JUNE 2015

In this update to our February 2014 Insights report, we explore how structural changes—such as Dodd-Frank regulations and declining bond inventories—have changed the U.S. corporate bond market and raised concerns about liquidity.

U.S. Bond Market: Liquidity Squeeze, Shrinking Bond Inventories and the Brandes Advantage

Brandes spotted the liquidity issue early, long before it made headlines.

When Small and Nimble Can Be Beneficial

As clouds of uncertainty over an expected rise in interest rates continue to cast a shadow on the U.S. bond market, another storm is brewing: one involving diminishing trading liquidity spurred by regulatory changes and the eventual withdrawal of the Federal Reserve's ultra-easy monetary policy.

Brandes spotted the liquidity issue early, long before it made headlines. Even though we cannot predict the future, we believe our constant vigilance can help us benefit as potential mispricing across bond market sectors takes place.

Highlights of this handout:

1. **Declining bond inventories have created liquidity concerns**
2. **Lower corporate bond inventories can benefit bottom-up bond pickers**
3. **Brandes is well positioned to take advantage of potential security mispricing created by market disruptions**

Declining Inventories Have Created Liquidity Concerns

So how did the potential liquidity problem come about?

Larger blocks of bonds have simply become more difficult to trade. The dealer role has largely transitioned from being able to bid or offer bonds on the wire to acting as a middleman matching buyers and sellers. The larger the block of bonds to trade, the more time it takes to trade and, in many cases, the more it costs to trade. As a result of more stringent capital requirements which are unlikely to be relaxed, dealers today are unable to hold as many bonds on their balance sheet (i.e., bond inventory). Financial regulatory changes over the last few years, most significantly the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), have forced bond dealers to scale back their capital commitments—with significant implications for fixed-income managers.[1]

[1] Signed into law in July of 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was designed to reduce the potential for future financial crises in the wake of events in 2008 and 2009 in part by strengthening capital requirements for banks that also served as corporate bond dealers.

Years ago, larger managers' business tended to be transactionally driven and built on wringing out incremental returns above the index through yield curve positioning, top-down relative value analysis or macroeconomic forecasting. This strategy generally involves a heavy investment in trading and trading infrastructure. In our view, success was largely contingent on strong alliance-based dealer networks that provided pricing advantages over smaller firms.

But with dealers committing less capital to trading, the potential for rising interest rates, and the eventual withdrawal of the Fed's historically unprecedented easy money policy—questions regarding liquidity, volatility and the overall resiliency of the bond market have been pushed to the forefront.

A number of factors have conspired to raise concerns over market liquidity:

1. **To meet Dodd-Frank requirements, banks have had to increase their capital *and* curtail risk-taking activities.** This may insulate the banks from risk, but the inadvertent result has been to shift the risk to institutional and retail investors.
2. **Trading has become highly concentrated in a few liquid issues.** Western Asset Management reports that just 44 of 756 issuers of the more than 6,000 bonds in the Barclays US Credit Bond Index account for 50% of all investment-grade trading volume.[2]
3. **Signs that market-making has become more limited.** According to the Office of Financial Research (OFR), inventories have grown more concentrated in high-quality liquid assets and dealer willingness to buffer periods of intense selling pressure has been more limited.[3]
4. **While newly printed bonds trade actively in the first month following their issuance, subsequent trading declines both sharply and rapidly.** According to BlackRock, within four weeks of issuance, trading volume declines 50% and continues falling from there.[4]
5. **Market anxiety about a potential liquidity crisis.** We believe that since the 2008 financial crisis, investors have not been subject to a true test of the market's resilience to provide liquidity.

We believe that since the 2008 financial crisis, investors have not been subject to a true test of the market's resilience to provide liquidity.

Lower Corporate Bond Inventories Can Benefit Bottom-Up Bond Pickers

In November 2013, we first brought attention to the changing dynamics in the fixed-income market landscape. Our conclusion was that while the fixed-income market has historically been dominated by large asset managers, important structural changes have helped level the playing field for managers with smaller fixed-income assets under management.

This is good news for Brandes.

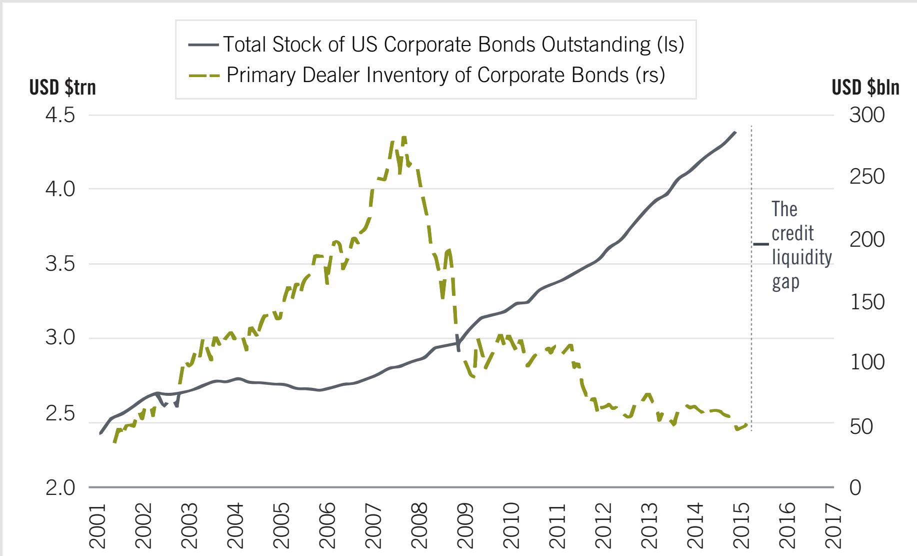
"With lower inventory levels (as shown in Exhibits 1 and 2), there is greater potential price volatility for corporate bonds ahead—and that could create opportunities to purchase securities at yields that are in excess of the underlying credit risk," comments Timothy Doyle, CFA, Fixed Income Portfolio Manager, Brandes Investment Partners.

[2] http://www.pionline.com/article/20150323/PRINT/303239986/loss-of-market-makers-may-lead-to-buy-and-hold-strategies

[3] 2014 OFR Annual Report, "Analyzing Threats to Financial Stability," (p.31 – Bank Loan Funds & Liquidity Mismatches) http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2014.pdf

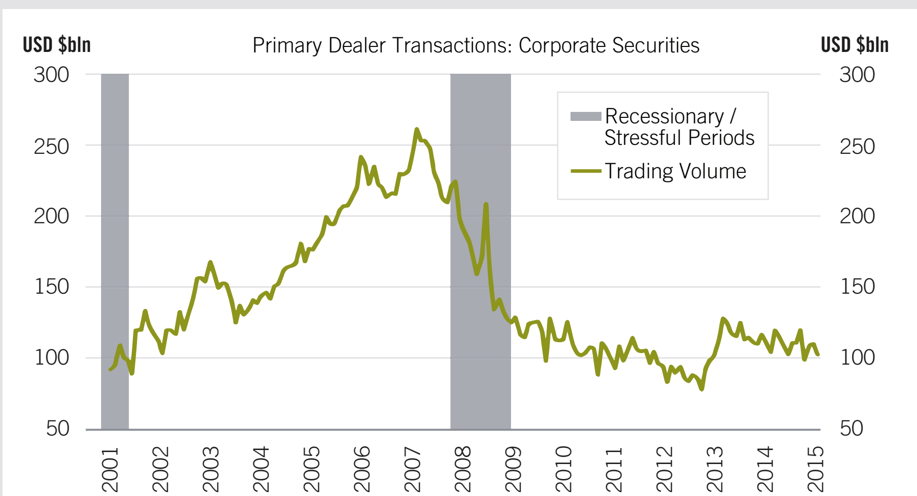
[4] http://www.institutionalinvestor.com/article/3423957/asset-management-fixed-income/the-bond-conundrum-a-plethora-of-issues-but-little-liquidity.html#.VXnJDvn48dU

Exhibit 1: Primary Dealer Inventories of Corporate Bonds Have Dropped as Bond Market Volume Has Risen, January 2001 – April 2015



Source: FRB, Haver Analytics, DB Global Markets Research, April 2015

Exhibit 2: But Primary Dealer Corporate Bond Trading Volumes Have Receded



Source: FRBNY, Haver Analytics, DB Global Markets Research, April 2015

When bond prices dip and yields spike in the short term, it can create buying opportunities for long-term managers focused on fundamentals.

Tim notes that greater price volatility as a result of the supply-demand imbalance can be an advantage.

1. **Greater Price Volatility = Potentially More Mispricing**
   In the equity market, falling stock prices can be a good thing for value managers as they often create an environment where solid businesses become undervalued due to factors that are often unrelated to company-specific fundamentals. This holds true in the bond market as well. When bond prices dip and yields spike in the short term, it can create buying opportunities for long-term managers focused on fundamentals. "In bigger market distortions, we expect to find bigger pricing inefficiencies," Tim adds.

2. **Level Playing Field for Trading Securities**
   There's been a dramatic reduction in the information advantage for large managers due to the introduction of the Trade Reporting and Compliance Engine (TRACE) reporting system. The TRACE reporting system requires dealers to report every trade in every public corporate bond within 15 minutes of execution. Dealers are required to report the size of the trade, the price, and whether they were a buyer or seller. This regulatory change has largely lifted the *veil of secrecy* off trading in the corporate bond market. Prior to execution, any investor can see in real time how often a bond has traded, what size has been trading, and importantly what price it has traded at. The market information previously reserved for the best accounts is now available to all.

Our view is pretty straightforward: You cannot take something that is relatively illiquid, repackage it, and then call it liquid.

ETFs to the Rescue?

One response to investors' desire for better liquidity in their bond investments has been a shift to fixed-income exchange traded funds (ETFs). It has become increasingly challenging to purchase corporate bonds outright, and some ETFs provide a liquid, tradable security to get exposure.

According to Bloomberg, ETFs have attracted $35.7 billion this year from investors worldwide. Last year the category attracted $84.9 billion.[5]

The catch, however, is that ETFs largely own the underlying "less liquid" securities that investors seemingly cannot trade. If there is a rush of withdrawals, ETFs will be compelled to sell the underlying securities and the *supposed* liquidity advantage is unlikely to be there.

"Our view is pretty straightforward: You cannot take something that is relatively illiquid, repackage it, and then call it liquid," says Tim.

Brandes Is Well Positioned to Take Advantage of Potential Mispricing

Generally speaking for the past 30 years, an investor could employ a *set it and forget it* approach to fixed-income investing. The interest-rate tailwinds were strongly at investors' backs and bond market liquidity was strong. "The natural inclination was to allocate to a large, established manager and focus attention on the more volatile and value-additive equity side of the portfolio," Tim notes.

"Years ago, in times of stress, the dealers would step in and use their balance sheets as the market's 'shock absorbers.' Dealers helped insulate bond prices from wide swings. But with their decreased balance sheet capacity and their more limited role now, it's no longer the case."

At Brandes, we look at the current market structure as one filled with potential to add meaningful value through thoughtful research and careful credit issue selection. The structural changes to the market have the potential to create opportunities over the longer term for smaller more nimble managers that are focused on underlying credit fundamentals.

Making the right investment decision is hard, and it can be even harder when that right decision is to "do nothing." In the last few quarters, the level of *dry powder* (i.e., highly liquid securities that are considered cash like, such as U.S. Treasury securities) in Brandes' fixed-income strategies has been relatively high. This *dry powder* is ready to be redeployed when we have a clear sight of opportunities among higher-yielding bond sectors.

[5] The Washington Post and Bloomberg, "Bond-Liquidity Desperation Sends Record Cash Into ETFs Worldwide" 4-15-15 – http://washpost.bloomberg.com/Story?docId=1376-NMDPDR6VDKHT01-37N0E2EMIKDQ3MEAR2C2RBGL90

Conclusion

We believe the prevailing supply-demand imbalance in the bond market may lead to a liquidity shortage, which in turn can create increased volatility and a meaningful disruption in financial markets.

We have spotted this problem early—and as a result, we are positioned defensively: We are ready to redeploy our dry powder to invest in what we believe are mispriced bonds that have the potential to appreciate in price and add value to client portfolios over the long term.

At times like these, being small and nimble can be beneficial.

Barclays U.S. Credit Bond Index: The Barclays U.S. Credit Bond Index is an unmanaged index consisting of U.S. dollar-denominated, publicly issued, fixed-rate corporate securities. The index is a total return index which reflects the price changes and interest of each bond in the index.

Yield: Yield - annual income from the investment (dividend, interest, etc.) divided by the current market price of the investment.

The information provided in this material should not be considered a recommendation to purchase or sell any particular security.

Unlike bonds issued or guaranteed by the U.S. government or its agencies, stocks and other bonds are not backed by the full faith and credit of the United States. Stock and bond prices will experience market fluctuations. Please note that the value of government securities and bonds in general have an inverse relationship to interest rates. Bonds carry the risk of default, or the risk that an issuer will be unable to make income or principal payment. There is no assurance that private guarantors or insurers will meet their obligations.

The information provided in this material should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any security transactions, holdings, or sectors discussed were or will be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance discussed herein. Strategies discussed are subject to change at any time by the investment manager in its discretion due to market conditions or opportunities.

Investing in exchange-traded funds (ETFs) involves specific considerations for investors including, but not limited to, expenses, liquidity risks, and the possibility that ETF shares may trade at prices above or below their net asset value.

Past performance is not a guarantee of future results. No investment strategy can assure a profit or protect against loss.

The foregoing reflects the thoughts and opinions of Brandes Investment Partners® exclusively and is subject to change without notice.

Brandes Investment Partners, L.P.
11988 El Camino Real, Suite 600
P.O. Box 919048
San Diego, CA 92191-9048
858.755.0239

MSMA150365
OAM070215MC3
10143 PUB 0615