

# best execution

ACROSS THE ASSET CLASS SPECTRUM

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**Robert Barnes,  
UBS MTF**

**The year of clearing**

**Trading platforms**

**The human touch prevails**

**Transaction Cost  
Analysis**

**The measure of success**

**i2i – exclusive interviews:**

**Marcus Hooper, Pipeline**

**Ray Tierney, Bloomberg Tradebook**



**R**egulation has ushered in a new era for trading, with sweeping changes to market infrastructure in motion on both sides of the Atlantic. In Europe, MiFID II and EMIR aim to create a more transparent and robust market by mandating central clearing and electronic trading for a broad range of derivative products. Exactly which products will fall under these regulations is still to be determined, but many over-the-counter products, which today are still predominantly traded over the phone, will soon have to be traded electronically.

The end-game for these regulations is to address the systemic risk in the derivatives markets that is widely believed to have brought about the credit crisis of 2008. But the forces of regulatory change that were unleashed by the credit crisis are not limited to derivatives risk management. The remit of MiFID, for example, has expanded to include additional asset classes; and regulators are also concerned with market participants' ability to demonstrate how they have achieved the best price in executing a trade. Taken together, these changes ultimately aim to protect investors, represented by pension funds and mutual funds who are active in these markets.

Both of these ambitions have brought greater focus on the transparency and efficiencies offered by electronic trading. In highly liquid markets such as equities, a number of

sophisticated approaches are widely accepted to measure the main components of trading costs – known as transaction cost analysis (TCA) - and thereby prove best execution. However in less actively traded markets, such as credit, analysing trading costs is somewhat more challenging. Although fundamental differences in the market structure and behaviour of credit markets prohibit an equities-like approach to TCA, there are unique characteristics that have allowed us to develop an alternative approach drawing on data that has become more widely available with the growth of electronic trading.

#### **Characteristics of the corporate bond markets**

A fundamental feature of the corporate bond markets compared to the equity markets is their highly fragmented nature. Compared to only approximately 11,000 equities listed on the two principal US equities exchanges, there are over 70,000 individual bond issues in the U.S. high grade and high yield corporate bond markets alone. Moreover, the individual characteristics of these bonds, such as maturity, optionality and credit quality, make a significant difference to pricing. A single issuer may have dozens or more different bonds, each with its own distinct profile. In addition, many of these bonds trade infrequently – the average bond trades less than twice a day – making them difficult to price accurately.

The advent of FINRA's (Financial Industry Regulatory Authority)

# The new capital markets landscape

*Alex Sedgwick*, head of research at MarketAxess explains that TCA in credit markets demands a different approach to equity markets, but choosing the right methodology can not only demonstrate compliance with best execution obligations but also identify meaningful cost savings.

TRACE (Trade Reporting and Compliance Engine) reporting in the U.S. in 2002 brought significantly more transparency to the corporate bond markets. FINRA requires that all U.S. corporate bond trades be reported to the TRACE consolidated tape within 15 minutes of the trade taking place. This data is then fed back to the market, thereby enhancing participants' ability to more accurately price even thinly traded bonds.

This consolidation of trade data and associated price transparency, alongside the greater adoption of electronic trading in these markets and the advent of new methodologies to analyse data, have allowed us to develop an objective approach to examine trading costs in the fixed income markets in new and compelling ways.

## **A new methodology**

The most commonly used approaches for measuring trading costs in the equity markets take into account factors such as the commission, market impact, execution delay and opportunity costs associated with a given trade. All of these measures assume a critical mass of volume traded daily in order to provide an accurate benchmark for the cost of a given transaction, and also rely on the highly automated nature of equities trading for accurate pricing of a given stock at any point in time. As discussed above, due to the comparatively small volumes traded, these methodologies are not appropriate for the corporate bond markets.

For the fixed income markets, a more straightforward approach is required in order to achieve a realistic comparison within the limitations of the data available. Our approach is to analyse execution costs in the fixed income markets by looking at the embedded costs of trading, consisting of the dealer mark-up plus any fee associated with executing the trade. Using an electronic platform such as MarketAxess, we can easily calculate the trading fees associated with each transaction, and we can therefore determine the cost of execution by comparing the electronically executed trade to a 'prevailing market price' using the data from TRACE.

For our first detailed study of transaction costs in the fixed income markets, we took a sample of 900,000 TRACE-reported trades over a 24-month period. From these we identified 150,000 trades for which we could establish a prevailing market price and for which we were able to compare electronic trades with a sufficient number of TRACE prints.

## **Findings**

The original intent of the analysis was primarily to quantify the cost of electronic trading compared to trading by voice in the corporate bond market. Our research found at a statistically significant confidence level that trading electronically consistently delivers cost savings to the end user across all trade size buckets and maturities.



**“ Although fundamental differences in the market structure and behaviour of credit markets prohibit an equities-like approach to TCA, there are unique characteristics that have allowed us to develop an alternative approach drawing on data that has become more widely available with the growth of electronic trading. ”**

In actively working with clients to generate reports quantifying the cost of execution (both voice and electronic), we have shown that this can be a key tool for compliance purposes and ultimately enables clients to demonstrate that they have fulfilled their fiduciary responsibility to achieve best execution. Over the longer term, these cost savings can also be shown to result in incremental gains and a measurable improvement in portfolio level performance.

This methodology has significant applications in responding to regulatory requirements and as such highlights the broader benefits of automation. The ability to calculate transaction costs in less liquid markets helps support one of the key goals of MiFID by providing a mechanism that can be used to prove best execution.

### **Benefits of electronic trading**

One of the primary advantages of electronic trading is increased competition, resulting from the ability to request prices from a broad group of dealers. The RFQ (request-for-quote) model widely used in the over-the-counter markets has the advantage of enabling clients to contact multiple dealers simultaneously. Inquiries are disseminated in a fraction of a second to a large group of participants, thereby increasing opportunities to obtain better pricing and significantly increasing efficiency.

By allowing easy access to a broader group of participants, the RFQ model has enabled the expansion of what was otherwise a highly fragmented market. The cumulative number of client

and dealer trading connections on MarketAxess has more than doubled since 2008, and clients are receiving twice as many dealer responses per inquiry in U.S. high-grade corporate bonds as they were two years ago. Enhanced dealer liquidity and competition from a greater number of dealers on the platform are driving meaningful transaction cost savings for investors across all trade sizes. Lower transaction costs in turn are driving increased investor order flow – the overall estimated year-to-date share of U.S. high grade trading volumes on MarketAxess today is 11.1%, compared to an estimated 7.5% for the same period in 2008.

### **Conclusion**

Through extensive research and analysis that has been made possible by, among other things, the presence of a consolidated trade tape in the US corporate bond market, we have been able to demonstrate the statistically and economically significant cost savings afforded by electronic trading in the fixed income credit markets. These savings result from the efficient aggregation of liquidity from a broad and growing group of market makers. The methodologies that we have developed can also be used by market participants to demonstrate compliance with their best execution obligations. We believe that similar benefits can accrue from the electronic trading of standardized derivatives as proposed by the European Commission, and from the increased price transparency afforded by a TRACE-like consolidated tape for the European markets, as envisaged in the MiFID II proposals. Ultimately, we believe that this will result in more stable, transparent and efficient over-the-counter markets. ●