

AllianceBernstein LP

"The inventories held by dealers, dealer prop desks, and hedge funds used to provide an effective shock absorber for the corporate bond market, but as they withdrew their capital after the financial crisis, volatility started to pick up," notes Jim Switzer, Global Head of Credit Trading at AllianceBernstein LP (AB) in New York. At the end of July 2016, the firm managed fixed income portfolios totaling \$279 billion, spanning the sovereign, corporate, structured and municipal bond markets. "At some point we saw that the wide market swings represented an opportunity for us," Switzer says, "to provide liquidity when the market needed it – buying bonds at attractive prices and adding alpha to our clients' portfolios."



JAMES SWITZER

Global Head of Credit Trading

"But we came to realize that to fully capitalize on the liquidity opportunity, we needed to make sure we had the right people in our trading organization – people who could recognize and take advantage of those dislocations. We also needed to refine our investment process to ensure that the insights of those traders were fully integrated." He adds: "We saw that this new way of doing business would require scale and efficiency through new technology, and we redesigned our systems to meet the new environment." AB draws pre- and post-trade information from a number of market data sources and electronic platforms, and transactions are routed through MarketAxess's all-to-all trading marketplace, Open Trading.™

EVOLVING INVESTMENT ROLES

Over the last five years AB has completely revamped its investment teams' work streams, bringing a global team of analysts, portfolio managers and traders together into one centralized investment process. "Portfolio

managers used to work with their analysts to decide what sectors and issuers offered relative value," says Ashish Shah, Chief Investment Officer of Global Credit and Head of Fixed Income: "Then the traders went off and executed on those decisions, because there were firm markets to trade in."

"Today, with dealers forced to take a smaller role in trading, and less liquidity in general available in the corporate bond market, the price where a bond is quoted may not be the price at which the bond trades, especially in the size we need to move," Shah notes. "For this reason, we have made the actual market dynamics for liquidity a starting point in our investment process. Recognizing where we can provide liquidity to the market, and when our clients can earn excess return for taking on a short-term liquidity premium in a security, are critical."

In the new regime, Shah explains, first it was essential for investment teams to understand how the marketplace had changed, in that both the sell side and the buy side had undergone consolidations. "The dealers still play an important role in guiding the markets, but the buy side has become far larger than the sell side. Thus, all participants have to be ready to transact with each other as efficiently as possible, and that requires access to different forms of liquidity, such as all-to-all electronic trading platforms."

Second, Shah says, investment teams, and particularly traders, needed to appreciate the new role liquidity played in an investment decision: "Not in the old sense of whether a particular bond usually trades easily, but instead in our ability to source or sell a bond today, and at what price."

Third was integrating the new role of liquidity with the firm's traditional fundamental viewpoints. "Our traders and portfolio managers sit back-to-back," Shah says. "We're doing the same fundamental research we always have, and our portfolio construction has not changed, but within each of those elements, our portfolio managers are working directly with our traders, reflecting the practical realities of liquidity."

Last, Shah adds: "Another important change has been increasing the cash holdings for many client portfolios, so we have the capacity to provide liquidity to the market when the opportunity to do so arises – in other words, when the pendulum swings too far from fair value. If we are able to take advantage of those dislocations, we can recover additional beta and alpha for our clients on the swing back."

"It's clearly a challenging environment," Shah concludes, "but the ability to make security selection and trading decisions dynamically, and move quickly, is giving AB a competitive advantage."



ASHISH SHAH
Chief Investment Officer
of Global Credit and
Head of Fixed Income

ALONGSIDE THE INVESTMENT PROCESS

Taking on the role of liquidity provider also necessitated changes in AB's routines away from the trading desk. "Our compliance and risk management organizations also understand that the fixed income markets have changed, and that there are headwinds in the new bond market structure, and they want to improve their processes, too," says credit trading head Jim Switzer.

"Open Trading joins two fixed income concepts that seem very simple," observes James Wallin, Senior Vice President in AB's fixed income group. "The first is in providing a trading and settlement infrastructure, making sure that all the regulatory,

accounting and financial plumbing are in place. MarketAxess offers all of that as an agnostic dealer, eliminating a lot of those questions and allowing us to focus on the markets and the economics of the business."

"The second benefit Open Trading offers is the ability to gather large pools of liquidity that are not artificially limited to a small group of counterparties, as can happen on the traditional dealer side," Wallin adds. The new liquidity sources that MarketAxess provides has enabled AB's fixed income trading desk to adopt a better-informed approach to best execution: "Traders don't have to talk to individual dealers to get an idea on a best execution. In fact, by using MarketAxess to reach out to so many trading partners, our traders can have a broader view vis-à-vis the dealers. Almost immediately, we realized that some of the better pricing on trades we were considering was coming from our Open Trading pairs."

Equity trading allows some precision in gauging best execution, due to explicit commissions and frequent trades in most stocks. In the fixed income markets, however, best execution remains an abstract measure. But Wallin believes MarketAxess enables AB to take an important step forward: "It gathers information from many market participants, and allows us to build cohorts of securities that get us toward a reasonable measure of best execution. It also enables us to handle the challenge – unique to fixed income – of finding what it's worth to trade a \$10 million position in a security with just \$50 million outstanding."



JAMES WALLIN
Senior Vice President,
AB Fixed Income

MINING A MOUNTAIN OF DATA

"As the market moves to more riskless principal trading, dealers are no longer shouting from the mountaintops," notes Jim Switzer: "They're making more targeted, discreet inquiries to select institutions where they see a high probability of getting a trade done."

"In this environment, we've had to find our own way to communicate with the outside world," he adds. "We've empowered our traders as the tip of the spear, and they must know which risks should go into our portfolios and what price levels make sense. ALFA (AB's internal fixed income trading system) serves as our surveillance on the market, telling us what bonds are out there available to trade."

"For our traders, ALFA is a force multiplier," explains Michael Herskovitz, Director, Fixed Income Risk Operations & Technology and Co-Head, Enterprise Operational Risk Management, and leader of the ALFA development effort. "There are over 80,000 corporate bond issues in the market, and we track as many of them as we can. We have orders we want to carry out, and we watch the orders the dealers want to execute. But all of that is simply too much information for any one person to keep in his head. So we use ALFA, which brings together multiple sources of information to corroborate trends our traders see in the market. ALFA also monitors their watch lists and notifies them when the right conditions are met for a trade. And our traders can change their criteria with just a few clicks. We're able to find the few nuggets of truly valuable pre-trade information without having to dig through everything that's out there."



MICHAEL HERSKOVITZ
Director, Fixed Income
Risk Operations &
Technology and Co-Head,
Enterprise Operational
Risk Management

Herskovitz says that while trades in some instruments still require human intervention, his team aims to make the process more efficient. "And in some categories of transactions, such as small trades of sovereign bonds where the markets are highly liquid, we are trying to automate them almost entirely – we can set up tools that ensure the best execution and right market levels with little human touch."

TRIPLE CHECK

For the fixed income management team, as well as with AB's management, the ALFA system has earned high marks. "There's a lot of market data out there, and ALFA lets us support all the different messaging protocols, and bring it to one place," says Mike Herskovitz. He notes that electronic trading now makes up about 80% of AllianceBernstein's fixed income ticket count, and about 20% of notional volume. With the introduction of Open Trading, MarketAxess has grown to be one of AB's top 10 counterparties.

He adds that for new client mandates, ALFA cuts the time to fully invest an account from weeks to days, and in day-to-day management allows more rapid repositioning of portfolios. "When we decide to increase duration or credit quality, if we can't go from the idea to execution in an efficient time, we're going to miss the opportunity," Herskovitz says.

ALFA's skill at market surveillance also is highly valued, says Jim Switzer: "We can leave the desk for a meeting and come back an hour later, and the ALFA system tells us what happened for anything we're working on. We know the buyers for securities on our lists, and we can move right to those trades. That is a huge advantage."

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– SWITZER

AB does not quantify an increase in client alpha from the ALFA system, but agrees that it's having a positive effect. "There's only so much alpha in the market, and the transaction costs are high," says Ashish Shah: "The sources of our alpha have changed. Often the trigger for a transaction is someone wanting to pay the market for liquidity, and ALFA helps us capture that."

Jim Switzer confirms improved results at the level of individual trades: "There's the 'eye test'," he says: "When we're a liquidity provider, we're buying closer to the bid side almost every time. It's indisputable that it works."

ALFA, like the evolution of the post-crisis bond market, is still a work in progress. "For electronic trading to work, and for managers to be able to claim best execution, we will need more transparency deeper into the market," Switzer explains. "With greater pre-trade transparency more buy side traders will be willing to say 'I'll trade at that price, because I see the depth of thought around these bonds.' That's something we have to explore, and are trying to figure out."

"But the big issue facing the corporate bond market is not liquidity – it's efficiency," contends Switzer. "As a market we need a new approach, where the buy side is making prices and providing liquidity. Bringing more investors into an active role in the market, through all-to-all trading and systems like our ALFA, will make everyone more efficient, and in time liquidity will improve on its own."