Liquidity risk in high yield bonds: Not what you may think

July 2014

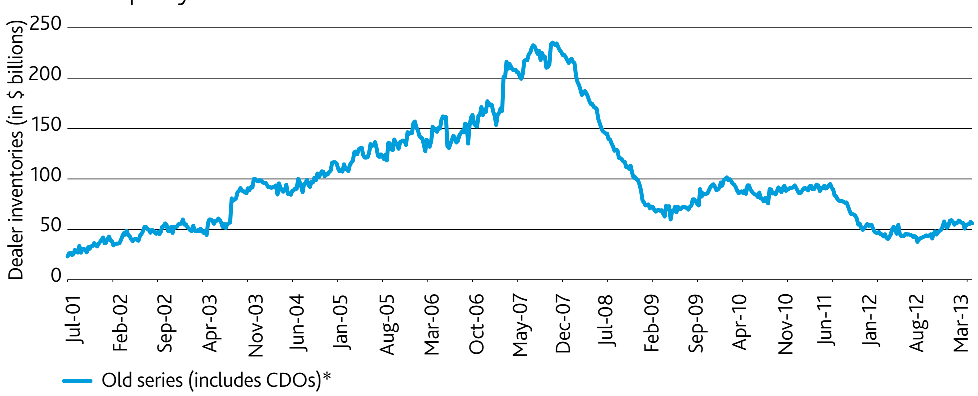
Introduction

In our opinion, after the management of credit risk, the management of liquidity risk is perhaps the greatest challenge in high yield bond investing. Is liquidity risk any worse today than it has ever been? If the shrill warnings of the dealer community are to be believed, we all should be selling our high yield bonds, and much of the rest of our investments, and placing the proceeds in money market securities.

Chart 1 below often serves as the starting point for these warnings. The chart illustrates historical totals for dealer inventories as reported by the New York Federal Reserve (Fed). The precipitous decline is said to portend a tectonic shift in the behavior of dealers brought on first by the credit crisis and then by the "two-headed dragon" of every Wall Street investment house's nightmare—the Dodd-Frank Act (which included the "Volcker Rule" separating proprietary trading from pure dealer activities) and Basel III capital controls.[1] At the height of lobbying over these measures, Wall Street at one point even asked its major institutional clients on the buy side to write to their congressmen and campaign against the Volcker Rule lest the downward curve in dealer inventories that we can see here turns into a cliff over which all our businesses and all our clients would fall.

Chart 1: Dealer inventories of all fixed income securities (old series)*

The end of liquidity?



Source: Federal Reserve Bank of New York, May 2014. For illustrative purposes only.

* The old series, which has been discontinued, comprised Primary Dealer Positions Outright Level Corporate Securities Due Greater than 1 Year. This included structured securities, which are pools of assets which seek to profit from credit spreads between short-term debt and long-term structured finance products.
Source: Bloomberg.

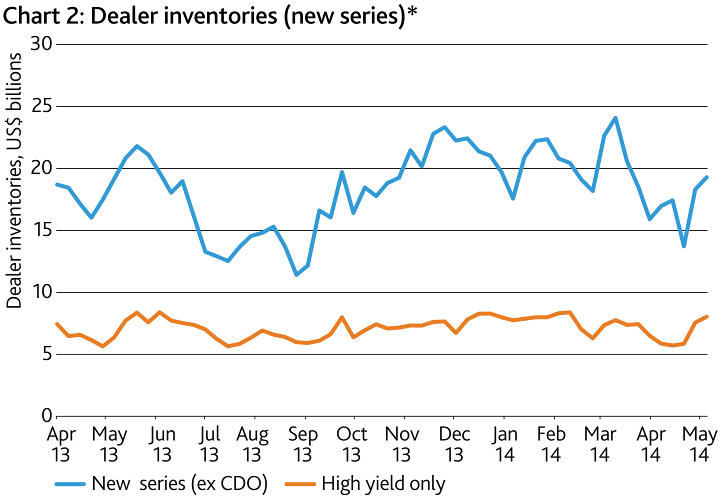
** Collateralized debt obligations

[1] The Dodd-Frank Act, named for its two sponsors, Senator Chris Dodd and Representative Barney Frank, is a set of federal regulations, primarily affecting financial institutions and their customers, signed into law by President Obama in 2010 in an attempt to prevent the recurrence of events that caused the 2008 financial crisis. Basel III comprises a comprehensive set of reform measures designed to improve the regulation, supervision and risk management within the banking sector.

But wait: What does this chart actually show? Well, first of all, it depicts only changes in dealer inventories of fixed income securities since the last recession, which occurred from late 2007 to mid-2009. How do we know this is not the normal response of dealer inventories to difficult times? Beyond this oversight, it turns out that this graph does not only reflect dealer corporate bond inventories, as was essentially intimated whenever and wherever it was rolled out. It also includes structured securities[2] such as subprime[3] and commercial real estate bonds in all their manifold varieties. The prelude to and denouement of the credit crisis coincided with the final gasp of growth and precipitous decline of the supplies of these securities. Very few still exist in any inventory, anywhere.

Is it any wonder that a series that includes structured securities should show such a scary decline? Does it say anything about dealer inventories of "good, old-fashioned" corporate bonds, or the high yield, below-investment-grade segment of the corporate bond market? We really cannot answer that question, but we can take a look at a new series the New York Fed publishes in lieu of this rather flawed predecessor. That series appears in Chart 2. While we cannot see what this may have looked like in prior recessions, because the data was not gathered in exactly this manner, we can see that dealer inventories have stayed fairly steady since the crisis—although Dodd-Frank has since passed into law and capital regulations are set to phase in over the next several years. Interestingly, the one period of rising interest rates and volatility during this timeframe occurred from May through June 2013. Inventories of bonds actually rose during this time. The "Street" did not seem to have lost its willingness to absorb demands for liquidity, which is a big part of the service these companies provide and the profits they make.

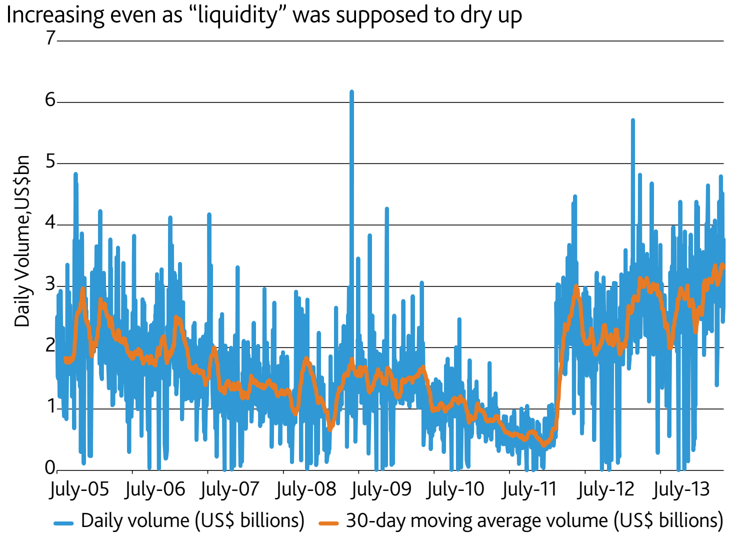
Chart 2: Dealer inventories (new series)*



Source: Federal Reserve Bank of New York, May 2014. For illustrative purposes only.
* New series is a combination of two series: Primary Dealer Positions Net Outright Corporate Securities Above Investment Grade Due in More than 13 months AND Primary Dealer Positions Net Outright Corporate Securities Below Investment Grade. Source: Bloomberg, June 2014

Neither Chart 1 nor Chart 2 necessarily tells us much about liquidity, however. Dealer inventories, even if precisely measured and presented, merely indicate how much of the market is held by market-makers. While market-makers should be the first to absorb increased liquidity requirements, they do not need to be the only ones. As prices change, different market participants will come to different conclusions about values. Buyers will seek sellers and vice versa, and one should see increases and decreases in trading activity, which is an indication of securities changing hands, but not necessarily always ending up in dealer inventories. Chart 3 illustrates that the actual trading volumes of high yield bonds has not really changed much over the years.

Chart 3: High yield U.S. corporate bond trading volume
Increasing even as "liquidity" was supposed to dry up



Source: FINRA TRACE, May 2014. For illustrative purposes only.
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.
The above data represents the FINRA – Bloomberg Active High Yield U.S. Corporate Bond Index which comprises the active (most frequently traded) fixed coupon bonds represented by FINRA TRACE, FINRA's transaction reporting facility that disseminates all over-the-counter secondary market transactions in these public bonds. Indexes are unmanaged and have been provided for comparison purposes only. No fees or expenses are reflected. You cannot invest directly in an index.

"While market-makers should be the first to absorb increased liquidity requirements, they do not need to be the only ones. As prices change, different market participants will come to different conclusions about values."

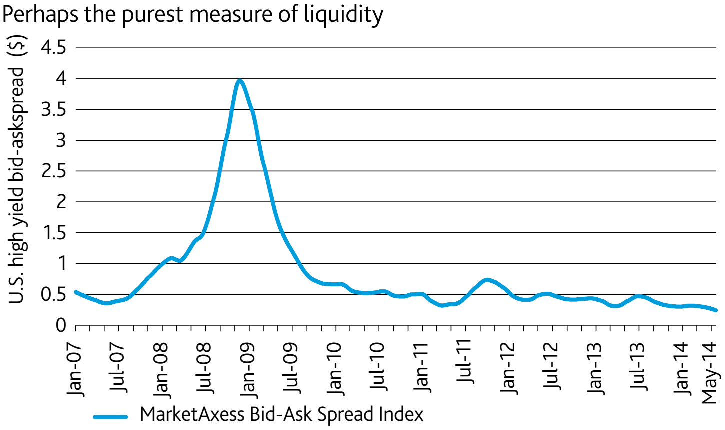
[2] Structured securities are pools of assets which seek to profit from credit spreads between short-term debt and long-term structured finance products.
[3] Subprime loans usually are issued to borrowers with lower credit ratings.

But even Chart 3 may not be telling us much about liquidity, in our opinion. It is possible that, over time, investors have maintained the same pace of trading activity but have been doing so at ever higher costs. The closest measure of that cost we can peg–and we believe perhaps the only true measure of liquidity–is actual bid/offer spreads.[4]

Until recently, such data did not exist, at least for public consumption, as far as we know. More recently, the advent of electronic trading platforms and the general explosion in data availability have begun to provide us with better insight into the elusive concept of liquidity. In Chart 4, we present data on average bid/offered spreads in corporate bonds, gathered by MarketAxess, an electronic trading platform. Interestingly, in our view, the data indicate that average bid/offered spreads have been declining since the credit crisis of 2007-2008, coming down from highs of about 3-4 points to under 0.5 point today. And this occurred despite the passage of Dodd-Frank and the inexorable march of higher capital requirements!

Chart 4: MarketAxess U.S. high yield bid-ask spread*

Perhaps the purest measure of liquidity



Source: MarketAxess, May 2014. For illustrative purposes only.

* The MarketAxess Bid-Ask Spread Index tracks a subset of 1,000 bonds selected on a quarterly basis that represent the most actively traded issues, as determined by a rank ordering process. The ranking is based on the number of times the bond has traded over several discrete time periods: the last year; each of the last 2 semi-annual periods; each of the last 4 quarters; and each of the last 12 months. The constituent bonds are exclusively institutional in trade size with a spread lower than 500 basis points in order to minimize outliers. Indexes are unmanaged and have been provided for comparison purposes only. No fees or expenses are reflected. You cannot invest directly in an index.

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Summary

When one thinks about liquidity in the global securities markets, high yield may not be the first asset class that comes to mind. However, demand and new issuance in the market remain robust, thereby creating an environment in which invested funds are easily convertible into cash.

We think that Aberdeen Global High Income Fund may potentially provide both individual and institutional investors with the ability to take advantage of opportunities in the global high yield market. The Fund seeks to maximize total return, principally through a high level of current income, and secondarily through capital appreciation.

[4] The bid/offer spread is difference between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

Key facts: Aberdeen Global High Income Fund

	Class A	Institutional Class
Ticker	BJBHX	JHYIX
CUSIP	04315J878	04315J860
Minimum initial investment	$1,000	$1,000,000
Gross/net expense ratios	1.01%/1.00%	0.75%/0.75%
Benchmark	BofA Merrill Lynch Global High Yield Constrained Index, hedged to U.S. dollars	
Distributions	Monthly: income; annually: capital gains	
Investment team	Aberdeen Global High Income Team	

While the Fund is no-load, management and distribution fees and other expenses still apply. The Adviser has contractually agreed to reimburse certain expenses of the Fund through February 28, 2015 (the "Expense Limitation"). Net operating expenses of the Fund, based on the average daily net assets, are limited to 1.00% for Class A shares and 0.75% for Class I shares. This arrangement does not include interest, taxes, brokerage commissions, and extraordinary expenses. The Adviser has also agreed to waive a portion of its management fees at the annual rate of 0.005% of the Fund's average daily net assets which is included in the net expenses of the Fund. Additional expenses are net of reductions related to fee waivers and/or custody offset arrangements. Please refer to the Fund's prospectus for more information on share classes within the Fund and which one is more appropriate given your investment resources.

For more information

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