Managers shifting to new reality of fixed income

Firms now set prices to get better execution and increase returns

By RICK BAERT December 8, 2014

The fixed-income trading desks of larger money managers are setting prices of trades instead of discovering them while applying the electronic trading skills of their equity brethren to adapt to the changing nature of the secondary bond markets at a time of lower liquidity.

With federal regulations reducing the amount of inventory that investment banks are holding and putting overall liquidity at a premium, managers like BlackRock (BLK) Inc. (BLK), State Street Global Advisors and AllianceBernstein (AB) Institutional Investment Management are taking responsibility for price-making, particularly on credit markets. They’re also using equity traders with experience in electronic trading to use bond automated-trading systems.

The changes, managers say, are intended to get better execution in the bond market and, ultimately, to help improve fixed-income returns.

“The market-making model is gone,” said James Switzer, global head of credit trading, AllianceBernstein, New York. “Now you’re looking at an agency model. Now, the broker is basically acting as a bookie. ... The toughest thing in the market on the buy side is price discovery. Traditionally, the market has used the Street as a crutch to price credit. Now the responsibility falls on us to set the price, not wait for it to be set.”

Current changes in fixed-income trading have revolved around three points, said Christopher Race, senior managing director, global head of trading, SSgA, Boston:

1) changes in work flows;
2) leveraging data to find best execution; and
3) the “electronification” of the trading desk.

Those three “create more leverage on the trading desk, where they’ve moved from price-taker to price-maker and liquidity provider,” Mr. Race said.

The implementation of regulations — like the Volcker rule banning banks’ proprietary trading, as well as having to back fixed-income inventories with increased capital under the Dodd-Frank Wall Street Reform
and Consumer Protection Act and Basel III — has made it tougher to trade bonds. And while many managers saw this coming when Dodd-Frank was passed in 2010, it's now — as the threat of rising interest rates hangs over the market — that the impact of the regulations is being felt.

“I think the writing is on the wall,” said Kevin McPartland, principal and head of market structure, Greenwich Associates, Stamford, Conn. “The Federal Reserve has given a lot of indication that rates will be rising, and when it does there won't be a sell-side buffer. It all comes back to that. Managers realize that and this is how they're taking action to deal with it.”

Richard Prager, managing director and head of BlackRock's trading and liquidity strategies group, New York, agreed. “There have been a lot of catalysts to accelerating the changes in trading. The big ones are the change in regulation and the amount of risk capital banks have on inventory. There's a need to change. Let's face it, the plumbing of the (over-the-counter) market is a bit creaky.”

Work in progress

For many money managers, the shift in the trading desk is still a work in progress. “The desk has gotten bigger and is now staffed by young but experienced people from hedge funds, proprietary trading desks, even the sell side,” said AllianceBernstein (AB)'s Mr. Switzer. “That's where electronic trading comes in. But in general, the buy side's not ready for this yet. Most trading desks haven't evolved; they still rely on the Street to set the price.”

Those trading desks that have become price-makers have done so by tapping traders from the sell side and from hedge funds, where they have experience in pricing bonds, as well as using the expertise in electronic trading among equity traders.

“Larger money managers are reorganizing their overall trading desks, with global heads of trading coming from the equity side, not the fixed-income side,” said Frank DiMarco, director of fixed-income brokerage at Investment Technology Group Inc., New York. “The equity traders are very sophisticated in terms of using electronic venues, so they're dipping back into their equity talent to assist the fixed-income side to move more into electronic trading. They're trying to help automate their fixed-income equity strategy by using equity people that have grown up with electronic trading, so they can assist the fixed-income side in the transition from voice-based trading to more electronic.”

"Going into high gear"

Putting more equity, hedge fund and sell-side people on fixed-income trading desks is “going into high gear now,” said Mr. McPartland of Greenwich, adding the inventory constraints caused by regulatory limits on the banks is “the macro issue. The micro issue is that there are new electronic bond venues, but even those with traditional bond traders still need to have the knowledge of a bond's true value, and not
rely on the sell side telling them what the value is. It used to be a trader called three dealers and got the quotes, and from that you took the best price. But now traders and regulators are looking more at best execution, so you need to take a good look at prices. Managers are finding that they can set the best price themselves."

The changes on fixed-income trading desks have been made, in some cases, to bring together the trading functions of equity and currency desks along with bonds, said SSgA's Mr. Race. "We took the asset-class question and started to view it instead as what's liquid and what's illiquid," Mr. Race said, with electronic venues used for liquid assets and voice-based trading with illiquid assets.

At BlackRock (BLK), "we have some home-grown traders," said Mr. Prager. "We've also hired some sell-side people. Then we have our new breed, which is young, very smart, very capable folks brought up around electronics. All of this speaks to having people who are comfortable being price-makers and not price-takers. That's the punch line."

Mr. Switzer said AllianceBernstein (AB) traders sit in with sector portfolio manager teams and discuss the top/down allocation to risk. "Now the trader knows our opinion, and so it's up to them to make it happen. He does consult with the portfolio managers beforehand, but if the trader has to wait for the portfolio manager to give the OK on a price, nowadays you'll never get anywhere."

Making bond traders more nimble and knowledgeable ultimately will show itself in better returns, although ITG's Mr. DiMarco said that impact won't be seen for a while. "Unfortunately in the fixed-income business, transaction cost analysis and measurements to see the impact on alpha dramatically lag the equity world," he said.

“There's really a lack of measurement tools in fixed income to see the immediate success of a program."

Still, BlackRock's Mr. Prager said, improved returns will be seen. "It's all about performance," Mr. Prager said. "You have to have a disciplined investment process, and part of that is role clarity between traders and portfolio managers. Trading hadn't been seen before as an alpha source and a cost. But with the evolution of all markets — not just fixed income — we've had to evolve our trading ... change in the markets makes you think of performance in a different light. You think about holding periods, the cost of liquidity. All of that needs to be taken into account when looking at improving performance."

The cost of making changes on trading desks has been borne by money managers, but the efficiencies resulting from the changes will save them money in the long run. “In the short term, these changes might create additional costs, but over the long term the shift should result in a more efficient and automated execution function,” Mr. McPartland said.