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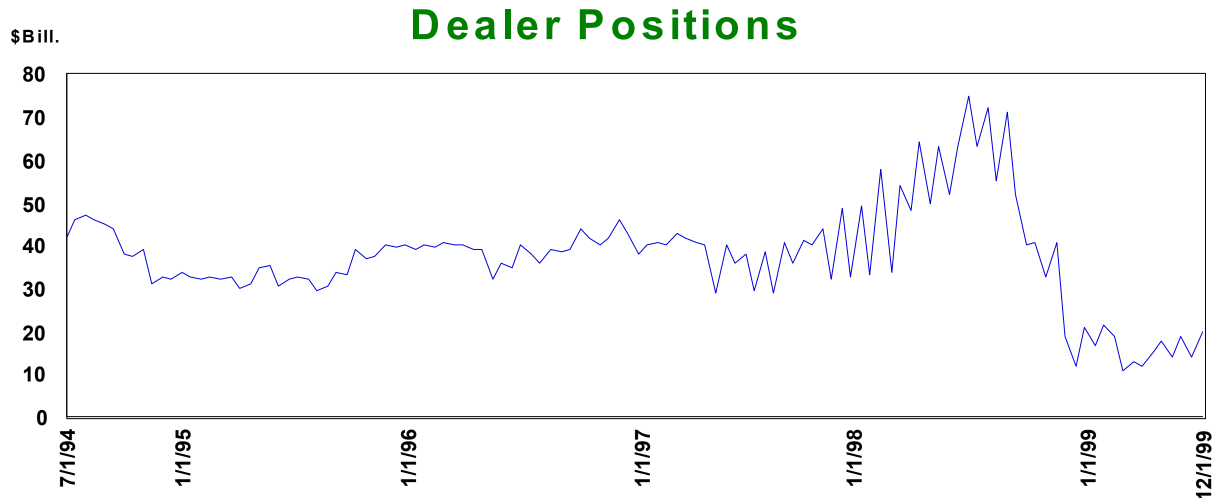
Evaporating Liquidity, or Where Have All the Dealers Gone?

Not that many years ago there were 38 Primary Dealers, that is firms designated to bid directly in Treasury debt auctions. But a lot has happened in the past few years. In fact a lot has happened in the past twelve months. Last summer, there were 29, now there are 25. Chase has become part of J.P. Morgan, DLJ part of CSFB and Paine Webber is now part of UBS to name only part of the action. Twenty-five is still a goodly number, but not all of them are real players. A few hang on to the designation as a matter of "face", others as a faded badge of honor (a bit like old-line families who keep the country club membership while fending off the bill collectors). So let's say about half are big guys and half are small fry. I'm not just making these numbers up either, as the top 40% of the dealers actually do 65-75% of the transaction volume in Treasuries. Interesting you say, but why does this matter? It matters because it is an indication of the shrinking universe of providers of liquidity in a market that is very thirsty, and getting thirstier.

One of the joys of this business is that so many of us are friends, competitors to be sure, but friends nonetheless. From time to time, when we happen to be on each other's home turf, we'll get together for a meal, or a different form of liquidity than the one about which I am writing, and we discuss the issues that concern us. For the past year or so, if liquidity or the lack thereof actually, wasn't the top topic it was second, and it is a well founded one. Think this through with me. As asset manager's portfolios get bigger, and they have and will as "economies of scale" continues to be the byword in the industry, their position sizes get bigger too. Now let's say one of the huge asset managers needs to sell $1 billion 5-year notes. The seller calls one or two dealers and asks for bids. In the days of yore, whoever bought the notes had a broad universe of dealers to whom to "re-sell" them, thus mitigating the risk. Now there are fewer outlets, and thus a higher risk factor.

A lot of nasty events have rocked the fixed income markets over the past several years. The Russian debt meltdown, the cratering of the Pacific Rim markets, the near death experience of Long Term Capital Markets, and the real death experience of other fixed income hedge funds to name just a few. Because the value of their inventory got clobbered each time, the street is a lot less willing to position securities than it once was, as is evident in the chart on the following page.

Chart 1



When the street loses money heads roll and a large number of traders were shown the door. Mitigating this somewhat should be the natural selection process inherent in fewer seats. That is only the best traders survive, and better traders mean more accurate prices. Keep in mind however, that behind the public persona swagger that all traders have, and need, there is still a human being. And human beings have fears. For these guys and gals, as for most of us, the fear of not having a seat at the table is the most deeply rooted, and they have seen their neighbor get the tap on the shoulder. It tends to make their bids and offers less aggressive not more. They still have to play though, or they lose their seat due to inaction. The result is a market with liquidity that is a bit like the old saying about the Missouri River, - "a mile wide, but only two inches deep."

Just for fun, let's think about how this might impact the asset management business, and I'll try not to get to a point of "redicto ad absurdium". As noted, the trend in asset management is like that in the entire financial services sector - consolidation. Consolidation means larger portfolios, and larger portfolios mean larger position sizes. If you buy the argument above, execution for those larger positions will be less good and that will inhibit the performance of the larger funds. There is supporting evidence of this in the equity market, where a number of larger funds have been closed to new money due to concerns about the ability of a manager to outperform when a fund gets too big. It requires no great leap of faith to apply the same argument to the fixed income markets. But wait you say, perhaps it does. Don't bonds have immensely more liquidity than stocks? The answer here is that yes they do, but real economies of scale in fixed income management can only be realized in the more "generic" sectors; Treasuries, Agencies, and plain vanilla pass-thrus.

Not surprisingly, these areas have been the ones that recently have done the best, performance wise. The increase in size mandated by the consolidation trend has in turn mandated greater demand for those bonds which can be “bought in bulk”. Intuitively, that means less focus on issues that depend on structure, and deeper research and analysis, which are the meat and potatoes of the smaller shops like . To draw an analogy, it is like the difference between going to Sam’s Club or your local butcher for steak. At Sam’s you get a good price on the prepackaged cuts and amounts they want to sell you, which is exactly what you want if you need to feed a large crew. At the butcher you pay a fair price for higher quality, and exactly the cut and quality that you want, allowing the talent of the chef to create a much more savory dish, but not for as large numbers.

Fine, but where does this leave us? Well, fund managers are nothing if competitive, and I would not be a bit surprised to see some of the best ones get frustrated by the Sisyphean task of trying to outperform with too large a portfolio. That frustration could lead them out of the business, or to smaller firms where their performance light can really shine. That in turn leads to money leaving the big firms in search of better performing smaller firms, which leads to small firms getting big, which leads to the best managers leaving the business, or going to smaller firms where their performance light can really shine…you get the picture.

The world is a cyclical place, and while I can’t say precisely when the pendular peak of the consolidation wave will be reached, the pendulum will swing back and the new wave will be de-consolidation. Perhaps one good indicator of the peak will be when no one in the graduating class at Harvard Business School wants to be a trader, or a portfolio manager. Being out in front of the wave can be very lonely, and sometimes a bit scary, but it is where one must be to catch the wave and get the best ride. The wave is coming, and it’s going to be a great ride. Hold on.

This and That

Kinda funny isn’t it? In the seventies Saul Steinberg tried to buy Chemical Bank, now you’ve gotta wonder if he has enough money for them to give him a no-fee checking account.

Henry Paulson at Goldman Sachs doesn’t want to provide unprofitable loans to win underwriting business. Maybe he remembers what happened to Bill Mayer at First Boston during the Wasserstein-Perella bridge loans days.

Why hasn’t anyone ever made a good Wall Street movie?

Has anyone noticed that M-2 has grown at a 10-14% rate in the first half of this year? Where’s Milton Freidman when you need him?

Vanderbilt Research Team