

Bond Compass

A Conversation on the Future of Fixed Income



STATE STREET GLOBAL ADVISORS **SPDR®**



Chris Concannon, President of MarketAxess, and Amy Hong, Head of Market Structure & Strategic Partnerships at Goldman Sachs, joined Gunjan Chauhan, Global Head of SPDR ETF Capital Markets at State Street Global Advisors, in December 2021 to discuss the future of fixed income. You can listen to their entire conversation here or read our summary of their exchanges on three key takeaways below.

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As the fixed income markets evolve, liquidity remains a challenge.

Amy Hong: Looking at the corporate bond markets, there are approximately 30,000 bonds you can trade in the US markets alone. Liquidity can be healthy and readily available in certain segments of the market while it can be quite challenged in other parts of the market. This is because at the end of the day, you need a ready and willing buyer and a ready and willing seller lined up at the same time in order for a trade to come to fruition.

We've seen a bifurcation over the past decade. On one end you have highly liquid bonds, where electronic trading has been an effective tool improving workflows and driving efficiencies across the market. But you also have the opposite end of the spectrum, where liquidity remains challenged. This is where additional wrappers, products and solutions, like ETFs, portfolio trading and other ways of expressing credit risk through derivatives, can be quite helpful.

Chris Concannon: Liquidity in the bond market is a true challenge, as Amy has said, given the diversity of product and the fragmented market. In most asset classes, equities and futures, liquidity tends to be set on a central platform or in central order books. However, in the bond market, liquidity is priced on request. That means the market is dominated by large institutional investors who enter the market and request price or request liquidity. That makes it very challenging to search for liquidity. MarketAxess has created a network effect of liquidity. Because we have thousands of investors on our platform and hundreds of dealers that are pricing bonds every day, liquidity becomes a bigger challenge.

When you introduce electronic trading and electronic solutions, however, you organize liquidity in a much more sophisticated manner for end users to access liquidity in real time.

The most important point around liquidity is, the more liquid the bond, the lower the cost of execution. So, it really impacts your outcome if you find a bond that is more liquid. So today, really what we're looking at and really planning for in the future is how liquidity will impact portfolio construction or even index construction because it's so important to the outcome of the actual investment. When you think about portfolio construction and

bonds, it's very different than with equities. In equities, they pick an investment theme around an individual symbol. In bonds, the theme is much broader. It's a sector theme or it's across sectors, it's an issuer and a rating and then maturities.

But it allows you to pick among several hundred bonds to exercise that investment theme. And so that liquidity component can change your portfolio alpha if you select liquidity correctly. So, the picture of liquidity, and liquidity that we see in our market, is now enhancing how portfolio managers are actually selecting bonds. And the same application can be used for building an index for an ETF or building an index that is used in a portfolio trade. That's truly transforming how the market will work going forward.

Trading innovations to meet clients' needs have increased transparency.

Hong: We started investing in automating workflows in the corporate bond markets over a decade ago, starting with automated pricing to accommodate the growing trend in client interest to trade bonds on electronic trading platforms like MarketAxess. We knew it would be untenable for our traders to manually tend to the growing electronic inquiries and requests for quotes, especially during times of market stress. So, we invested in auto-pricing capabilities, which then over the years evolved into what we now call systematic market making. Today, we are interacting with thousands of client inquiries over the course of any given day. Through these investments in innovation paired with our trading talent, we are active across tens of thousands of instruments, and able to offer our clients pre-trade price transparency and ease of execution.

Similarly, our innovations in bond portfolio optimization capabilities have delivered a new tool to our clients' toolkits. A number of years ago, we invested in enhanced bond portfolio optimization capabilities so that we could seamlessly provide primary liquidity in fixed income ETFs. We recognized that the ability to optimize a list of bonds based on attributes and market liquidity could be really powerful in the hands of investment managers and started offering what we now call "portfolio trading" to our clients. In addition to being able to trade large lists of bonds seamlessly, we help clients solve for liquidity holistically across their portfolio and not just on a bond-by-bond basis. Our clients find our proprietary analytics, pre-trade price transparency and ease of execution to be valuable, as can be evidenced in the growing adoption and market volumes in portfolio trades.

Concannon: If you look back in time, transparency was first introduced to the bond market through trade reporting. The requirement to report to trace has really had an impact on the overall market, but the missing piece is that pre-trade transparency. Where is a bond trading right now? Using a trade reporting way to trade is like driving a car looking through the rearview mirror. So really, pre-trade is a critical component. And it's now here; here at MarketAxess our product Composite+ provides that true transparency, pre-trade. Where is a bond trading now? Where are things quoting right now on a bid and offer basis? Things that we are accustomed to in other asset classes like equities, where we enter the market and we see a price already formed, and we can actually decide what kind of investment we want to make relative to that price.

In the bond market, we are just now seeing these pre-trade transparent products being developed, and they're in high demand. And obviously, we have dealers who are constantly streaming price into the market, and price is becoming available to all clients through electronic means.

Extending data-oriented trading will fuel future innovation.

Hong: Whether we're talking about evaluated pricing or other analytics like liquidity metrics, I think we're still in the early innings of the fixed income market data revolution. For example, many third party pricing sources today are lagging market indicators. There is still a lot of investment to come in these types of capabilities as the market continues to evolve. It's exciting to envision how improved market data and analytics will enhance market confidence, increase participation, and fuel different investment strategies. We're at an exciting inflection point. Ultimately the innovations we see in data and analytics will reshape how the fixed income markets operate, from portfolio construction to trading.

Concannon: If you think about our market, we aggregate all this liquidity inside the market, and so we have a unique view into how price is being formed in the bond market across thousands of instruments. And so, it's that unique view that we take, fully aggregated, fully anonymous, and show price in real time where bonds are being traded with AI that predicts where the next trade will take place. So, Composite+ is quite an innovative tool in the bond market given it has access to the full breadth of our bid and offer data across the entire MarketAxess network, so it's a fairly unique offering.

We are also looking at other data products, similar to what Amy was talking about, that look into the market from a depth perspective — true liquidity that's available in the

market today. Not the liquidity that was there six months ago, but where we are today in real time. And it's that same capability, that unique look into the market, where we can see how deep can you trade a bond in the market, right now in this moment, without impacting price — what is truly available in the market. And that's a true challenge for clients today, looking at a market that's price request. Again, it's not on demand, so products that we are developing really will show levels of liquidity, both on the buy side and on the sell side of the market — so unique attributes that clients, in a sense, have in high demand right now.

The other point to make around transparency in data, as the market further electrifies, it desperately needs the data to actually electrify. Automated tools, automated trading, automated dealer quotes, they're all driven off of a data element. There's not always a human behind this modeling, so the data becomes that much more critical to the market and to the evolution of the market.

If you look at the market, and we've touched on how diverse the product set is and how complicated it is to source liquidity, the challenge for large institutional investors is that expense ratio, really dealing with how to lower costs for our end clients, but still achieve the same level or even higher execution quality. And that's electronic trading — it has proved out in other asset classes, and that same demand is rolling into the fixed income market, driven by automated solutions, where you can upload a list of bonds and send it in the market and have it execute with very little human interaction.

Hong: Similar to the journey we've taken at Goldman to improve our client service through innovation, many of our clients are also deriving efficiency gains and enhancing their capabilities leveraging technology.

Much of what we discussed today is related to liquid bonds, where electronic trading has improved market efficiencies and we have made a lot of progress on data and analytics. There are useful tools and solutions like the ones Chris highlights which our clients leverage every day, and there is much more innovation to come. For example, it is highly resonant that our clients seek improved transaction cost analytics both pre- and post-trade.

Further down the liquidity spectrum or for larger sized trades, a data-driven approach for things like best execution can be difficult because there is insufficient data available.

This is where we continue to invest in differentiated and proprietary solutions jointly with our clients to improve processes for blocks and voice trades.

I think it's important to encourage our clients to continue to invest, develop and evolve along with us every step of the way. Technology is an enabler and as I like to say, market structure evolution is never complete; it's a continuum.

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