What Happened to My "Anchor to Windward?"

Investors buy bonds for stability. A big cliché in investment management is that in stormy times, bonds should be a portfolio's "anchor to windward." This September, there were two well-publicized events that raised concerns over the stability of the bond market itself. First, Blackrock published a Viewpoint* that characterized the secondary bond market as broken and called into question the liquidity of the market. And second, "bond king" Bill Gross surprised the market with his departure from PIMCO and the massive Total Return Fund.

The operative sentence in the Blackrock commentary was, "We believe the secondary trading environment for corporate bonds today is broken, and the extent of the breakage is masked by the current environment of low interest rates and low volatility, coupled with the positive impact of QE on credit markets." **At Richmond Capital, we respectfully disagree.** It is true that the overall volume of corporate bonds traded has declined, and the ability to execute in the secondary market for very large trades is likely diminished as large banks carry less inventory. However, for trades of less than $5 million the liquidity in the market is quite good. In fact, the amount of bonds traded electronically on MarketAxess (our primary execution platform for corporate bonds) has increased as new entrants have entered. As of the 1st quarter of 2014, MarketAxess activity represented 13.4% of Corporate TRACE trades, up 12.3% year over year.

The concern about liquidity is squarely focused on what will happen during the next event that causes corporate bond spreads to widen. With more and more corporate bonds owned by retail investors through mutual funds and ETFs, many wonder whether risk aversion and herd mentality could heighten volatility. Indeed, on October 15th, a 20 basis point spike in Treasury yields at 9:30 a.m. when the fixed income ETFs began trading, suggests the ETF market still has some liquidity issues. However, markets are dynamic, not static entities. As the fixed income ETF market evolves, we believe that new entrants will be enticed to provide liquidity. Also, other developments will occur in this fixed income evolution. One mentioned in the Blackrock piece of particular note is the continued development of trading platforms to allow end purchasers of corporate bonds to transact with each other without a market maker in between.

The Bill Gross departure news and its ongoing potential impact on the bond market have been big conversation topics amongst clients and consultants. We offer two encouraging thoughts:

1. The impact on separate accounts managed by Richmond Capital should be minimal. Since our clients' portfolios are invested in distinct separate portfolios that do not use derivative securities, any fallout from mutual fund liquidations should not be of consequence.

2. We believe strongly that the types of investments in our clients' portfolios (investment grade corporate bonds, Treasury and Agency securities, Agency mortgage-backed securities, and AAA-rated asset-backed and commercial mortgage-backed securities) will not be significantly impacted.

*BlackRock Viewpoint, September 2014 -- Corporate Bond Market Structure: The Time for Reform is Now.

Over the years, the investment world has tried to redefine fixed income in order to produce more equity-like returns. First was the move to "Core-Plus," which primarily added non-investment grade bonds. More recently, the mandate buzz-word is "Unconstrained," which offers managers a virtual blank check in terms of what types of securities can be included in a portfolio. The hard truth is, when yields available in the markets (due to a variety of reasons) are low, the expectations should commensurately be lowered. With investment grade bond yields low, the "Unconstrained" enthusiasts want to redefine what has long been considered a "bond" by including such assets as emerging market debt, high yield, and levered derivative positions. The correlations of these securities to equities are generally higher than with traditional bonds. We believe fallout from the events at PIMCO, or potentially other large firms, is much more likely to occur in these types of investment products.

What happened to my "anchor to windward?" At Richmond Capital, we think nothing. We think that embedded in much of the "liquidity concern" conversation is the creeping understanding that many investments held by bond funds are no longer traditional bonds. We remain committed as a firm to continue to invest our clients' assets in high quality, diversified, cash bond portfolios. We are long-term investors, not traders, and view the current market volatility as a chance to add cheaper positions for long-term gain.

Fixed Income Data Bank

Index Returns

	Qtr.	1 Yr.	3 Yr.
Barclays Aggregate	0.17%	3.96%	2.43%
Barclays Int. Aggregate	0.03%	2.74%	2.09%
Barclays Govt/Credit	0.17%	4.08%	2.54%
Barclays Int. Govt/Credit	-0.03%	2.20%	2.02%
Barclays 1-3 Year G/C	0.04%	0.77%	0.92%
Barclays 1-10 Year TIPS	-1.99%	0.61%	0.93%

Source: Barclays *As of September 30, 2014*

Treasury Market Yields

	9/30/14	6/30/14
3 Month	0.02%	0.02%
2 Year	0.57%	0.46%
5 Year	1.76%	1.63%
10 Year	2.49%	2.53%
30 Year	3.20%	3.36%

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