FIXED INCOME

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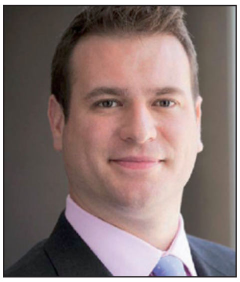

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From Crunch to Crisis: Data Quality Remains Key

After an initial rally following the credit crunch, the fixed income markets have again become a quagmire of volatility and uncertainty. But while traders can't control the performance of sovereign economies, they can control how they source, use and manage data to gain more control over their risk, and use that to identify opportunities in—and beyond—bonds.

In spite of—or perhaps because of—uncertainty created by the sovereign debt crisis in Europe, fixed income traders and investors are stepping up their participation in the markets, seeking out new opportunities for exposure to higher returns, and are increasing their focus on data quality to support more profitable trading and risk management, according to panelists and audience polls during a recent webinar hosted by *Inside Market Data*.

At the time of last year's webcast on the same topic, the fixed income markets seemed on the road to recovery. Since then, European sovereign debt has been plunged into crisis, culminating in Greece's default, and even prompting Fitch to revise its outlook on the UK from stable to negative, indicating a slightly greater than 50 percent chance of a downgrade within two years.

"We are seeing continued dollar-dumping, keeping yields at historic lows, so the fixed income markets remain in a precarious position, having previously shown signs of recovery and increased volumes," said Christopher Gersch, director of portfolio management at Chicago-based Altimus Capital. "But scandals around European sovereign debt and ratings downgrades have put the brakes on any return to business as usual… and the predictions we have are that the bond market will continue to be volatile for the next six months."

Yet bonds are still in demand, and demand for data continues to rise, to support new analytics as trading practices adapt to changing markets. Almost two-thirds of respondents to an audience poll said they need more and higher quality data to support their trading activities, regardless of whether they are more or less active in the fixed income markets than one year ago [*see Fig. 1*].

"Certainly we've seen the actors in the market becoming much more sophisticated in the way they use data," said Alexander Sedgwick, head of research at bond trading platform MarketAxess. "Traditionally, we had seen a lot of research folks and people looking at fixed income data very much from a macro perspective, trying to understand the broad flows in the market. But there has been an interesting shift over the past two or three years both within best execution and on trading desks, because we are seeing a lot more interest in using data to drive specific trading decisions… at a very detailed level."

Greg Carlin, vice president of securities evaluations at S&P Capital IQ, told listeners that increased volatility is matched by increased availability of data, but is also driving demand for more information. "We are experiencing a time when we have greater access to trading data, so even though the markets are certainly volatile, they are to some degree more transparent than they have been over time," Carlin said. "Our driving principle with regard to anything we develop is that we need better quality fixed income data and we need more of it, and we are working on relationships beyond TRACE and the Municipal Securities Rulemaking Board, as well as exploring alternative approaches to valuation that provide more analytics and look at things more from a fundamental perspective—the outputs of which can be used for relative value analysis."

However, firms are maintaining a positive outlook on the market overall, as evidenced by just under 45 percent of the audience saying they increased their fixed income trading over the past 12 months, compared to around 26 percent saying they traded less fixed income. Indeed, according to data from fund flows data provider EPFR Global, investors committed a record $7.57 billion to bond funds in the second week of March, just before the webcast took place, driven by high-yield, emerging markets, municipal and mortgage-backed securities funds.

And there is some evidence that investors are moving funds to the US: The US Department of the Treasury's January data showed almost $95 billion in net purchases of long-term US securities by foreign investors and institutions. This may in part be in response to the influx of money into emerging market bond exchange-traded funds in recent years, which has made it difficult to transact the underlying bonds, Sedgwick said.

"If you look at emerging markets, I've seen numbers that suggest there has been $12 billion net inflow over the last two years into emerging market funds, compared to $2 billion on average for the three years before that," Sedgwick said. "Ultimately what that means is that these were wildly over-funded coming into this year, and a number of people are actively hunting for yield,

How have your firm's fixed-income trading and data demands changed over the past year?

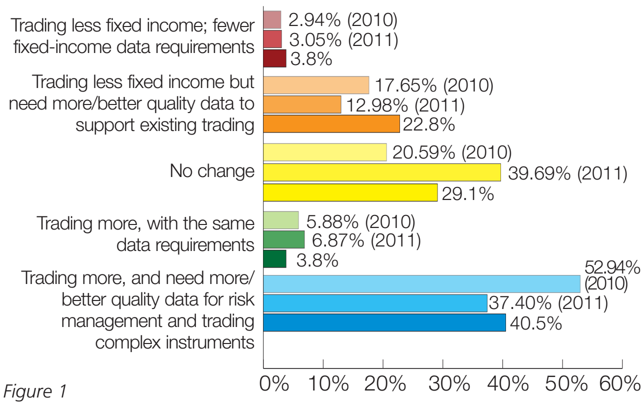

Figure 1

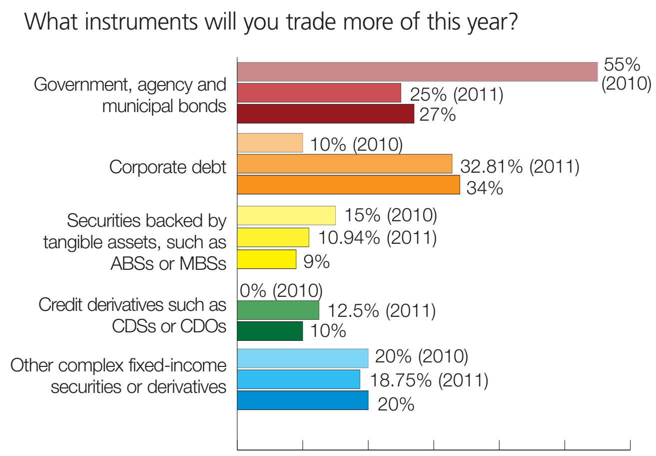

Figure 2

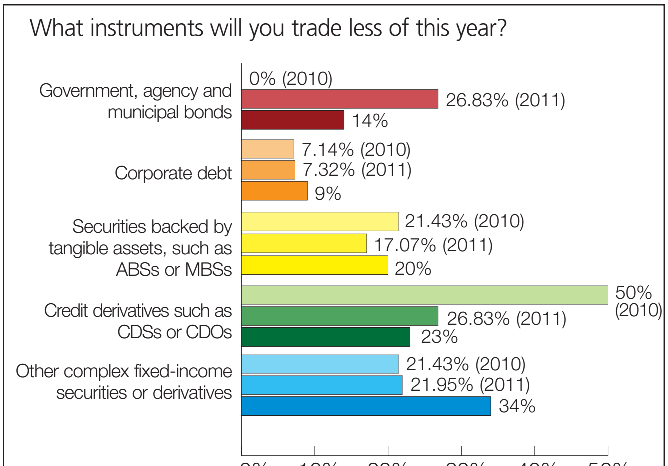

Figure 3

and are looking at asset classes like high-yield and—to a lesser but significant extent—corporate bonds. But they are finding it difficult to achieve meaningful yield without incurring significant duration risk."

In fact, corporate bonds and government securities topped the list of fixed income instruments that the audience said they are likely to trade more of this year, with 34 percent of those polled saying they would trade more corporate debt, and 27 percent saying they would trade more government, agency and municipal bonds—both slight increases over last year's predictions [*see Fig. 2*]. The popularity of asset- and mortgage-backed securities, as well as credit derivatives, declined slightly over last year, while demand for other fixed income securities or derivatives remained in the same region as for the past two years.

"We've seen a lot of muni bond buying in Europe, given the sovereign debt crisis, and given that there are still a lot of A-rated and AA-rated munis out there that are still in good shape and yielding more than US treasuries," Carlin said. "I would venture to say that in some cases, munis became a yield instrument for some time last year."

In fact, Ed Ventura, president of consultancy Ventura Management Associates, believes Europe's crisis could lead to more use of certain assets. "There's a lot of caution out there, but there's also the quest for returns," which may prompt firms to create derivative products around their holdings to increase their returns and reduce the risk inherent in their positions, Ventura said. "And bringing that back into the data realm, it becomes a question of what are the factors and attributes that will drive [market] behavior and allow firms to maintain a certain level of stability while focusing on returns."

But conversely, 14 percent of listeners said they will trade less government, agency and muni bonds this year, while nine percent said they will trade less corporate debt [*see Fig. 3*]. However, the biggest drop-offs were in the areas of complex fixed income securities and derivatives (34 percent), credit derivatives (23 percent) and securities such as ABSes and MBSes (20 percent).

"Given the overall trading environment and higher volatility, fund managers told us late last year that they are holding more cash and liquid bonds in case of an event where they become forced sellers. And we observed that while market liquidity has fallen overall, turnover—defined as the total amount traded divided by the total amount outstanding—was actually constant year-over-year for more recent bonds issued in benchmark size. As more of the market has crowded into these… what we saw at the beginning of this year was opportunistic participants looking for relative value plays using off-the-run bonds," Sedgwick said.

Opportunists are also looking across asset classes to other sectors that offer more value at specific times. "If I look at the assets we have under management and where we are shifting a lot of our [money held in] fixed income, we are going to cyclically-traded things like commodities," Gersch said. "As credit in terms of US personal debt grows on a monthly basis, we are going to have a credit bubble, so commodities plays are going to enable some great trading. And algorithms that we used for fixed income seem to be translating really well to the grain markets right now, so that's where we are focusing a lot of our attention."

And as traders seek more flexible access to an array of markets and asset classes—together with more widespread adoption of automated trading strategies—trading is inexorably moving away from voice-brokers towards exchanges and exchange-style platforms. According to one audience poll, the number of firms trading fixed income exclusively via voice brokers and specialist broker platforms dropped to zero for the first time—after a decline from 2010—while those using a mix of broker platforms, voice brokers and some electronic markets also declined to 11.1 percent, compared to 23.5 percent last year and 41.7 percent in 2010 [*see Fig. 4*]. In comparison, the number of firms trading exclusively on electronic exchange-style platforms continued to rise year-on-year to 22.2 percent (from 8.3 percent in 2010 and 14.7 percent last year), while those using a mix of exchange-style platforms and electronic broker platforms also rose to 27.8 percent (from 8.3 percent in 2010 and 17.7 percent last year)—though most still use an equal mix of execution venues.

"You can see a move to more electronic exchanges and more automation. But whenever you increase automation, you need to increase governance, and be able to normalize feeds and apply

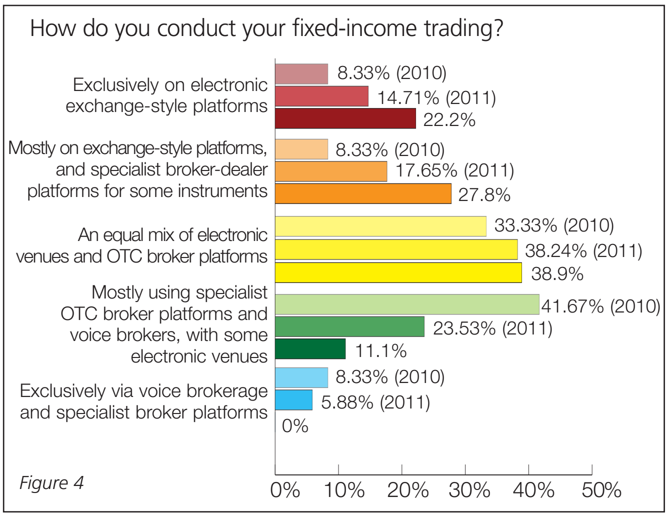

Figure 4

your algorithms," Ventura said. "It comes back to having that focus on understanding the data that you have and that you need, and knowing where to get it and how to make it meaningful for your particular enterprise."

Sedgwick said that—like the equities markets before them—block-size trades have fallen from comprising 60 percent of volume to 40 percent, while the number of round-lot-size trades have risen, as fixed income traders concerned with execution risk break up large trades into smaller orders. "As we've seen difficult liquidity in the market, we've seen a lot of flow gravitate towards electronic execution. A lot of that has to do with the fact that people see the ability to tap a larger liquidity pool via an electronic platform than they would be able to via voice, for example. When you see reduced dealer inventories and the need to find people to take on block-size trades, finding that deeper liquidity pool has definitely been attractive," he said.

However, despite Gersch's comments and a recent spate of data technology vendors releasing feed handlers and order-routing components to support algorithmic trading of fixed income assets, Sedgwick noted barriers to widespread adoption beyond the most liquid instruments. "There's a lot of interest in streaming markets… but people are coming to terms with the fact that this may not be possible—not just because there are legacy protocols in the market, but also because of the nature of the market itself," he said. "Equities, commodities, treasuries can trade via streaming markets, and the streaming prices allow for instantaneous execution. But in the corporate bond market, turnover is only around 80 percent—so not every bond trades even once a year… and that kind of market doesn't lend itself to streaming prices." Nevertheless, Sedgwick acknowledges that traders will seek to deploy tactics from other asset classes into fixed income markets, such as for "equity-like transaction cost analysis"—especially as data volumes increase. "To the extent that people in the market will want to do that, I think we're going to see a shift in terms of the technology needed to analyze fixed income pricing," he said.

Fixed income participants are also likely to see a shift in levels of automation around price challenges, to enable providers to handle these more efficiently in the face of increasing volumes of challenges—and to eliminate or reduce the effort associated with comparisons, where clients challenge a list of securities that another vendor may have priced slightly differently, Carlin said. Pressure from market and regulatory forces to supply more transparency will also drive change. "What we see in terms of changes in data demand over the last few years is that whereas it used to be enough to deliver a price then confirm that price by phone call, now it's 'Can you provide the price, provide supporting market data points, and by the way, how about the assumptions you made based on those points'…. And I think we'll see more demand for more underlying data as we go forward," Carlin said.

However, it seems the greatest value will come not from a single dataset, but from the ability to use more powerful analytics to correlate between different data sources and asset classes as participants cast a broader net to catch more information. "Participants in the cash markets who traditionally only looked at one or two sources of data are starting to branch out and realize that there are alternative data sources that they need to take into account. For example, we see a lot of people from the perspective of pricing and overall market dynamics looking at fixed income ETF trade prices through the day," as a proxy for actual bond

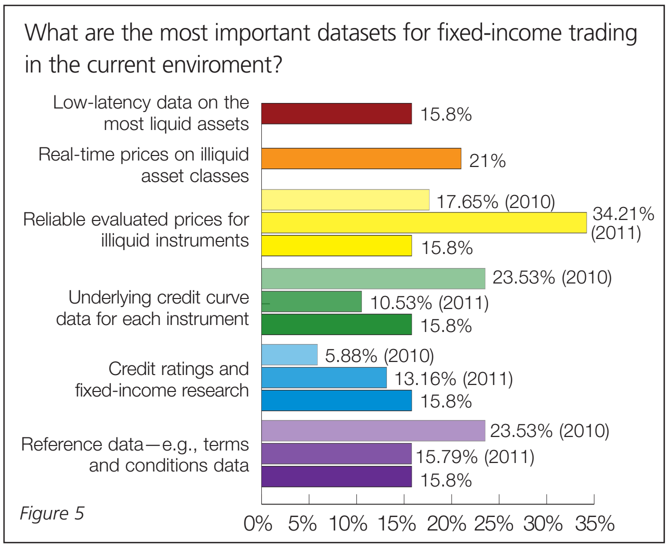

Figure 5

prices, Sedgwick said, reflecting the importance of real-time prices for illiquid assets, which 21 percent of the audience said is the most important dataset for fixed income trading, compared to low-latency data on liquid bonds and evaluated prices for illiquid assets, which each only attracted 15.8 percent of votes, and underlying curve data, ratings, research and reference data, which attracted similar weights [*see Fig. 5*].

Gersch also noted greater importance of related instruments, such as ETFs, especially when setting up algorithmic models that—as Sedgwick had already stated—may not be suited to the underlying bond markets. "For example, our programmers are incorporating iceberg orders based on ETF information, not the fixed income market itself—so being able to correlate assets is very important, and using that data to analyze and execute in the fixed income markets is something that you're going to see more and more," Gersch said.