F I X E D I N C O M E

(Il)liquidity Premium in Credit Markets: A Myth?

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Across multiple measures of "liquidity" and a variety of methods to control for correlated characteristics of more (less) liquid bonds, we find only limited evidence of a liquidity premium in the cross section of corporate bonds. Specifically, whilst illiquid bonds have slightly higher credit spreads and directionally higher average returns, portfolios that tilt toward (away from) less (more) liquid bonds exhibit considerably higher levels of volatility. Economically, the low Sharpe ratios of illiquidity factor mimicking portfolios are hard to justify for an investor. This is puzzling as theory suggests investors should demand a risk premium for holding less liquid assets.

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