Perpetual knowledge bank series: liquidity risk

By Perpetual Asset Management
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Liquidity refers to an investor's ability to sell a bond quickly and at an efficient price. This is determined by the difference between the bid – or the price at which the market is willing to buy the security – and the offer, which is the price at which the market is willing to sell the security. It is commonly known as the bid offer spread.

For example, if a small gap exists between the prices buyers are bidding and the prices sellers are asking on large, actively traded bond issues, then the market has low liquidity risk. However, as the spread rises on less actively traded bonds, so does liquidity risk. If a market is not liquid, it can become very difficult to trade without adjusting the price. The other factor that has an impact on liquidity risk is the volume which can be transacted at a particular price or bid offer spread.

Generally, Australia's benchmark government and semi-government bond issues are very liquid with investment grade corporate bonds more liquid than non-investment grade bonds. This is because bonds can have many variables which can reduce the number of suitable buyers, some of whom may be mandated to consider only investment grade bonds or certain types of securities. Portfolio managers control liquidity risk by constantly monitoring security prices and allocations to different security types. Prices that are out of line with comparable securities, or 'stale' prices that stay static for long periods, can be tell-tale signs of risks, including liquidity risk.