Corporate Bond Trading:

Building Networks, Realising Liquidity

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Executive Summary

Regulators are challenging the traditional, principal-based market making model for corporate bonds, forcing an end-game that will see bonds trade like stocks in a transparent, equity-like exchange framework. In the short term, the effects of such wholesale change will be negative. Secondary market liquidity will be damaged and become even more fragmented than it already is. Despite a recent primary market issuance boom, secondary trading liquidity is spread across a plethora of names in a global market place where anyone, from the retail investor to the most heavily regulated mutual fund, can trade. A Japanese pension fund trader may well be interested in a Bolivian bond but how does he find the seller? Does he even know that this is the right trade for him? These are the challenges in a global market that is a mile wide and an inch deep.

As the Volker Rule and new capital adequacy rules punch a hole in bank balance sheets, the appetite of over-the-counter dealers to warehouse corporate bonds to facilitate secondary market liquidity has become dampened. This is turning the spotlight onto the importance of networks and the ability to draw latent liquidity on buy-side books out into the realm of trading possibility. This will be essential if primary markets are to be supported and corporates are to have the access they need to public funds to propel their growth. We are already seeing new all-to-all markets emerging, networks that allow institutional investors to find one another and bring natural, dark liquidity out into the light of day.

Alternative primary market structures are also being discussed; ones that could see issuers list single debt securities of varying maturity, instead of multiple bonds on demand. Listed debt securities could be drawn down from whenever funds are needed and would trade in the open market, subject to the two-way whim of investors. New pricing technologies are also emerging. Using historical trade data and complex predictive algorithms, they attempt to simulate the gut-feel and intuition seasoned traders rely on when pricing bonds. This will provide a much needed benchmark which will in turn improve liquidity.

Should the secondary market succeed in its revolution, buy and hold investment strategies will give way to trading. Turnover will increase as buying

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and selling the cash positions become the more effective way to express an investment view and to hedge. New competitive elements will emerge, spreads will tighten, and execution quality will become measurable.

The TABB Group Vision Note *Corporate Bond Trading: Building Networks, Realising Liquidity* is based on conversations with corporate bond dealers, agency brokers, interdealer brokers, exchanges, MTFs, multi-dealer trading platforms, data providers, technology firms, trade associations, investment managers and hedge funds. The study provides a detailed description of how regulation is forcing change in the way corporate bonds trade globally and explores the new competitive elements and technology solutions that will step up to provide alternatives to the existing status quo.

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