Can Bonds Go Electronic?

Alternative trading systems promise to bring stock market transparency to the Canadian fixed income market.

FIELD NOTES

BY SCOT BLYTHE

Bonds are different from stocks, to borrow from F. Scott Fitzgerald. While stock prices and order volumes are flagged right away during trading, giving investors buy or sell signals, bonds have long lacked that kind of price immediacy. Now, Alternative Trading Systems (ATSs) are bidding to deliver much of the transparency of stock markets to bond trading by engineering a real-time, tradeable bond ticker. But there are catches.

Obviously, there are vast differences between the two markets, not the least of which is their respective sizes: last year, more than $3.8 trillion in Government of Canada bonds changed hands; trading on the Toronto Stock Exchange, in contrast, amounted to $640 billion, despite the TSX's market capitalization of $1 trillion. The Bank of Canada pointed out in a 2000 submission to the Ontario Securities Commission that "the average number of trades a day in Canada rarely exceeds 500 in fixed income markets while the equity market observes tens of thousands of trades a day. The dollar value of fixed income trades on average are in excess of $5 million, relative to the average size of TSE trades of approximately $38,000."

Past attempts to bring the price transparency of equity markets to the bond arena initially caused securities regulators to baulk. For larger investors, price transparency may come at the expense of best execution, as transparent price signals make large orders harder to fill. More—rather than full—transparency is the goal of Canada's debt market participants. Why full transparency doesn't work lies in the unique nature of debt markets.

Unlike equity markets, there's no central marketplace for bonds, simply dealers trading out of their own inventory. Until now, there has been no equivalent to the TSX's or NASDAQ's data feeds to provide price discovery. Only recently has CanPX, a joint venture of 13 members of the Investment Dealers Association and four inter-dealer brokers, stepped forward to provide data software systems for the most liquid Government of Canada bonds.

The cost of trading may also discourage more widespread participation in the bond market, especially among smaller non-institutional investors. Additionally, economic information has already been factored into bond prices to a large extent, making it hard for buyers to gain any kind of informational advantage. Perhaps the most critical difference, however, is the emphasis put on price discovery versus liquidity: equity investors seek price bargains, while liquidity is perhaps more important in the bond market, especially because retail investors are few.

There's certainly a lot of liquidity inherent in the current trader-dealer bond system: on average, two new fixed-income issues are floated each week. On the TSX, $8.6 billion worth of new listings debuted in 2002, while on the bond side the federal government alone auctioned off $61.4 billion in new debt. Add to that the regular issuance of short-term notes, such as banker's acceptances and commercial paper, and you have a highly liquid market of buyers and sellers.

Price transparency has motivated a tentative embrace of electronic bond-trading. According to Maureen Stapleton, executive director of fixed income at UBS Global Asset Management in Toronto, bond sellers have had "a pretty clear idea of where things were and what kind of flows were happening without having to show your hand in any way." Buyers, on the other hand, don't have access to that information.

Traditionally, bond investors have shopped around by phoning a succession of bond dealers. In so doing, they risked revealing their intentions. Now, there are two electronic trading systems in Canada, CanDeal

Scot Blythe is investments editor at Advisor.ca, a web site for financial services professionals in Canada.

PHOTO BY JOSEPH MARRANCA

> "One institutional investor told us they like anonymity when they're selling, but when they're buying they want to know who they're dealing with."

and CBID, offering better transparency and execution without multiple phone calls. As electronic platforms, CBID and CanDeal are relative newcomers, having received their regulatory approvals in 2002. In the U.S., electronic communications networks (ECNs) first emerged in the late 1990s.

"Within 15 to 20 seconds you can get a price back from four dealers simultaneously" using the CanDeal system, says Mark Carpani, fixed income funds manager at Mulvihill Capital Management. "That's physically not possible over the phone."

Jacques Prevost, head of quantitative analysis at TAL Global Investment Management, says the CBID system "is a much truer market system, more akin to the TSX, which is open to anyone who wants to put a trade through and not [be] limited to five dealers."

While the TSX provides one model of price discovery, it was unsuited to the bond market, as the Canadian Securities Administrators found out when institutional investors, the Investment Dealers Association and the Bank of Canada objected to its first concept proposal. When the ATS rules were finally approved in November 2001 Doug Hyndman, chair of the CSA at the time and current chair of the British Columbia Securities Commission, acknowledged that equity and fixed income markets had to be treated differently when it came to price transparency.

With too little transparency, bond investors may not get the best price. With too much transparency, they may not get the best deal, as liquidity dries up and only partial orders are filled. The percieved benefits of transparency also hinge on what side of the market you're on."One institutional investor told us they like anonymity when they're selling, but when they're buying they want to know who they're dealing with," says Sang Lee, an analyst for Celent Communications in Boston.

Transparency is just one of a number of complexities inherent to bond trading, says Phil Wright, vice-president of CanDeal. Others include liquidity, operational efficiency, risk management, and best execution. "Every system will have some type of pricing or transparency component where the client is getting some view of the marketplace," he says. As that transparency component comes into play, however, risk management becomes crucial, since the spread between bidding and offering prices would widen and dealers would find it harder to hedge their exposure in the futures market. The result, he says, would be a shallower bond marketplace.

While there are drawbacks to every system, a host of infrastructure issues are resolved by electronic trading, most importantly the compliance aspect. Certainly electronic trading cuts down on human error, such as a \$15-million order misheard as a \$50-million one.

There has been a precedent for electronic bond exchanges south of the border: the late 1990s saw a profusion of bond ATSs crop up in the U.S., taking their cues from the success of equity ECNs during the halcyon days of the Internet, Lee says. He says many of them failed to provide enough liquidity and subsequently perished.

While electronic volumes are increasing, institutional dealers are still doing more than 90% of their trades over the phone. As the U.S. experience shows, fledgling electronic markets need liquidity to grow and thrive, Prevost cautions. "There is liquidity, but it's hard to judge how big and deep it is," he says. While he concedes that electronic bond markets are an experiment that's just beginning, he predicts that "at best, one or two ATSs will remain standing."

Many institutional traders may also find it hard to give up their relationships with their preferred dealers, especially if it means signalling their intentions to the market at large.

That said, there's still a final hurdle for electronic trading to overcome: breaking the telephone habit. "It will not be as easy as turning the equity market into an electronic equities market" was, says Celent's Lee. ■