BondCliQ

The Inside Market **September 2019**

As a new solution provider, we intend to make your assessment process easier by clearly and consistently articulating our approach to improving the US corporate bond market through our monthly blog post (The Inside Market). This post will touch on just a few topics, but there will be many more to come. To be clear, **this forum WILL NOT be used to talk in detail about the BondCliQ product**. We have a nice website for that, thank you (www.bondcliq.com). Your feedback, criticisms, thoughts, and, of course, encouragement are welcome. Feel free to comment openly or directly to me (chris@bondcliq.com).

A Better Corporate Bond Market: Human Beings Required

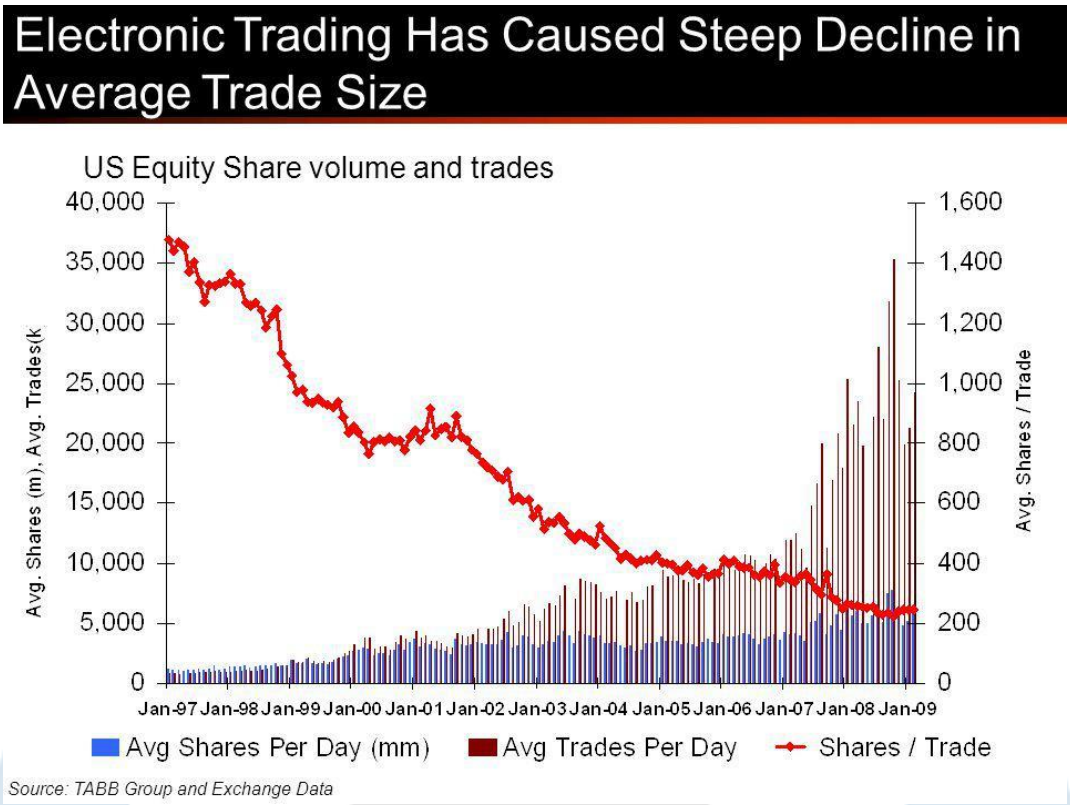
Sci-Fi books and movies provide a glimpse into the potential future, but there are two different approaches. Some project an existence where computers and technology play a dominant role in almost every aspect of life, creating a world that is unrecognizable from what we know today. Things are neat, clean, and simple because robots and push-button solutions take care of everything from food to travel.

The other type of sci-fi presents a world that is complicated by innovation. While **new technology provides benefits, it also creates new problems and dilemmas that require human intervention to solve**. Given what we've seen in the last 35 years, the more complicated version of the future is far more plausible.

Late last week, a Bloomberg article discussed the potential for technology to "replace traders with algorithms and replace salespeople with APIs." The goal of this effort is to move big corporate bond trades from the phone and chat to a screen, just like trading in stocks, currencies, and futures. This is not the first article of its kind, but typical of a widely held view that "going electronic" is the panacea for bond liquidity. Those that evangelize this idea often do so while omitting critical details about the real impact of electronic trading on financial market structure. Instead, we are presented with a neat, clean, corporate bond market of the future that requires little to no human support. **The real story on electronic trading in financial markets is far more complicated.**

Blockbuster

One undeniable fact is that electronic trading does not solve block liquidity issues. That is not to say that a block can't trade electronically; they do, just not in block sizes. This chart tells the real story:



Removing a salesperson from the trading process has an obvious consequence: minimizing transaction sizes. Why? Because when you attempt to trade large size electronically, the market moves away from you. Without the ability to bi-laterally negotiate a block trade with a human being, buy-side institutions must break down their block orders into micro-lots to hopefully avoid detection on electronic platforms.

Swimming with Sharks

Another key aspect of electronic trading that is never mentioned in the discussion on the future of corporate bond markets is the predatory environment that follows "going electronic." Here is a description of how equity markets have reacted to buy-side algorithms that are used for block trading:

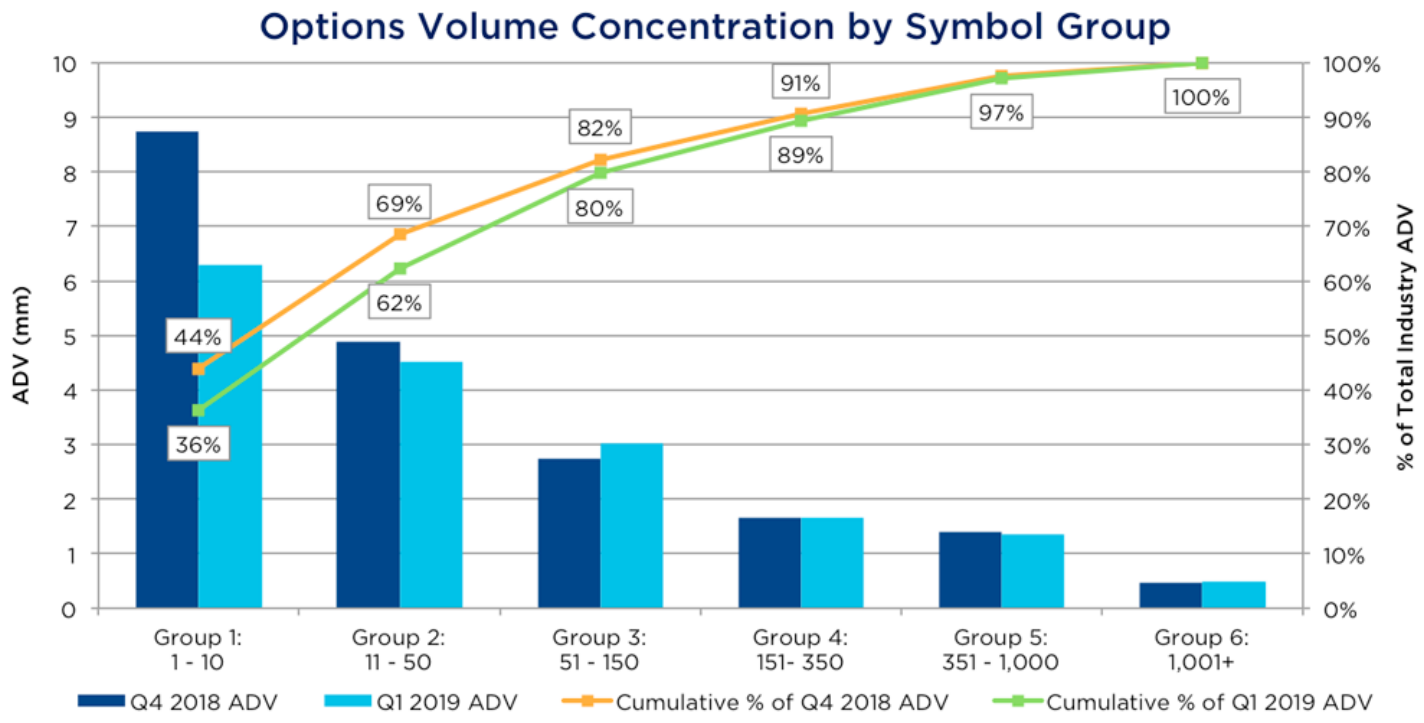
"Buy-side firms use algorithmic trading systems to break up large orders into much smaller ones and feed them steadily into the market so as to reduce the market impact of large orders. In order to detect the presence of such large orders, HFT firms place bids and offer in 100-share lots for every listed stock.

Once a firm gets a "ping" (i.e. the HFT's small order is executed) or series of pings that alerts the HFT to the presence of a large buy-side order, it may engage in a predatory trading activity that ensures it a nearly risk-free profit at the expense of the buy-sider, who will end up receiving an unfavorable price for its large order. *Pinging has been likened to "baiting" by some influential market players since its sole purpose is to lure institutions with large orders to reveal their hand." –* Understanding HFT Terminology

Easy-E

According to the Bloomberg article, "Thirty percent of all bond trades are electronic, an all-time high." FINRA does not track or publish pure electronic trading volumes for corporate bonds, so this may be more of an opinion than a factual statement. Missing from this and other declarations of corporate bond electronic growth are the details. **What, exactly is trading electronically?** We do not see the details because the true e-trading narrative may not be as exciting as we've been led to believe. **What if a large percentage of corporate bond e-trading volumes were comprised of recently issued bonds and short duration (<7 years) investment-grade paper?** These areas of the market have historically not had liquidity issues, so the net impact of electronic trading could be improving execution efficiency in bonds that are easy to trade while freeing up human traders to focus on more difficult, higher value transactions

A quick examination of the highly electronic US options market illustrates that very few contracts make up most market volumes. In fact, the NYSE reported that options on SPY accounted for nearly 20% of options volume for 2018.



The efficiencies achieved through electronic trading have major benefits to all market participants. However, evidence shows that these benefits can only be applied to areas of a financial market that have certain attributes (large float, good credit quality, known name). Algorithms and APIs can't solve for execution for bonds that don't have the same attributes, but humans can.

Faster isn't better

While it is possible to trade institutional orders faster with electronic trading, we must ask if the efficiency gains offset the environmental consequences? For bonds with the right attributes, yes, but those bonds are a fraction of the broader universe of securities. If the goal of innovation is to improve trading conditions, then we must find the proper balance between humans, technology and data. Replacing one element (humans) and relying too heavily on another (technology) will not produce a healthy market environment. **BondCliQ is contributing to the formation of a better market by improving the accuracy, reliability and access to pre-trade institutional pricing information.** This data immediately helps human beings make better trading decisions and supports the development of more electronic trading. The right future for the corporate bond market is one where both humans and technology live long and prosper.

-Chris White (CEO – BondCliQ)