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Stack the odds in your favour

How to get paid for scarce capital and liquidity

Key takeaways:

- Illiquidity is likely to be one of the defining characteristic of markets for years to come, leading to more shocks than in the past and of a higher magnitude.
- This has substantial implications for investors. They have to cope with ever lower returns and a potential market meltdown if liquidity evaporates.
- Loic Guilloux from H2O Asset Management explains how to transform market constraints into investment opportunities offering true diversification and superior returns to investors.

Little by little, a world of ever scarcer capital and liquidity has been created. Financial institutions now operate differently, market structures are changing and the impact is being felt on all asset classes, including even the most liquid ones. In short, only now are several effects of the Great Financial Crisis really catching up with investors. The question is: how can they escape the illiquidity trap and stack the investment odds in their favour?

Loic Guilloux

Head of New Business Development

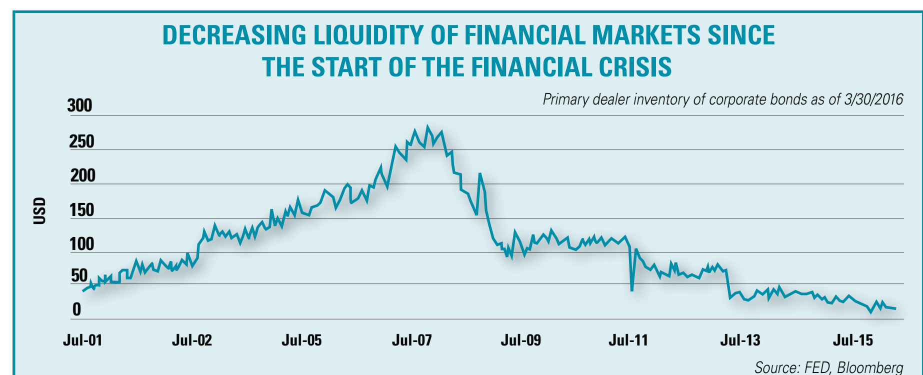
H2O Asset Management

A world of illiquidity

It wasn't so much the financial crisis that sapped capital from the financial system as the response to it. Regulators have demanded massive deleveraging of the financial sector: Leverage for investment banks, for example, has shrunk to about 25% of its pre-crisis levels. The effect on liquidity in financial markets has been more dramatic still.

As well as demands for banks to retain considerably more Tier 1 capital for their asset exposures, they have to increasingly hold capital for their operations. Examples of this include a major German bank, which was judged by BAFIN, the German financial regulator, to have insufficient capital for its operational risks during summer 2016. It penalized its core Tier 1, thereby further restricting its ability to transact in the markets and create sustainable revenue streams.

DECREASING LIQUIDITY OF FINANCIAL MARKETS SINCE THE START OF THE FINANCIAL CRISIS



Source: FED, Bloomberg

It's only going to get harder

Tough as the last few years have been, financial institutions are braced for capital to become scarcer still and for an illiquid environment which could endure deep into the future.

A new round of regulation – known in financial circles by its unofficial name "Basel IV" – will restrict the capital available to banks even further. Under "Basel IV", banks will have to issue more junior and longer term debt, which will reduce their return on equity and further cramp their ability to operate in markets. The capital they must hold for lending to companies will also rise in many cases.

In addition, VaR will disappear as the prevailing measure of market risk and be replaced by an expected shortfall measure that will be more capital demanding. This is a risk revolution and will entail a fundamental review of their global market business.

Related to the point above, banks will also have to report all trading business activities line by line and capitalise, perhaps, a hundred individual lines of business on a standalone basis. As a consequence, the previous diversification benefits of holding disparate and non-correlated assets will no longer apply and banks will be forced to exit several business lines in order to mitigate capital requirements under the new rules.

The impact of all this on risk-weighted assets, which are used to determine the amount of capital that must be held by banks is considerable. According to the European Banking Federation, the current E12tn of risk-weighted assets will rise to E18tn once the regulations have been implemented. Banks might be more resilient as a result, so regulators will demand a little less core Tier 1 capital, but this is only slight compensation.

The impact on markets

The market impact is tangible: according to the US Federal Reserve, primary dealer holding of corporate bonds has fallen by 90%. The inability of market makers to provide liquidity is a genuine concern. The world's proprietary trading desks have been disbanded, along with the expertise they could commandeer. In the case of market shocks, these traders were once able to inject liquidity into the market at short notice, calming investors' nerves and smoothing volatility. The withdrawal of this liquidity and expertise can only lead to more market shocks than in the past and of a higher magnitude, albeit with less likelihood of systemic crisis.

The impact on investors

This, of course, has substantial implications for investors. They are concerned about the low returns in a capital-constrained world and also worried about a potential market meltdown if liquidity evaporates.

The challenge is probably greatest for the many large institutions in Europe which have significant fixed income exposures. If a sizeable number of institutional investors decide to sell large allocations at the same time, they will find few or no buyers.

The issue is exacerbated by an increasingly difficult price discovery process, in which quoted prices disappear much faster than in the past. Portfolio reallocations thereby become more expensive.

Waiting for the ticking timebomb

Investors are increasingly aware of the difficulties and dangers of disappearing liquidity, and feel there are few alternatives to holding traditional asset classes.

But they don't have to wait for the ticking timebomb to go off: they have more options than they might believe. Indeed, they can use the current situation to their advantage by employing investment strategies that seek to exploit illiquidity and deliver strong, uncorrelated returns to markets.

Introducing Barry

Let's consider three Barry strategies, specifically created to address the impact of capital and liquidity constraints on investors.

Tapping value from future market shocks

The first strategy aims to exploit market shocks to produce returns. The investment team acts on the theory of mean reversion. That is: what goes down, must come up.

The strategy holds its assets largely in money market instruments until signals have been identified through volatility and selected data. "As long as that shock is not judged to be created by a paradigm shift, we sell volatility, and then buy it back once the market has corrected", says Loic Guilloux, H2O Head of New Business Development. Alternatively, the team may buy and sell the underlying asset to achieve the same goal. This necessarily means that many positions will be held for short periods.

The strategy is suitable for all investors seeking uncorrelated returns.

Tapping value from the next rises in global interest rates

The second strategy is predominantly a hedge against a brutal rise in rates. The premise is that yields on government bonds issued by governments in the Eurozone, the UK, the US and Japan will rise.

H2O believes that liquidity in the bond market is currently still sufficient because there is a balance between supply and demand: governments have to issue debt mainly to refinance maturing issues; and investors – particularly those who manage liabilities – have little choice today but to buy these bonds even at very low yields.

However, the demand side of the equation is precarious. There is a limit to how much central banks can buy and there is the issue of falling demand from institutional investors. At some point, investors in their mutual funds and life policies will balk at paying fees for tiny returns and vote with their feet. When this happens, the likelihood is of a sudden and huge correction.

"As we do not know when the next significant rise in rates will occur, we employ an options strategy to prepare for it," says Guilloux. "The options provide a small carry and the main pay day will be one-off and probably very sizeable".

This strategy is suitable for all investors wishing to hedge their fixed income portfolios, and the ones wanting to take profit from a convex rise in rates.

Tapping the extra revenues from fees paid by banks seeking to optimise their capital needs

The objective of the third strategy is to both help banks to solve their capital constraints challenges, while offering return opportunities to institutional investors. In essence, the strategy seeks to take transactions off banks' balance sheets and hence to freeup the capital that sat behind the asset.

"From the bank's perspective, it provides an alternative to having capital at a lower cost," says Guilloux. "From the strategy's viewpoint, we aim at a return of about 8% through quarterly distributions to the underlying investors." In this respect, it should be attractive to pension funds, insurers, family offices and funds of funds as a substitute for low-yielding bonds.

Taking a long-term view

Illiquidity is not a passing phase; it is likely to be one major characteristic of markets for many years. "For this reason, we aim to provide solutions that can both protect investors and enhance their returns over the long term," says Guilloux.

The over-arching philosophy is to hand back to investors the value they lost through the transformation of market structures. Barry strategies represent one of the few ways to transform the constraints of the new market environment into strong investment opportunities offering real diversification and superior returns.

Written on December 7, 2016

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