Innovations Ease Corporate Bond Trading

Q2 2017

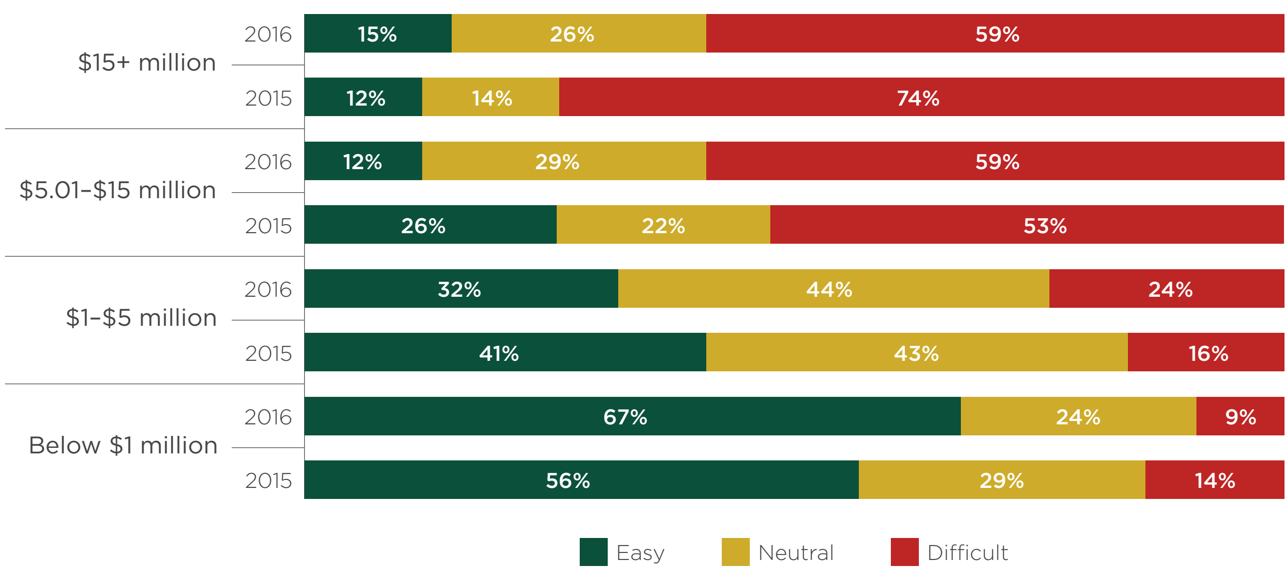
ALL-TO-ALL TRADING, COUPLED WITH AN ARRAY OF TECHNICAL INNOVATIONS, IS MAKING TRADING CORPORATE BONDS EASIER FOR THE BUY SIDE

67% OF INVESTORS SAID EXECUTING CORPORATE BOND ORDERS OF $1 MILLION IN NOTIONAL IS NOW EASY OR EXTREMELY EASY

Trading corporate bonds is finally getting a little easier. No, we are not going back to the good old days, nor are the Trump administration's promises to scale back financial regulations—and the Volcker Rule in particular—driving banks to take on large bond positions again. What we are seeing, however, is an adaptation to the current market structure and with that, a smaller but much more efficient buy-side trading desk.

Two-thirds of the investors we spoke with believe that executing corporate bond orders of $1 million in notional size or less is now easy, up from 56% the year before. Corporate bond execution venues and offerings that were a mere idea a few years ago are finally consolidating and starting to bear fruit. Meanwhile, the quantity of data available has grown, along with the number and quality of tools to analyze and action the data.

ABILITY TO TRADE CORPORATE BONDS BY NOTIONAL SIZE RANGE



Note: Based on 51 respondents in 2015 and 34 in 2016.
Source: Greenwich Associates 2016 Market Structure & Trading Technology Study

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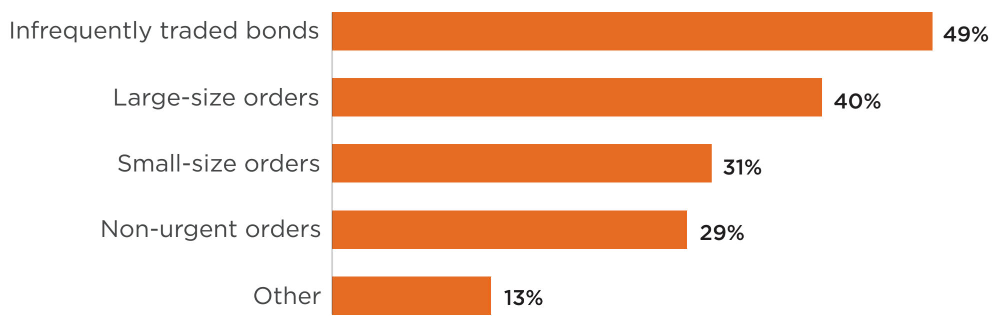
What's Next?

While orders above $1 million in notional size still can present challenges, orders of $5 million and up are particularly tough to execute. Helping to match those buyers and sellers is the holy grail of corporate bond technology firms. By cracking the code for matching large and often illiquid bond trades so that information leakage and time spent searching for liquidity is minimized, these firms aim to both control the corporate bond market and rake in profits. Large and illiquid orders are, in fact, the main reason buy-side bond traders look toward newer trading mechanisms today.

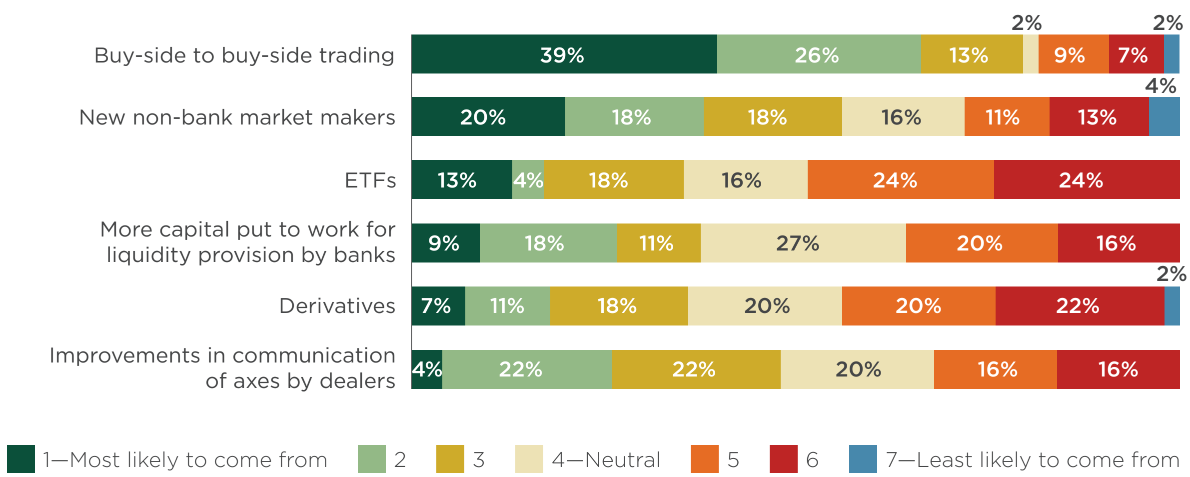
ELECTRONIC TRADING PROTOCOLS USED OTHER THAN TRADITIONAL RFQ



Note: Based on 45 respondents. Respondents were allowed to select multiple responses.
Source: Greenwich Associates 2016 Market Structure & Trading Technology Study

While fintech focuses on block trades, forward-looking bond investors are less interested in round-lot executions. Although this is due in part to the growing average trade size on electronic platforms, these investors are increasingly focused on solutions that provide anonymous all-to-all trading and the resulting access to new liquidity providers. Why? Because they see these attributes as key sources of new liquidity in the next one to two years—alongside ETFs, derivatives and other market enhancements.

EXPECTATIONS OF ADDITIONAL LIQUIDITY SOURCES IN 1–2 YEARS

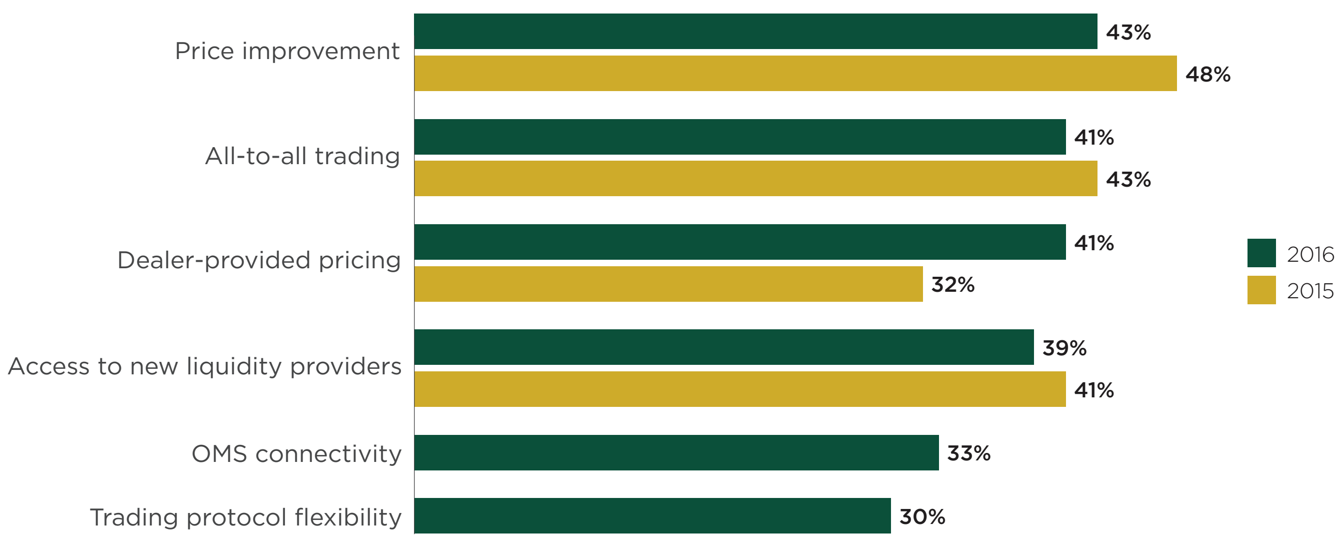


Note: Based on 46 respondents.
Source: Greenwich Associates 2016 Market Structure & Trading Technology Study

Anonymous all-to-all trading may conjure images of continuous central limit order books, such as those used in futures and equities markets. In this case, however, that view is too limited. Trading among all market participants, without the counterparties knowing one another, can occur via a host of protocols including auctions, dark/lit pools, on-demand order books and, of course, continuous central limit order books. In a market where liquidity in any given name is rarely consistent, approaches that allow market participants to get involved in and when demand occurs will likely be winners at the institutional level going forward.

We've said it before and we'll say it gain: Major (and minor) corporate bond dealers are not going anywhere and will continue to be at the center of risk transfer in this market. Their balance sheets, data, expertise, and role as new-issue underwriters ensure they are critical partners for asset managers and hedge funds investing in U.S. credit. However, these same dealers have reduced their capital commitment to this business, creating a liquidity gap that still needs filling. And while no single technology or trading model innovation can make up for the principal liquidity lost, a combination of several will get the market as close as can be reasonably hoped for.

MOST IMPORTANT CRITERIA WHEN SELECTING A FIXED-INCOME TRADING VENUE



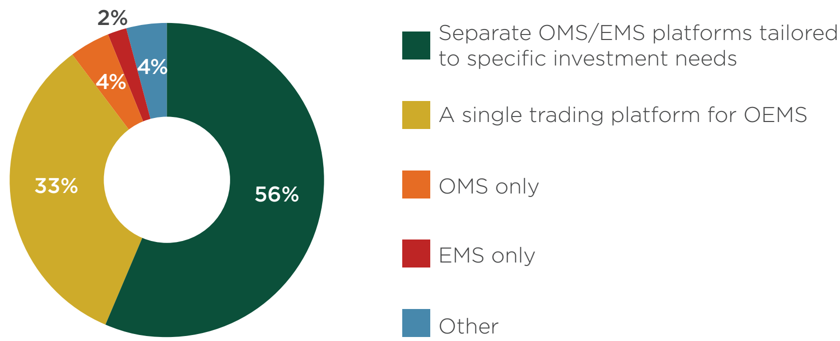
Note: Based on 75 respondents in 2015 and 46 in 2016.
Source: Greenwich Associates 2016 Market Structure & Trading Technology Study

API Doesn't Rule Out UX

Conversations about electronic-trading adoption in other markets—such as government bonds, FX or equities—center around automated trading driven by direct connections between the trader's execution management system (EMS) and the variety of liquidity pools needed to ensure best execution is found. Despite the steady growth of electronic trading in corporate bonds, buy-side bond traders still rely heavily on the screen and the mouse, as opposed to algorithms and direct connections.

The next logical question is exactly which screen do they rely on? Again, contrary to other electronic markets, corporate bond buy-side EMSs are almost non-existent. With Bloomberg's TSOX and AB's Alpha the largest exceptions, only 2% of buy-side traders utilize either a third-party or internally built, standalone EMS to access the corporate bond market. Order management systems (OMS) are quite common, however, with Bloomberg's AIM, BlackRock's Aladdin and Charles River the most used. Even so, in less than one-third of those cases are bond orders executed directly from the platform.

PLATFORM USED TO ACCESS CORPORATE BOND MARKET

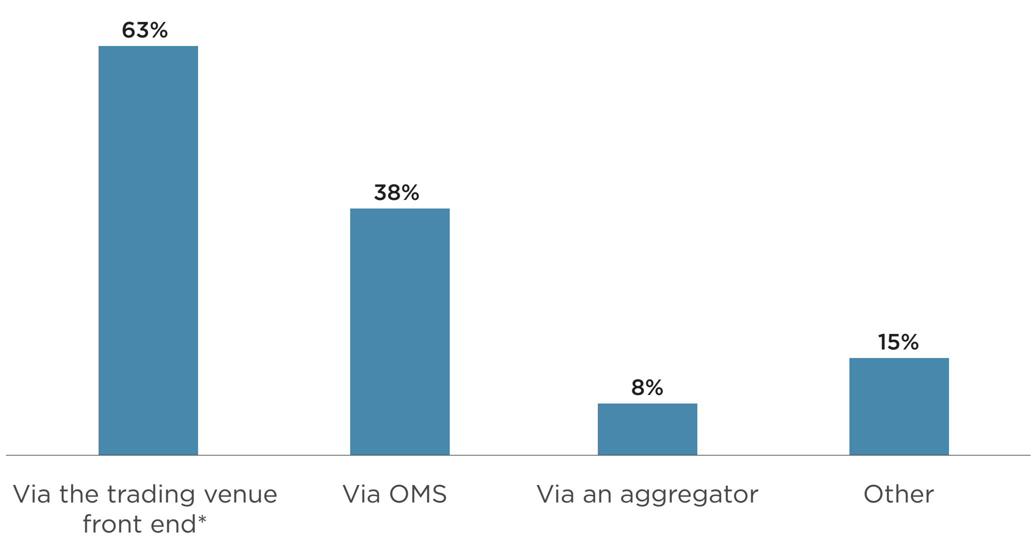


Note: Based on 48 respondents. May not total 100% due to rounding.
Source: Greenwich Associates 2016 Market Structure & Trading Technology Study

This brings us back to the execution venues themselves, where proprietary user interfaces (UI) are still the primary window for investors into electronic bond-market liquidity. Native front ends bring with them a user experience (UX) that is perfectly suited for all of the features and functions within the given platform. By contrast, an OMS or EMS provides an aggregated view, which must normalize all liquidity pools to create a single interface. As such, Bloomberg, Liquidnet, MarketAxess, Tradeweb, Trumid, and others have all poured tremendous time and money into the look and feel of their front ends in hopes that their screen will literally sit in the center of the trader's center monitor.

It is also important to note that the larger players in this space see little benefit to their liquidity being aggregated, as doing so would put them in more direct competition with other liquidity on a single screen. While all are confident that their liquidity is deep and spreads are tight, encouraging quick access to quotes elsewhere isn't in their best interest. Trading in equity markets is done largely via venue aggregation technology today, but that only came about following the implementation of Reg NMS, which essentially required the change. Nothing similar is expected in corporate bonds in the foreseeable future.

CHANNELS USED TO SUBMIT ELECTRONICALLY TRADED ORDER

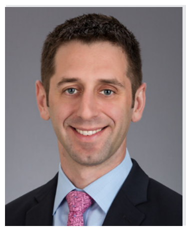


Note: *e.g., Bloomberg, MarketAxess, Tradeweb. Based on 48 respondents.
Source: Greenwich Associates 2016 Market Structure & Trading Technology Study

Conclusion

The corporate bond market is electronifying faster than electronic trading volumes are growing. In other words, total notional volume executed via the screen underestimates the impact of technology innovation on the ecosystem. All-to-all trading in and of itself won't transform the market, but coupled with improved data, analytics, liquidity intelligence tools, user interfaces, and trading systems, the changing face of the market becomes more readily apparent.

It is because of these innovations that trading corporate bonds has become easier for the buy side. Challenges remain, mind you, but it is no longer the near impossible feat that it was following the credit crisis in 2008. And while regulatory changes at the hands of the Trump administration remain largely opaque, expectations for an expanded definition of market maker in the Volcker Rule and revised bank capital rules should give the market hope that the hardest period of this cycle is behind us.

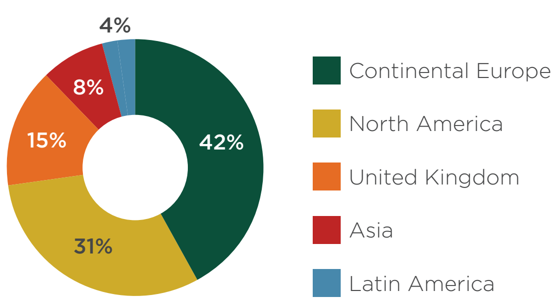


Greenwich Associates Managing Director Kevin McPartland is Head of Research for the Firm's Market Structure and Technology practice.

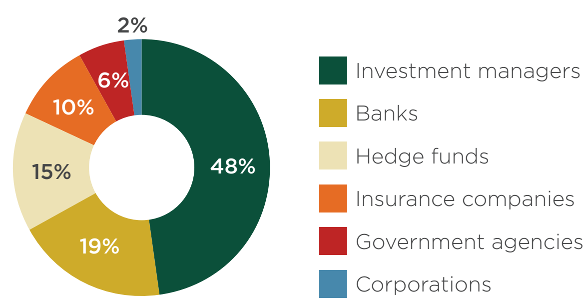
METHODOLOGY

From June through August 2016, Greenwich Associates interviewed 50 buy-side traders across the globe trading fixed-income products to learn more about trading desk budget allocations, trader staffing levels, OMS/EMS/TCA platform usage, and the impact of market structure changes on the sector.

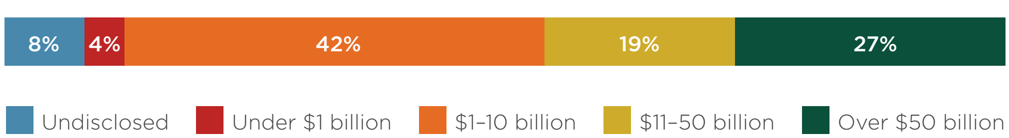
RESPONDENTS BY LOCATION



RESPONDENTS BY INSTITUTION TYPE



RESPONDENTS BY TRADING VOLUME



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greenwich.com ContactUs@greenwich.com Ph +1 203.625.5038

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