MAY 2015

Agincourt
CAPITAL MANAGEMENT, LLC

INVESTMENT UPDATE

One can hardly pick up a finance-oriented periodical these days without reading about the impending doom that faces investors due to the lack of liquidity in the capital markets. Everything we read on this topic, from *The Wall Street Journal* to brokerage firms' research reports warn us that liquidity is terrible right now, and that sometime soon it will be virtually impossible to execute a trade. It's gotten so bad that we expect our UPS delivery guy to ask, "What's all this I hear about liquidity?" next time he pops in the office. Word gets around, you know.

But the strange thing is, from our vantage point, we haven't noticed any real change in liquidity over the past few months. In fact, in some very important ways, it's easier than ever to get trades done today, compared to many periods in the past—and that's not just counting periods of serious market dislocation. But we're getting ahead of ourselves; let's take a step back and make sure we have our terms and concepts straight before this discussion goes any deeper.

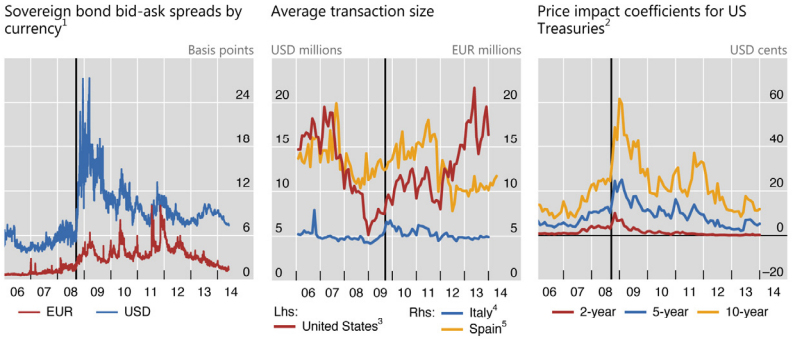
Typically, when we talk about liquidity in the securities markets, we're describing the ease in which one can trade a security—obtaining a good price to either buy or sell an investment instrument in a timely manner. Especially during periods of stress, executing trades quickly and easily can be a problem, as broker-dealers who typically make active markets in stocks/bonds/etc. back off from doing so and refuse to trade, or do so only with a large concession to where the price of that security "should" be.

Talking about liquidity in general terms is easy: executing trades quickly and at low cost. Beyond the simple definition, the definition becomes murkier. What do we call it when (as often happens) liquidity is good for one asset class but extremely poor for another—for example, during periodic "flight to quality" episodes, when junk bond liquidity dries up while Treasury bonds remain highly liquid. Likewise, there are times when it's easy to trade small lots, but executing trades in institutional-sized blocks is far more difficult. And who's to say what "normal" liquidity is in the first place—there are no standards for liquidity in the capital markets.

In order to keep the discussion on-topic and somewhat concise (too late!), we will focus just on the US bond market; after all, that's where our attention is, and why our clients hire us. And while it's not that much easier to find statistics that can give us an objective idea of liquidity, we have fewer blind alleys to wander through if we stay away from stocks, real estate, emerging markets, and so on. For guidance, we will piggy back on a March 2015 Quarterly Review by the Bank for International Settlements ("Shifting Tides—Market Liquidity and Market-Making in Fixed Income Instruments"). This excellent report by the BIS provides an objective look at the current state of liquidity in the bond markets, using measurable data as a proxy.

The charts on this page, lifted from the BIS report (because sourcing this data is all but impossible), shows three different measures of market liquidity. In the first chart, the BIS graphs the historical "bid-ask" spread (the difference between what price a brokerage will demand/ask for a specific bond, and the price they will pay/bid for the same bond, at the same time) for both Euro- and US dollar-denominated sovereign bonds. The bid-ask spread data is very difficult to extract, but is a direct measure of the cost of transacting a trade, and is arguably the single best measure of market liquidity. As you can see, for US dollar sovereigns, the bid-ask spread quadrupled, from approximately six basis points (0.06%) to more than 24 basis points (0.24%) during the financial crisis, but has since settled back to just above its pre-crisis level. Likewise, the Euro-denominated bonds are back to their pre-crisis levels as well. The second chart isn't nearly as meaningful, as it shows the average size of trades over time in US, Italian and Spanish government bonds; this chart shows that the average trade size for US 10-year bonds shrank in the months leading up to the financial crisis, and that this measure has rebounded to its pre-crisis level. The inference is that transaction size shrank due to dealers not wanting to take on inventory, but a $20 million trade in 10-year Treasuries is not overly large, by any stretch, nor was it during the crisis, so we don't get the relevance of this one. And finally, the last chart shows historical price impact coefficients—the estimated price

Post-crisis recovery in sovereign bond market liquidity — Graph 1



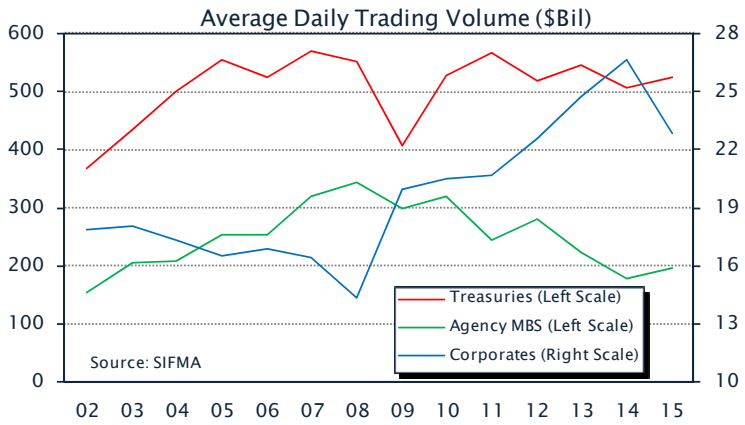
The black vertical lines correspond to 15 September 2008 (the date of the Lehman Brothers bankruptcy).

[1] Based on Markit iBoxx indices; includes domestic and foreign sovereign bonds denominated in US dollars and euros, respectively. [2] Estimated price change per $1 billion net order flow; monthly averages. [3] Average transaction size for 10-year US Treasury note. [4] Average transaction size on MTS Cash, an inter-dealer market and the most important wholesale secondary market for Italian government bonds. [5] Average transaction size for Spanish public debt.

Sources: CGFS Study Group member contributions based on national data; Markit iBoxx; BIS calculations.

change for a $1 billion trade—for Treasuries of varying maturities. Here again, there was a clear increase in this data series during the financial crisis, but these coefficients have returned to their pre-crisis levels, too.

As long-term investors of high quality bonds, we aren't as concerned with a lack of liquidity in the Treasury market as we are about what happens to high grade corporate bonds during periods of market volatility and stress. After all, even in the darkest periods of illiquidity in our market, we can get a reasonably good bid or offer on a Treasury security. But when the economy and overall corporate credit quality both weaken dramatically (and simultaneously), selling pressure for corporate bonds can escalate very quickly. We've seen in the past (including the 2008-2009 period) that investors want to shed their lowest quality or most problematic bonds during these periods, and we fully expect to see a similar flight to quality next time around. And this is where the real concern for future bouts of illiquidity lies. The next chart puts into perspective the relative size of the US government and credit markets, by average daily trading volume. Notice that the volume of trades for Treasury and agency-issued MBS is 10 to 20 times the size of the corporate sector; it's not news that corporate bonds have never enjoyed the degree of liquidity that government-backed bonds have. And yet, the volume of trades for most US bond sectors has remained healthy since the financial crisis (MBS trading volumes have been suppressed by the fact that the Fed, through QE, has bought out a large percentage of the outstanding "float" of MBS). Trading volume in the corporate market, like that of Treasuries, indicates no signs of illiquidity.



The main concern, and it's primarily coming from Wall Street sources, is not that we may have a typical flight to quality in the next cycle, as investors rotate from one asset class to another, causing short-term bouts of illiquidity as specific markets get crowded; rather, it's that Wall Street itself, because of new regulations placed on brokerage firms, will somehow not be able to provide their traditional role of market maker, and that investors will suffer as a result. There is evidence that brokerage firms are not maintaining the same inventory levels of fixed income securities that they have in the past. To hear these firms, you'd think that they had been benevolent guardians of liquidity in the past, and that new tougher regulations are forcing them to exit the business. Call it healthy skepticism, but we're not buying it.

First of all, brokers are in the business to make money; if there is money to be made in trading bonds, they'll do it, and if that requires a high level of inventory, they will add to their inventory. In addition, "inventory" also includes bonds placed into their proprietary trading positions, put on the books to be flipped for profit, which has never had anything to do with increasing liquidity for customers. If inventories were high in the past—and keep in mind that Wall Street firms had been shrinking their inventories used for client trading for years prior to the crisis—it wasn't necessarily to provide market liquidity, it was to make money for the firm. Dodd-Frank regulations have forced brokers to be better capitalized, get out of the higher-risk proprietary trading business and to take "haircuts" on higher-risk inventories in order to prevent another financial crisis. So, yes, inventories have shrunk, but these firms never much used their inventories to benefit clients like us in the first place.

What's missing from the brokerage firms' warnings is the fact that over the past decade, electronic trading of bonds has grown exponentially, and for firms like ours, is now the main way we get trades done on a day-to-day basis. Electronic trading doesn't necessarily remove the major brokerage firms from the equation (nearly all participate in these exchanges, as do many additional regional brokerage firms) but it has changed the business model dramatically. And it has, in some ways, eliminated the need for inventories by allowing firms like Agincourt, for a small per-transaction fee, to bypass Wall Street and trade directly with other investment managers who may be looking for bonds we're selling or vice versa. The real-time (and historical) price discovery of real trades and increased number of "eyeballs" on each of these trades has done more to increase liquidity over the past decade for corporate and mortgage-backed securities than any loss that has occurred from shrinking Wall Street inventories.

Of course, the best way to not be dependent on Wall Street for liquidity is to buy high-quality, highly-liquid bonds in the first place. And this is Agincourt's advantage: We build liquidity into our clients' portfolios well before they need it. And when our clients do need to raise funds, even during periods of stress, the fact that they have a separate portfolio means that they don't have to wait in line, pay fees, or experience other impediments to redeem their shares like those invested in funds do. Some of our clients were surprised to find that during the financial crisis, we were a better source of liquidity for their cash needs than their generic bond index funds.

We have no doubt that our market will eventually experience another bout of illiquidity; investors and the markets they trade in always move to extremes, crowding the exits when fear becomes the order of the day. We don't welcome those periods, but we are well-prepared for them.