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Investors Are Only Beginning to Size Up the Risks of What They Own

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The migration of risk is a recurring phenomenon in the financial markets, and after a decade and a half of yield-curve manipulation by the U.S. Federal Reserve, investors should be extremely wary. The recent blowups in the banking system are the perfect example.

By pushing interest rates to near zero and holding them there, the Fed dramatically reduced the cost of capital, providing enormous support to an economy battered first by a dire financial crisis and then a devastating global pandemic. The Fed's policy succeeded in large part because extreme interest rate suppression essentially neutralized relative-value analysis. Simply put, relative to an absolute yield of nearly nothing, almost any return above zero seems reasonable.

The problem, of course, is that securities that were attractive only when compared to flat or negative yields were destined to look ugly when interest rates normalized. Accordingly, the longer interest rates flirted with the zero bound, the more risk built up in precincts customarily considered boring and "safe," particularly in the fixed-income arena. Silicon Valley Bank's failure to hedge this risk effectively killed it. But it wasn't the first time markets have seen these dynamics unfold.

Remember back in 2008 when for the first time a retail money market fund failed to maintain a $1 per share net asset value and "broke the buck"? At the time, the $65 billion Reserve Primary Fund held only about $785 million in commercial paper issued by Lehman Brothers. But that relatively small exposure was enough to cause its NAV to drop below $1, prompting investors to flee in such numbers that assets under management declined by two thirds in only 24 hours. That's how fast it happened.

That the fund's demise was triggered by commercial paper was ironic. The fund's managers had conspicuously avoided the asset class well into the 2000s. It was only in 2006 that they apparently decided the returns were worth the risk, and they shifted gears quickly. By early 2008, asset-backed and financial-sector commercial paper made up 56% of Reserve Primary Fund's portfolio.

And then those assets imploded.

Following a decade and a half of basement-level bond yields, the Reserve Primary Fund's demise offers a timely cautionary tale. How well do investors understand the nature and the risks of what they own?

Take the Nuveen High Yield Municipal Bond Fund, the world's biggest high-yield municipal bond fund. How many of its investors were aware that its largest holding is not a municipal bond but rather an equity position? Probably more after Bloomberg wrote an article about it last month. And to be both accurate and fair, Nuveen came by the shares honestly. Bonds it owned in FirstEnergy were converted into equity following a debt restructuring in 2020. Moreover, they may ultimately pay off handsomely. Nuveen provides "above-and-beyond" transparency in making investors aware of its holdings and strategy, a spokeswoman said in an email. But as Bloomberg pointed out, investors in its bond fund needed to understand not only that it holds the shares but also how infrequently they trade.

That last point is crucial.

Retail investors aren't accustomed to thinking about liquidity risk, particularly when it comes to large, publicly-traded investment vehicles. But fund managers spent the last decade and a half committing billions to securities offering less yield and less liquidity than they would have otherwise accepted under almost any other circumstances.

Against that backdrop, think about what happens when redemptions roll in. Fund managers logically sell what they're able to sell: their most liquid, attractive holdings. That's what buyers want, particularly when markets get dicey.

If the portfolio is comprised of high-quality, highly liquid positions, it's business as usual. But if the quality and liquidity of the assets materially deteriorate with each redemption request, it doesn't take much by way of outflows to reduce an otherwise stable fund into a financial kill box.

Recall as described above how little exposure the Reserve Primary Fund had to Lehman Brothers commercial paper. Not junk bonds—commercial paper.

Investors sensitive to liquidity risk can limit their investments to exchange-traded funds, and as of year-end 2022 almost $10 trillion was invested globally via ETFs. But that liquidity may come at a steep cost. For example, during the market sell-off in March and April 2020, many fixed income ETFs plunged to unprecedented discounts to their net asset value.

Last month, several academics published a paper analyzing how bond ETFs can actually reduce the liquidity of the corporate bond market during periods of market stress.

As the authors of "Steering a Ship in Illiquid Waters: Active Management of Passive Funds" explained it, in order to process inflows and outflows, ETFs trade creation and redemption baskets with market makers called authorized participants. But because bond ETFs in some cases track thousands of issues, their creation and redemption baskets typically do not include every bond in the index.

It would seem to make sense that including a bond in an ETF basket would make that bond more liquid. But during a sharp sell-off, its inclusion can become a handicap. When redemptions vastly outweigh creations, the authorized participants responsible for making a market may logically become averse to purchasing even more of the bonds that redemptions have already forced into their hands.

This is not a new concern. Both the International Monetary Fund and the Bank for International Settlements have raised questions about it. But how many Main Street investors share their concerns, or are even aware of them?

After so many years of dramatically mispriced risk courtesy of quantitative easing, investors are rapidly realizing that the quality of the assets they ultimately own should make them nervous. Fund managers may have overpaid for much of what they bought only because the Fed left them few reasonable alternatives. But they still overpaid.

And if investors have sufficient reason to doubt not only the quality of what they own but the liquidity as well, self-interest and common sense dictate a swift exit. The issue for the financial markets and the broader economy is that when panic becomes prudent, it quickly turns pervasive.

So tread carefully. Given how much risk the system must at this point contain, we've barely begun what is sizing up to be the mother of all financial hangovers.

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