



BOND CONCEPTS

Liquidity

Picture this: you're in a bustling room filled with people, and there's only one exit. Now, imagine if all these people suddenly needed to leave at once – those near the exit would manage fine, but it would be a chaotic struggle for everyone else. Now, shift your focus to the world of bond investors. Think of bond liquidity as the number of available exits in the room. When a security is highly liquid, investors can smoothly come and go without a hitch. However, when liquidity tightens, it's like a crowd of investors attempting to squeeze through a single door. In this article, we explore liquidity in the bond market and its intriguing effects.

What is Liquidity Risk?

Liquidity risk within capital markets refers to the ease at which an investor can exit a position, converting an asset to cash. It is an often-overlooked aspect of fixed income investing that many investors experience differently than they may for stocks. Liquidity risk factors appear at both the individual security and portfolio levels – and the dynamics will differ based on the type and size of a portfolio.

Factors Affecting Bond Liquidity

To better understand liquidity and the associated risks, it is important to know how the bond market works. Unlike equities, which trade on centralized public exchanges, bonds trade in an over-the-counter market, mostly inaccessible to the general public. In these markets, buyers and sellers of bonds come together to set the price of a given issue. Buyers enter a “bid” for what they are willing to pay for the asset, and sellers set the “ask” for what they expect to receive for the asset. The aggregate of all these deals makes up the spread over a given period. These complex mechanics are important for the market but make bonds a less liquid asset class than equities.

Highly-liquid investments can be bought and sold with ease and without a significant change in price. Liquidity tends to decline when there is an imbalance in the number of buyers and sellers or because of price volatility. Liquidity risk is especially magnified during times of market stress. For giant bond funds, it can be incredibly difficult to exit a position when there may not be a market for such a large amount of bonds. Due to their massive scale, even seemingly minor adjustments in the giant portfolio's risk budget can potentially move the markets and cause significant price volatility.

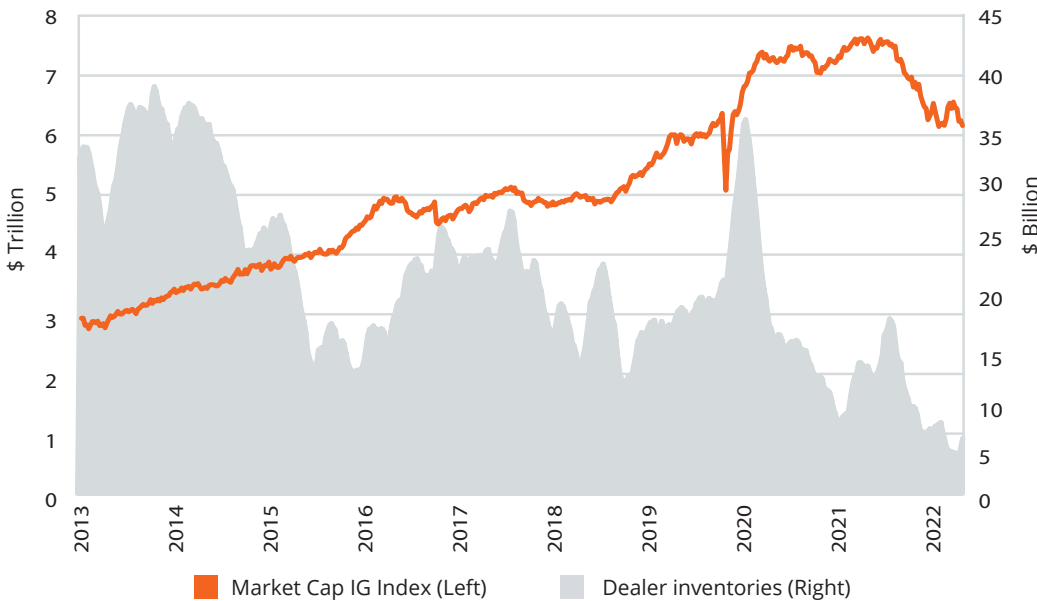
Regulatory Changes

Following the 2008-2009 financial crisis, increased regulation reduced Wall Street's influence over certain areas of the bond market, and large banks and broker/dealers no longer held vast inventories of debt, leaving the mega fund managers and ETFs without a large-scale trading partner to buy or sell securities.



As depicted in the graphic below, two distinct trends occurred simultaneously: the investment grade bond market grew rapidly as corporations took advantage of low rates, and dealer inventories shrunk significantly.

Bond Market Size vs. Dealer Inventory

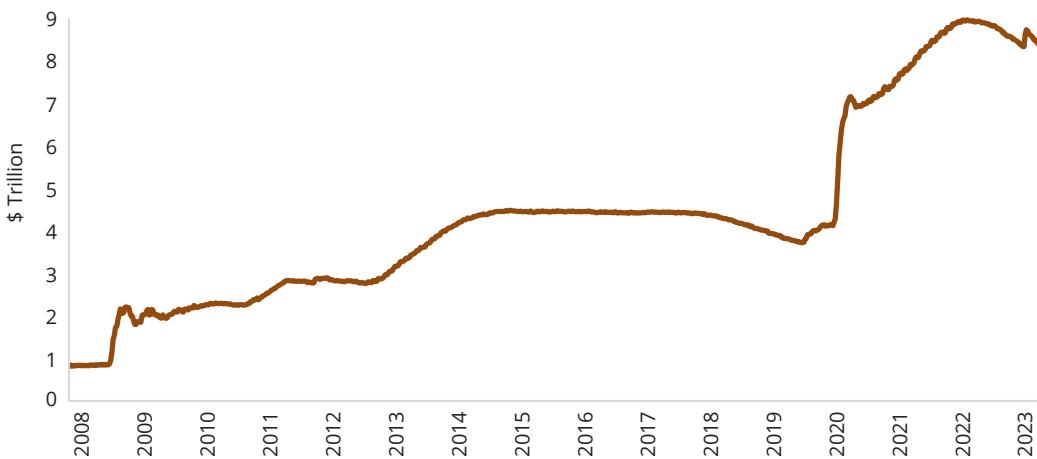


Since 2013:
Bond market size:
grew 59%
Dealer inventories:
shrank 60%

Quantitative Easing and Bond Market Liquidity

When interest rates are low, and the Federal Reserve is reluctant to cut rates further, it may use another tool in its arsenal, quantitative easing. Through this policy, the Fed aims to stimulate the economy by adding liquidity to the market through the purchase of bonds in the secondary market. During the beginning of the COVID-19 pandemic in 2020, the Fed initiated a massive quantitative easing campaign, purchasing historically large amounts of treasury bonds and mortgage-backed securities.

Total Assets of the Federal Reserve



As of 8/9/2023. Source: US Federal Reserve.

As shown above, assets on the Fed's balance sheet grew quickly. When the Fed eventually returns to normalized monetary policy, it will need to unload these assets, putting trillions of dollars worth of bonds back on the market and likely offsetting the balance of buyers and sellers.



Measuring Liquidity

The bid-ask spread is one of the easiest ways to gauge the liquidity of a bond in the trading market. The more liquid a security is, the tighter the bid-ask spread. As liquidity falls, the dealer takes on the additional risk of holding securities in their inventory. As a result, they will demand higher compensation, and the bid-ask spread will widen. Investors can examine the spreads of individual issues to assess liquidity or to compare with other sectors across the bond market.

The Hidden Cost of Liquidity

Liquidity often takes a back seat to other, more familiar, fixed income risks. When the economy is healthy and the bond markets are running smoothly, liquidity is relatively easy to find, and transactions are executed seamlessly. However, during times of market stress, liquidity can quickly evaporate, leaving investors who need to sell without a trading partner.

Much like the people standing near the door, highly liquid securities grant investors seamless entry and exit. As we explore the complexities of bond liquidity, it becomes clear that this often overlooked aspect can wield substantial influence, especially as the room becomes crowded. The bond market's inner workings, the interplay of buyers and sellers, and the impact of regulation and quantitative easing all underscore the importance of understanding and managing liquidity risk.

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In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

