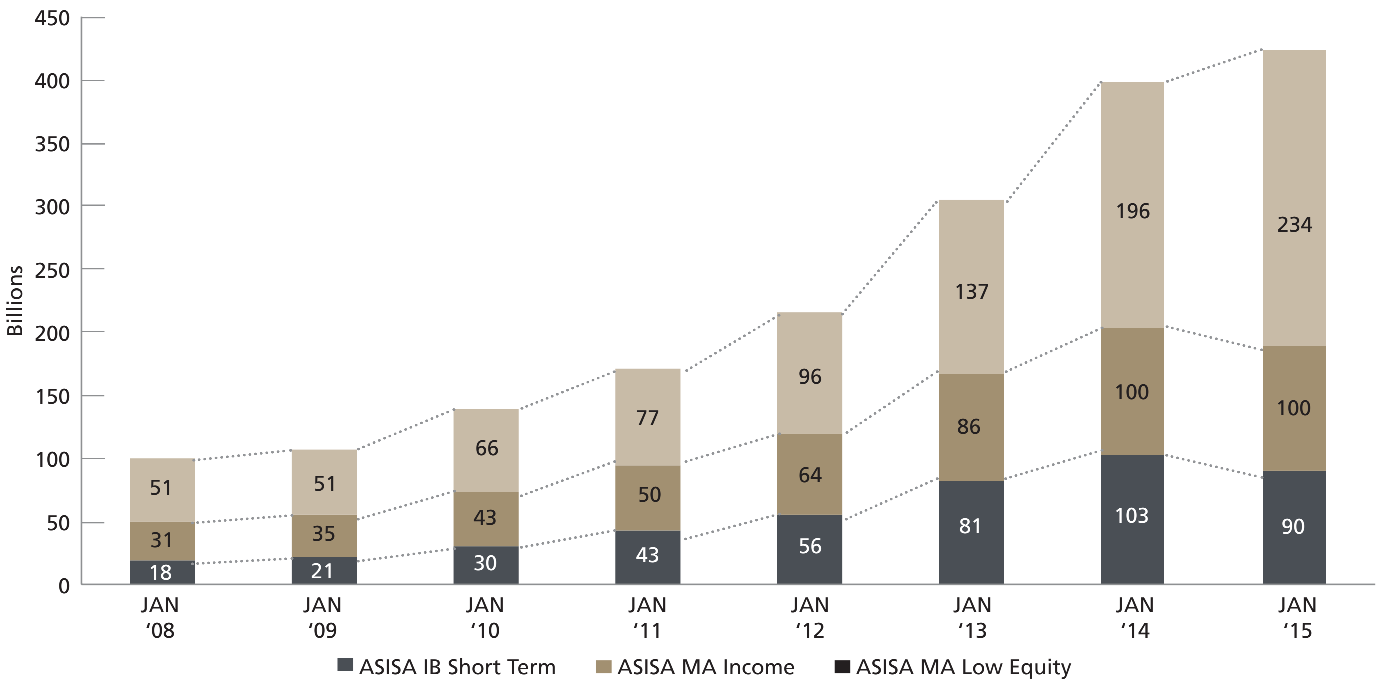
The higher demand for fixed income investments has not only been in South Africa – there have also been significant inflows in international fixed income funds. Since 2008, US corporate and foreign bond mutual funds have seen a $1.2 trillion inflow and worldwide mutual funds have seen inflows of $3.1 trillion. The search for yield has resulted in asset managers and funds becoming significant lenders and becoming more important for systemic financial stability.

Graph 1: Interest rates since 1998



Sources: Bloomberg, PSG Asset Management

Graph 2: Growth in South African fixed income and multi asset funds since 2008



Sources:Morning star and PSG Asset Management

The other main factor that has impacted liquidity since the financial crisis is regulatory changes, forcing the 'too big to fail' banks and insurance companies to bolster capital reserves. The banks were also encouraged to reduce their trading books, as the Dodd-Frank Act made it more costly and balance sheet intensive for the banks to trade.

The impact has been felt both internationally and locally. Graph 3 shows how the US banks' dealer bond holdings (the trading book for banks) has declined from $150 billion in 2006 (around 4% of the free float) to $50 billion in 2014 (around 0.5% of the free float). At the same time, investments in bond funds have increased from around $2.3 trillion to around $3.5 trillion.

The result is that we have seen significantly lower secondary market trading and liquidity. This can be attributed to increased demand for fixed interest from asset managers and banks to hold capital as well as lower trading from banks due to higher regulatory balance sheet costs. The lower liquidity environment means it is important to consider how your funds are managing their cash and liquidity positions. If asset managers become forced sellers of fixed income instruments, this can prompt a change in the supply/demand dynamics.

Considering liquidity is part of our investment process

So how does this impact your investment in our funds?

At PSG Asset Management, we consider the liquidity of instruments in our portfolios as part of our overall portfolio management strategy. We have developed our own risk framework to evaluate our credit investments. Our 3M philosophy (as discussed in the second quarter edition of 2014 of this publication) has ensured that we have stayed away from investments that have not met our hurdle rate, which has enabled us not to take any fixed income capital losses thus far. We consider global investment macroeconomics and where global rates should be, as explained by Ian Scott and Shaun le Roux in the previous edition of *Angles & Perspectives*. We believe we have positioned our funds to ensure we have buying ability if there is a sell-off in the markets, yet still earn a decent yield in 'clever cash' while we wait for opportunities.

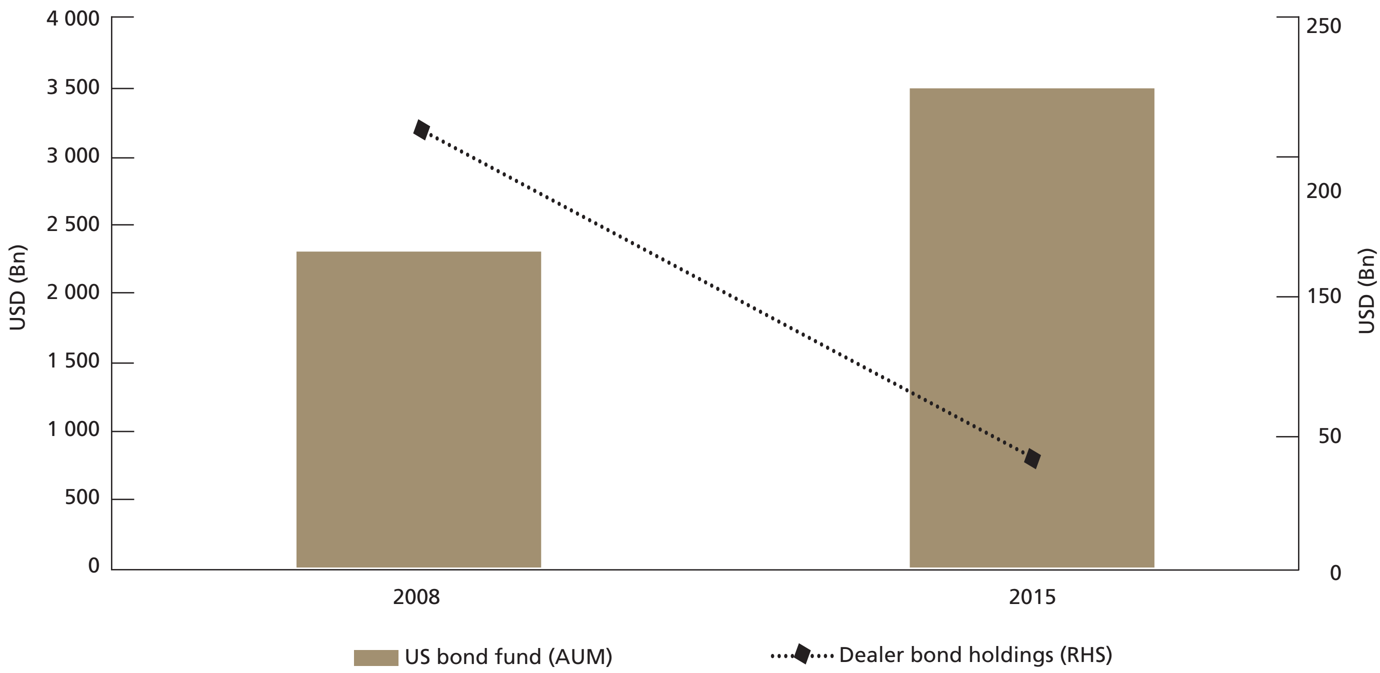
Our 3M philosophy considers liquidity as part of the Margin of Safety for our fixed income investments. This doesn't mean that we don't own any less liquid investments, but it means that our lower liquid investments have met our hurdle rate for both the credit risk and liquidity compensation.

What we are currently invested in

Within all our fixed income and multi asset class portfolios, whether it be our PSG Income Fund, PSG Diversified Income Fund, PSG Stable Fund or PSG Balanced Fund, we consider the aggregate liquidity positions of the portfolios. We currently have significant amounts of cash and negotiable certificates of deposits (NCD) to ensure we can meet anticipated outflows and have the ability to buy high quality assets in the event of a market sell-off.

Our fixed rate NCDs exposure is tradable and has a sufficient Margin of Safety in the price to sustain a number of interest rate hikes. Our portfolios are well positioned for a rising interest rate environment (with a low duration and high floating rate exposure), which would benefit investors as interest rates rise over time. We have low allocations to fixed corporate bond issuers. This means that even if we see interest rates increases, we do not expect any significant negative valuation movements as we are comfortable with the Margin of Safety in the price at which we acquired the investments.

Graph 3: Liquidity in the US bond market – 2008 versus 2015



Sources: BIS, ICI, Barclays Research

We do not currently have longer duration sovereign bond exposures or property exposure, as these investments have not met our fair value purchasing hurdle yet. We have also stayed away from lower liquidity credit-linked notes and inflation-linked bonds, as they do not currently meet our Margin of Safety rate.

Our fixed income portfolios do not have significant exposure to investments that have high foreign debt investor exposure (for example South African sovereign debt, Transnet and Eskom), which should provide some comfort if there is a global sell-off of emerging market investments. We will invest in these names when we feel that we are being compensated accordingly for the credit and term risk, but to date we have not reached that point.

Our investors' capital is protected in a lower liquidity environment

As a smaller asset manager, PSG Asset Management is more nimble and has a greater ability to sell an investment block (equity and fixed income) that is material to our funds but still small to the large asset managers. We think that being more nimble protects our investors' capital in a world where liquidity is reduced through regulation.

It is important to remember that with fixed income instruments, as long as we, as stewards of your capital, have done our 3M credit analysis properly, you should receive the capital back at maturity as well as a set interest payment. The temporary shorter-term capital market-to-market fluctuations will only be relevant if you as an investor are forced to disinvest from a fund at the time of a liquidity or valuation squeeze or if you sold out of the fund when equity share prices are down.

That is why, in addition to understanding how we invest, a thorough analysis of the end investor, be it direct investors or an adviser's clients, is the key to aligning our investment horizons for the best possible outcomes.