CINCINNATI ASSET MANAGEMENT

BIGGER ISN'T ALWAYS BETTER IN BONDS

Key Points

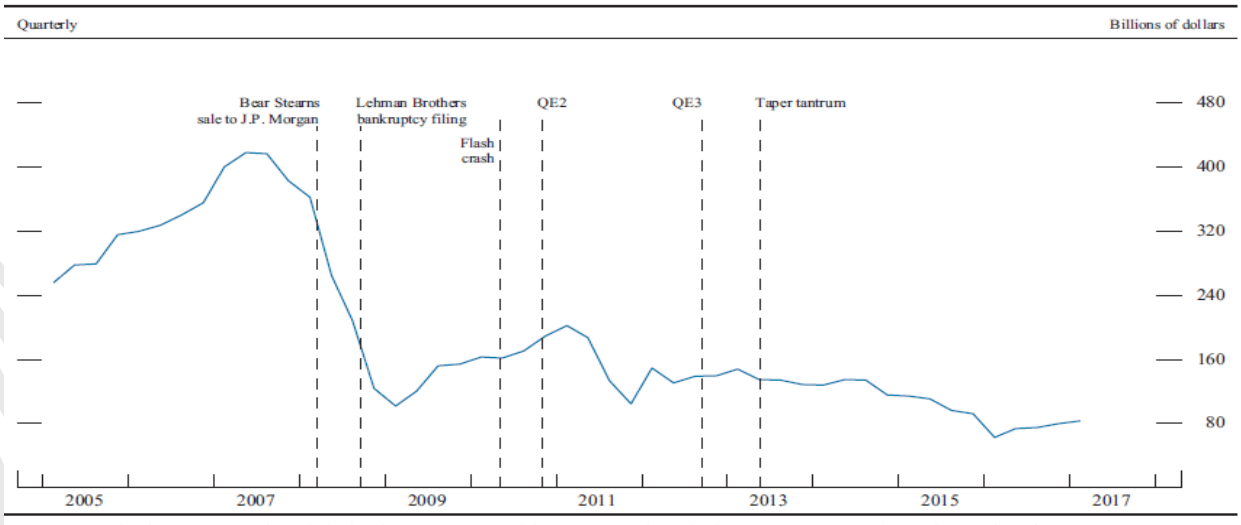
- *Reforms that have made global markets safer challenge large corporate bond managers.*
- *Large bond transactions are more difficult and costly to trade since 2009 with one model showing a turnover rate of 32 days compared to 6 days for a comparative benchmark.*
- *A large bond manager's clients can miss its best investment ideas when they are rationed.*

It may no longer be true that "bigger is better" when picking a corporate bond manager. After the financial crisis, reforms to cut global risks have changed some basic features of the corporate bond market. Bond market volumes are healthy and exceed levels of 2007, but the average bond transaction is 40% smaller today. Bond managers that rely on large transactions strain to adapt to today's market. Large transactions are more costly and hard to trade according to the Federal Reserve, and small managers have always struggled with thin resources and limited market contacts. Our research indicates the best opportunity to minimize transaction costs, maximize portfolio liquidity, and deliver risk-adjusted value across economic cycles can be to select a professional manger from within a "sweet spot" range of assets under management (AUM). [1]

Bond investors can benefit from knowing how bond markets have evolved after 2009, many institutional investors already do. Greenwich Associates, a consulting firm, reported in 2016, that more than 80% of 400 large credit investors said their investment strategies were limited by the bond market changes.[2]

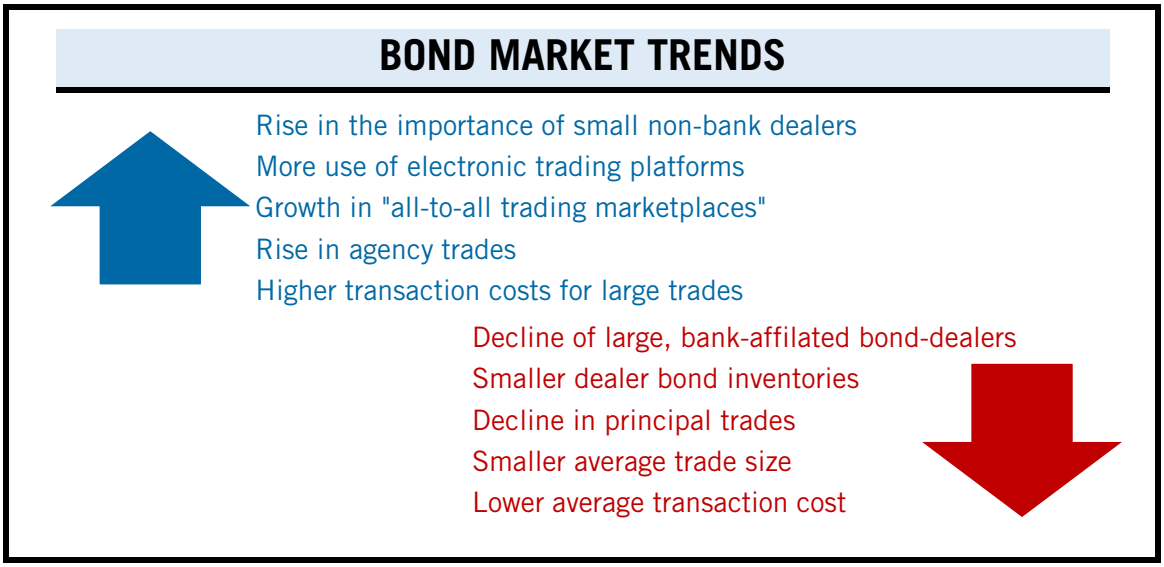
Most investors understand that stocks trade on exchanges, but some may not be aware that bonds trade over the counter. Bond dealers have a meaningful impact on trade costs as they go about matching buyers and sellers, and smoothing order imbalances from their own inventories of bonds. After 2009, the role of smaller non-bank dealers grew and bond inventories shrank after the Volcker Rule and Basel III reforms. That transition brought an increase in agency trades, where dealers match buyers and sellers, at the expense of principal trades, where dealers use their own bond inventories to satisfy customer orders. Bond inventories fell to 2% of trade volume (2016) from 14% (2007).[3]

Dealer inventories of bonds



SOURCE: Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States," L.130 Security Brokers and Dealers, June 8, 2017.

At the same time, electronic bond trading and "all-to-all trading marketplaces" which link bond dealers, investment managers, and professional investors grew. In combination, these factors brought more trades, but smaller trades. Now, volumes by every measure surpass pre-crisis levels.



A Federal Reserve report in 2017 noted the success of post-crisis reforms at reducing global risks but conceded the new regulations made corporate bond trading "more costly at times."[4] The Fed identified higher costs for large bond transactions. Overall, bond market liquidity is robust according to the research of Deutsche Bank and J.P. Morgan ("more market activity in a wider number of issues").[5] But this trend to more and smaller transactions challenges large managers.

- **More Costly Trading and Less Liquidity.** Asset managers of all sizes sometimes combine like securities from separate clients for efficient trading. The aggregated trades of large asset managers can reach tens of millions of dollars and often far more. These out-sized transactions are more costly. Writing in the *Wall Street Journal's* "Streetwise" column, James Mackintosh contrasted the "crucial differences" between current and pre-crisis bond markets: "[I]t's now harder to trade bonds, making big positions less attractive."[6] Clients can pay higher costs when their manager relies on large-sized transactions.
  - **Opportunity costs.** Tiny-sized trades are costly, too, so investment managers set a minimum trade size that reflects the level of assets under management and other factors. Large managers necessarily set higher minimums but these eliminate investment choices. A "sweet spot" manager can snap up value bonds that a large manager ignores because of their size. The large manager's clients are unaware of the missed opportunities. The table below compares purchases for two CenturyLink bonds. Larger sized par amounts were not offered, but a bond trader estimated that a purchase for $10 million to $15 million of this CenturyLink bond could be executed by working an order over several weeks at a tighter (smaller) spread than indicated in the table.

Bond transactions*	Par $	Spread	Yield %
CenturyLink, 6.75%, due 12/1/2021	85,000	185	5.04
CenturyLink, 6.75%, due 12/1/2021	2,265,000	178	4.96
*Details above represent actual CAM purchases based on TRACE data on November 9, 2018. For illustrative purposes only.			

  - **Trading volume.** Newly issued bonds trade actively, but trading volumes drop sharply after issuance. Bond turnover falls to 10% eight months after issuance from 53% in the first month.[7] As turnover shrinks, large managers struggle to accumulate bonds. In contrast, "sweet spot" managers more easily fill their investment needs even with reduced daily trade volumes.
  - **Average transaction.** The average trade size for corporate bonds declined since the financial crisis. Academic research reported an average bond trade of $1,212,800 for April 2014–October 2016 after analysis of 65.6 million trades for 22,449 CUSIPs. The pre-crisis average trade was $2,004,300.[8] Diseconomies of scale challenge large managers with higher transaction costs and fewer investment opportunities. These forces are apparent in the time needed for large managers to buy or sell their bond holdings. Research indicates that large holders of the 50 largest corporate bonds need 32 days to build/exit their positions compared to a "sweet spot" manager's 6 days for its composite portfolio.[9]

- **Added Risk.** With the market changes since 2009, a large asset manager might regularly struggle to invest its clients' funds.
  - **Credit standards.** A tweak to ease its credit model could add scores of bonds as investment candidates and ease a large manager's task of investing client assets. Clients would never know. "Sweet spot" asset managers with abundant investment opportunities are not tempted in the same way.
  - **Idea rationing.** Large managers add risk to clients' portfolios when they need to select the second, third, and, maybe, even fourth "best" investment ideas because the bonds of their number one choice are in short supply and rationed. "Sweet spot" managers do not have that same need. A "sweet spot" manager can focus on its best 20-25 ideas and normally satisfy client investment needs even at today's lower transaction levels. Large managers may need more than five times that number of investment positions for clients. Their "best" ideas are watered down.

- **Narrow focus.** Many large asset managers organize along functional lines separating tasks of analysts, portfolio managers, and traders. "Sweet spot" asset management firms often staff using generalists with overlapping – but clearly defined – responsibilities. The *Harvard Business Review* reported on studies that favored this generalist structure in mature fields like asset management. *HBR* noted creativity gains came from combining different skills.[10]

Financial market reforms since 2008-2009 brought market changes that test large asset managers. Their routine transactions strain the market's new transaction limits and can diminish portfolio liquidity. Costs for large transactions are elevated. Clients pay. In contrast, clients of professional managers from a "sweet spot" range of AUM benefit from the elevated trade volumes. Trading is more efficient for these managers with transactions costs generally lower on average sized transactions. The market's greater volumes enhance their portfolios' liquidity.

So consider that it may not be true anymore that "bigger is better," and you could benefit by finding that "sweet spot" to make a noticeable difference.

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[1] CAM used public and proprietary data and good faith estimates in estimating a range of asset levels for maximizing efficiency and portfolio liquidity while minimizing trading costs in a composite portfolio of client accounts. The data included average account size, portfolio turnover, transaction, and miscellaneous costs, across a range of market conditions. For the purpose of this paper, the "sweet spot" for AUM is estimated between $1 billion and $10 billion.

[2] Bessembinder, H., Jacobsen, S., Maxwell, W., & Venkataraman, K. (2016). "Capital Commitment and Illiquidity in Corporate Bonds," Unpublished paper, p. 2. https://cpb-us-w2.wpmucdn.com/people.smu.edu/dist/6/414/files/2017/09/BJMV.JF2017.pdf Retrieved November 2, 2018.

[3] Melentyev, O. "U.S. Credit Strategy Liquidity Vacuum and Its Costs," Deutsche Bank Markets Research, (May 6, 2016).

[4] Monetary Policy Report. Board of Governors of the Federal Reserve System. July 7, 2017, p. 28. https://www.federalreserve.gov/monetarypolicy/files/20170707_mprfullreport.pdf Retrieved November 2, 2018.

[5] Glezer, P. "U.S. Corporate Bond Liquidity: 1H17 Update," J.P. Morgan, (July 27, 2017), p. 5.

[6] Mackintosh, J. "If GE Debt Gets Junked, Markets Have Reason to Shudder," *Wall Street Journal*, (November 20, 2018) https://www.wsj.com/articles/if-ge-debt-gets-junked-markets-have-reason-to-shudder-if-ge-debt-gets-junked-markets-have-reason-to-shudder-1542713581 Retrieved November 23, 2018.

[7] Beinstein, E. "U.S. corporate bond market liquidity: a review of the data," J.P. Morgan, (August 6, 2013).

[8] Bessembinder. p. 53.

[9] CAM identified large holders (November 2018) of the 50 largest high yield bond issues and calculated average daily trading volumes (January-November, 2018) for those bonds. The turnover of 32 days was calculated using that holder and trading data. The comparable data for a "sweet spot" manager's composite bond portfolio produced a turnover rate of 6 days.

[10] Teodoridis, F., Bikard, M., & Vakili, K. "When Generalists Are Better Than Specialists, and Vice Versa," *Harvard Business Review,* (July 13, 2018) https://hbr.org/2018/07/when-generalists-are-better-than-specialists-and-vice-versa November 20, 2018.