LIQUID SECURITIES - may be bought/sold quickly

transaction should have little impact on price

BOND MARKET LIQUIDITY

EQUITY MARKET LIQUIDITY

Reasons:

Also, fixed-income markets are predominantly

Issues:
- Search costs
- Need to obtain quotes from multiple dealers
- Less transparency than in equity markets

These issues are typically LESS SEVERE in case of:

Time after issuance

issuance

On-the-run issues

MOST LIQUID

Previously issued bond now becomes

If bond is ILLIQUID → investors require

↓

compensation for costs which may be encountered if investor tries to sell the bond before its maturity

Additional yield

Typically:

GOVERNMENT BOND LIQUIDITY

- large issue sizes
- used as benchmark bonds
- used as COLLATERAL in REPO agreements

Non-government bond liquidity

- smaller issue sizes → below threshold of major bond indexes
- if issuer is low quality → dealer hesitant to hold inventory
- infrequent issuers → less well-known in the market

Effects of LIQUIDITY on BOND PORTFOLIO MGMT

PRICING: recent bond transactions

But regulatory efforts to ↗ transparency in corporate bond markets

INFREQUENT TRADING ⇒ TRANSACTION PRICES ≠ CURRENT VALUE

↑

underlying factors change frequently

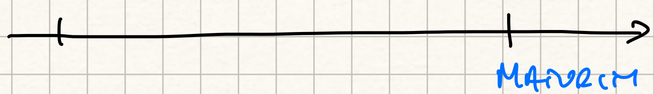
Possible solutions: MATRIX PRICING (using observable yields from LIQUID Benchmark bond with similar maturity & duration)

+ BENCHMARK SPREADS (from bonds with comparable parameters and credit quality)

PORTFOLIO CONSTRUCTION ← influenced by investor's LIQUIDITY PREFERENCES

ILLIQUID BONDS

SOME investors impose **MATURITY RANGE** restrictions → avoiding L-T bonds



BOND dealers – service clients who want to BUY & Sell

BID-ASK QUOTES from dealers – SOME ILLIQUID bonds may not be quoted by any dealer!

BID-ASK SPREAD will be
for ILLIQUID BONDS

BID-ASK SPREAD also depends on

- Government bonds / vanilla corporate bonds from LARGE ISSUERS

versus · Corporate bonds with embedded options from SMALL ISSUERS
ABS's

IMPACT on PORTFOLIO MGMT: ILLIQUIDITY

↓

⟷ BID-ASK-SPREAD

↓

↗ TRADING COSTS

ALTERNATIVES to DIRECT BOND INVESTING
(to overcome illiquidity costs / constraints)

• ETFs and Mutual funds

Mutual Funds - Direct bond trading often involves MINIMUM LOT SIZES = $1 million
⇓
impossible for smaller investors to follow replication strategies & fully DIVERSIFY

- Mutual funds ← investors buy and redeem units at NAV (no need to directly grapple with bond illiquidity)

Fund costs: UPFRONT LOAD + mgmt Fee may be justified given ↑

- Mutual bond funds have NO MATURITY DATE
→ fund manager must continuously replace maturing bonds

ETFs: like Mutual Funds but tradeable

• Exchange-Traded derivatives: bond futures, options → exposure to underlying bonds
+ interest-rate contracts

- OTC derivatives
  - IRSs — often liquid (multiple dealers, competitive pricing)
  - TOTAL RETURN SWAPS ⇒ combines

    UNDERLYING: equity, commodity or BOND index

$$\begin{tikzcd} \boxed{\text{Total Return Receiver}} \arrow[r, shift right] & \boxed{\text{Total Return Payer}} \arrow[l, shift right] \end{tikzcd}$$

OTC contract based on ISDA master agreement

Benefit: Total Return Payer = DEALER ⇐ has more favourable access to Bond Index constituents

Total Return Receiver = Investor gains access to subset of fixed-income market which is ILLIQUID, administratively complex to maintain a portfolio

Important considerations: Investor gains EXPOSURE

⇒ increased regulatory oversight, capital requirements for dealers