



Beyond the Inflection Point: The Future of Credit Trading

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Prior to joining Flow Traders, Ramon spent the majority of his career in London, where he held various management roles in trading, sales and structuring, working for J.P. Morgan, Nomura and Lehman Brothers, among others.

Ramon holds a master's degree in Econometrics from the Erasmus University Rotterdam and is a CFA charter holder.



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Matheus joined Flow Traders in 2015 and has built a strong foundation in emerging markets and high-yield debt, and led the company's expansion towards US treasuries, inflation, mortgages, municipal debt and investment-grade markets. Matheus became Head of Fixed Income Trading in July 2018, and subsequently Head of Trading and Managing Director in March 2019.

Matheus holds a bachelor's degree in Economics (Finance and Operations Management) from Wharton School, University of Pennsylvania.



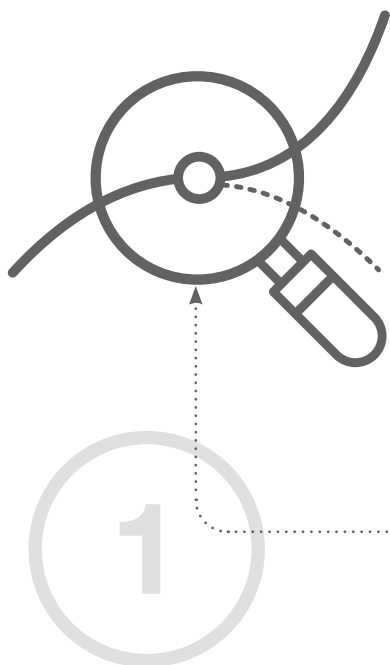
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Jasper joined Flow Traders in 2014 as a trader on the Fixed Income ETF desk. In 2019 he became head of the European Credit ETF desk. Since 2020 he has been Head of Fixed Income Trading EMEA, where he is responsible for the European credit, emerging markets cash bond and ETF desks.

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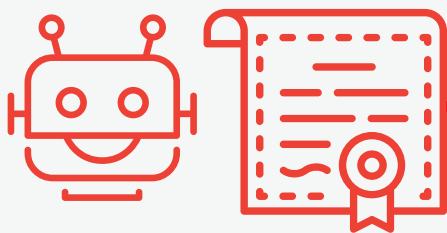
Key Findings



Credit markets are approaching the inflection point of electronic trading

Electronic trading in European credit has increased dramatically over the last few years, with 45% of € investment-grade (IG) credit now executed electronically, reaching 75% on a ticket-count basis. The COVID-19 pandemic has further accelerated this trend, with 64% of respondents in our survey saying they increased the amount of request for quotes (RFQs) on platforms.

This increase has contributed to the approaching inflection point of electronic trading in credit markets, comparable to what we have witnessed in other markets, such as foreign exchange (FX), US equity options and exchange-traded funds (ETFs). This transition is being driven by better pre- and post-trade information, the rise of algorithmic trading and new trading protocols being embraced by the buy- and sell-side. Initially driven by regulation such as MiFID II, it is likely that the regulatory landscape will continue to accelerate this electronic trading trend. According to our survey, the pending Central Securities Deposit Regulation (CSDR) means that the market is actively looking at the optimization of reporting and automation of processes to minimize buy-in risk and penalties.

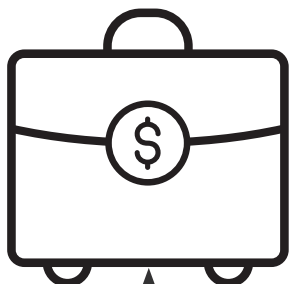


Algorithmic trading in bonds is gaining traction

Our survey indicated that the rise in algorithmic trading has improved the credit market, with 54% of respondents stating it has had a positive impact on the execution of odd lots. The majority of our respondents said that algos improved odd lots, larger blocks and relationships with dealers, while 33% of respondents also mentioned that algos have improved price discovery.

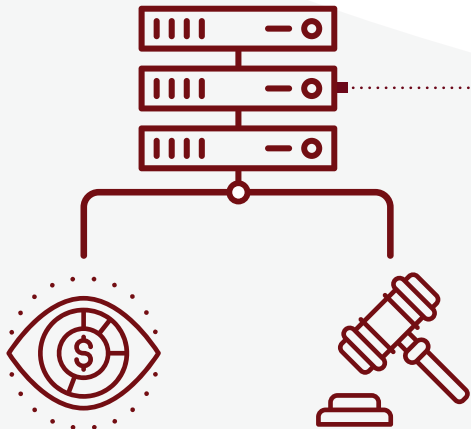
Indicators of past performance – such as historical hit ratios, best indicative prices on screen (pre-trade information) and relationships – still seem to dominate dealer selection. However, firm/live pricing is an increasingly important factor in the execution choice, as stated by 31% of respondents.

Key Findings



Portfolio trading seeing significant growth in European markets

Most survey respondents see major benefits in portfolio trading (PT), most notably to save costs, save time and ensure certainty of execution. Existing users indicated that their usage of PT was up 50%, with PT now representing around 6% of the total credit volumes traded daily in Europe and the US. In 2019 this was 0% in Europe and around 2% in the US. Currently, there doesn't seem to be a single common way of consuming PT axes. While these are also available in a limited capacity on third-party platforms, 41% of respondents said they would like access to the dealer portfolio axes/ interests to be able to target quicker and more efficient execution.



New trading protocols on the rise

Investors are undoubtedly interested in using trading strategies and new trading protocols, such as auctions, matching platforms, firm prices, two-way pricing/request for market (RFM), PT, and central limit order books (CLOBs) via dealer pricing API protocols. And there seems to be a clear preference for trading protocols that provide pre-trade transparency and execution certainty, and address concerns around data leakage such as firm/live prices and RFM. The majority of respondents (52%) measure execution slippage by reconciling executed prices and comparing them to pre-trade indicative or composite prices, and this analysis becomes even more efficient if reconciliation is based on firm prices.

In addition to the increase in new trading protocols, there is room for additional platforms and direct pricing, according to 37% of respondents. The latter is limited by the order management system (OMS) and execution management system (EMS), as well as the technology spend. Our survey also indicated that liquidity trees defined as prices by size bucket and portfolio axes are also on the mind of investors.

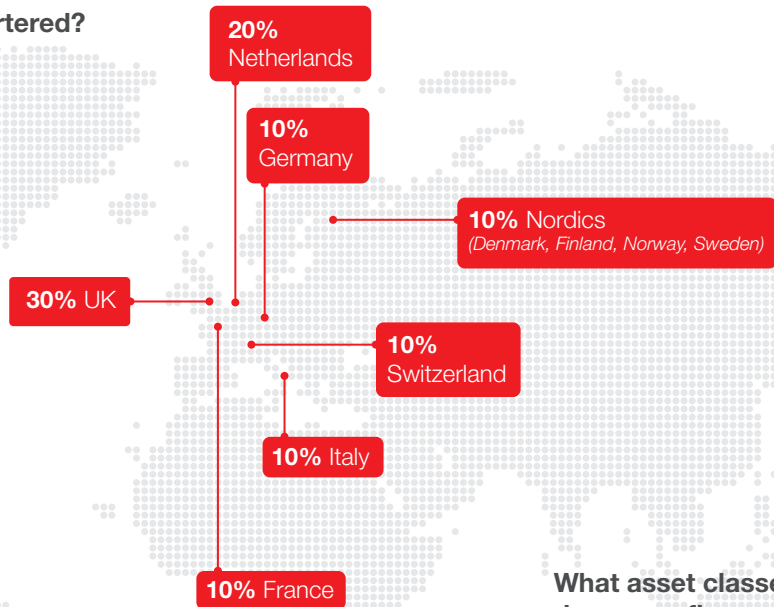
Methodology

In the third quarter of 2021, WBR Insights surveyed 100 Heads of Trading and similar roles from asset management firms across Europe to find out what they thought of credit market structure, the future of credit execution strategies, and PT.

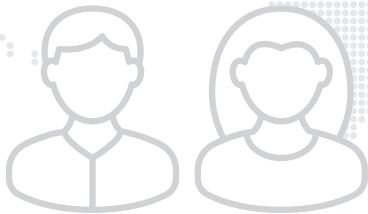
The survey was conducted by appointment over the telephone, and the results were compiled and anonymized by WBR Insights and are presented here with analysis and commentary from Flow Traders.

The goal of this whitepaper is to provide greater insights and understanding into how the credit market structure and execution strategies are shaping results across Fixed Income firms.

Where is your company headquartered?



Which of the following best describes your job title?



- 29% Head of Fixed Income Trading
- 22% Director of Fixed Income Trading
- 10% Head of Derivatives
- 10% Head of Credit
- 10% Head of Bonds
- 10% Head of Rates
- 9% Head of Emerging Markets

What are your organization's global assets under management in US dollars?



- 32% \$250bn to \$500bn
- 21% \$10bn to \$50bn
- 19% \$10bn or less
- 17% \$100bn to \$250bn
- 11% \$50bn to \$100bn

What asset classes does your firm currently manage?



- 100% Equity
- 88% Fixed Income
- 58% Private Equity
- 39% Foreign Exchange (FX)
- 22% Real Estate

Q&A with Flow Traders

■ How has COVID-19 impacted the credit markets?

We have seen a significant increase in the number of tickets traded electronically over the past year; in € investment grade (IG), for example, electronic trading is well above 40%. And while high-yield (HY) and emerging market debt (EMD) have a much lower electronic execution rate, we have still seen an uptick in electronification in these areas and expect it to continue to increase. The size of individual electronic trades is also growing; where in the past tickets of €250k-€500k were predominantly executed electronically, now it is not uncommon to see RFQs of €1 million or more.

■ What do you think is the future of credit trading?

While in the past credit markets could not be compared to other asset classes, this seems to be changing as a consequence of electronification and algorithmic trading driven mainly by market regulation and the penetration of non-bank liquidity providers such as Flow Traders. What has become clear is that we are close to the inflection point of electronification, resulting in more efficient and transparent execution. Looking at the technology developments we have seen over the past 10-15 years in other classes, such as equity index products or FX, we can expect to see similar developments in bond markets. Once we are past the inflection point, we expect to see electronic trading volumes developing by at least a multiplier of three, or higher.

■ What do you think will be the impact of algo trading on credit markets?

Applying our advanced algorithms in bond trading has enabled us to absorb all available market information and arrive at the most competitive price. Additionally, it allows us to quote on average within five seconds, leading to more efficient execution. If algo trading continues to increase at this pace, this will lead to a market equilibrium where information is immediately reflected in the price, leading to the best price for the investor.

■ What do you think will be the main driver for dealer selection in the future?

We foresee that firm/live pricing markets will dominate the credit market. With firm prices being updated virtually every second, we can provide certainty to the investor that 'what you see is what you get' and that this is the best possible price reflecting the current market. The buy-side already uses firm prices as a factor but it will become increasingly more important for decision making.

■ What is your view on the type of protocols that will be used in the future?

We believe all protocols that promote pre-trade transparency and cost efficiencies – such as firm prices, requests for two-way markets, and CLOBs – will increase in volume and importance. We think that two-way markets will also solve some of the concerns the buy-side has around information leakage just as we have seen in ETF markets. Additionally, we believe PT will continue to be an important protocol.

■ Do you think there is room in the market for new bond venues?

We believe that competition among venues and new platforms has a positive impact on the market in general. It drives innovation, which leads to new trading protocols, an increase in electronic execution rates, and a rise in more sophisticated auto-execution mechanisms, as well as driving down direct and indirect execution costs.

■ What are the major benefits of portfolio trading?

The benefits of PT are certainty of execution, cost savings, and transparency. PT allows end investors to receive a fair and competitive price for all their bonds, including their illiquid ones. In our opinion, the all-or-nothing protocol is one of the more important and innovative concepts in PT. Increasingly, other asset classes within Fixed Income are being used for PT, such as £ credit, as well as large mixed portfolios consisting of rates and credit products.

The ETF ecosystem will also add additional liquidity to the credit markets, as a lot of bonds are traded by ETF market makers on the back of their Authorized Participant (AP) activities. As ETFs are used as hedging tools for PTs and they are traded without going to the bond market, such as on exchanges, this means liquidity can also enter the bond market in this way.

■ What are the portfolio trading market developments in Europe and the US?

According to our estimates, PT in Europe has grown from virtually nothing to around €16bn of executed volumes per month in just two years, representing around 6% of total trading in European credit markets. This growth was already evident in the US, and we expect that the increase in executed volumes will continue to grow in both regions to at least 10% of the total market.

PT trading is still dominated by IG, but we also see fast growth in HY and EM. We also embrace the initiatives of the venues to automate trading processes. Where in the past PTs were predominantly priced via sheets and negotiated in chats, we now see a clear trend towards electronic methods ways of execution. Additionally, the size of trades has also increased and it is now not uncommon to see trades above €500 million.

■ The Central Securities Depositories Regulation (CSDR) implementation is on everyone's agenda. How do you think this regulation will impact the market?

We expect that CSDR will affect liquidity, especially on the offer side. This will increase the importance of dealers, who are providing constant liquidity and who have substantial bond inventories from axes. Past settlement performance and dealer relationships will increase in value for buy-side investors, as the penalties for failing settlements and buy-in risks will be very costly.

Chapter One: Credit Market Structure in 2021

In the past, the most likely scenario at a credit trading desk would have involved rushed phone calls, a trader scrawling a price into a notebook and a portfolio manager reliant on bank or broker-dealer balance sheets.

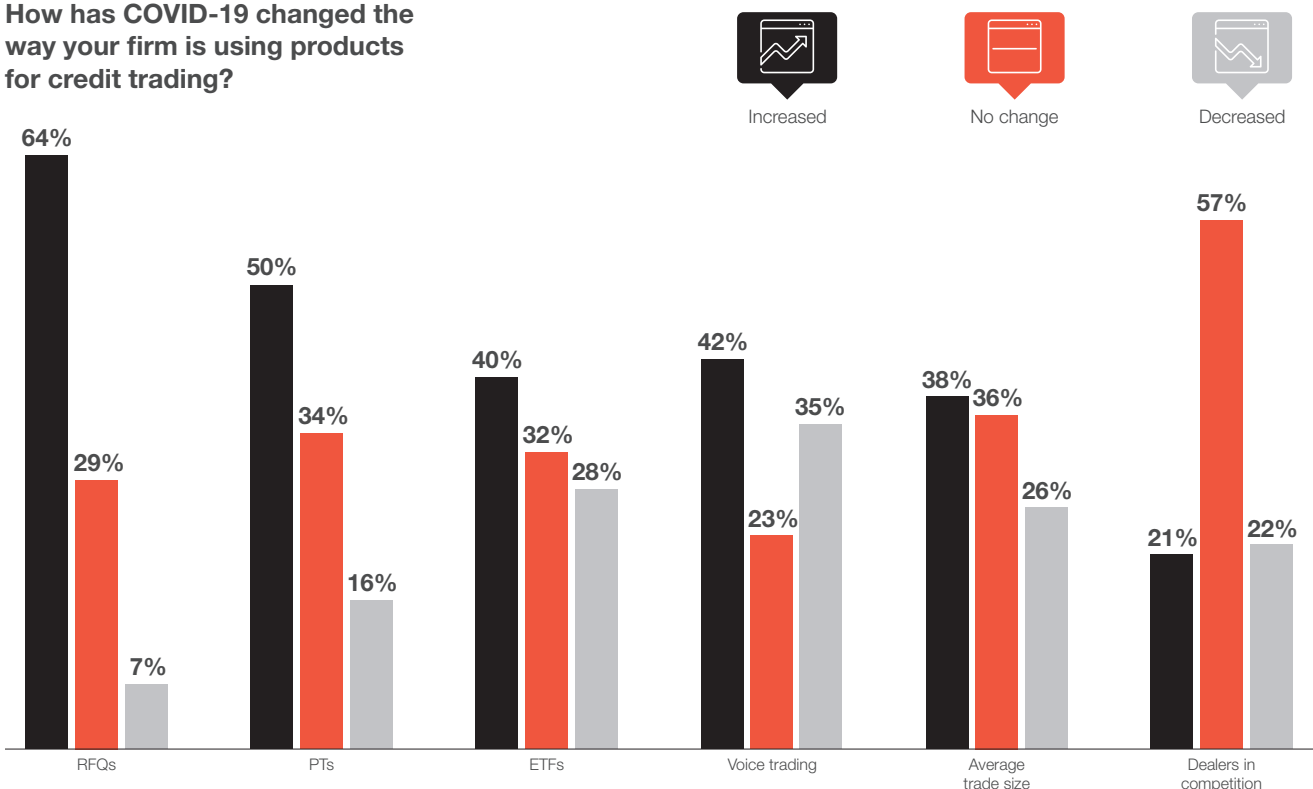
While historically credit trading has been mostly bilateral, bespoke, and largely arranged by phone or Bloomberg messages, some portfolio managers tried using an electronic RFQ platform for their odd lots, while a few utilized exchange-like platforms with a click-to-trade protocol.

Yet over the past few years, credit trading has fundamentally changed because of the availability of data, regulation, new market participants, and increased electronic trading protocols. Most recently, it has been accelerated by the COVID-19 pandemic, with new automated workflows and faster adoption of electronic credit trading. This technological evolution has partly been catalyzed by the global regulatory reforms enacted in the wake of the 2008 financial crisis, which resulted in the maturation of equities options, futures, and foreign exchange market structures.

As a result of the COVID-19 pandemic, buy-side organizations have changed how they are using products for credit income trading. As a result of these developments, it is little surprise that our survey respondents cited a 64% increase in RFQs. However, 42% of respondents still highlighted voice transactions as a method they continue to rely on, which is probably due to larger orders still being processed by voice. This is especially true in more challenging times, such as during the global pandemic where the buy-side relied heavily on relationships in the market.

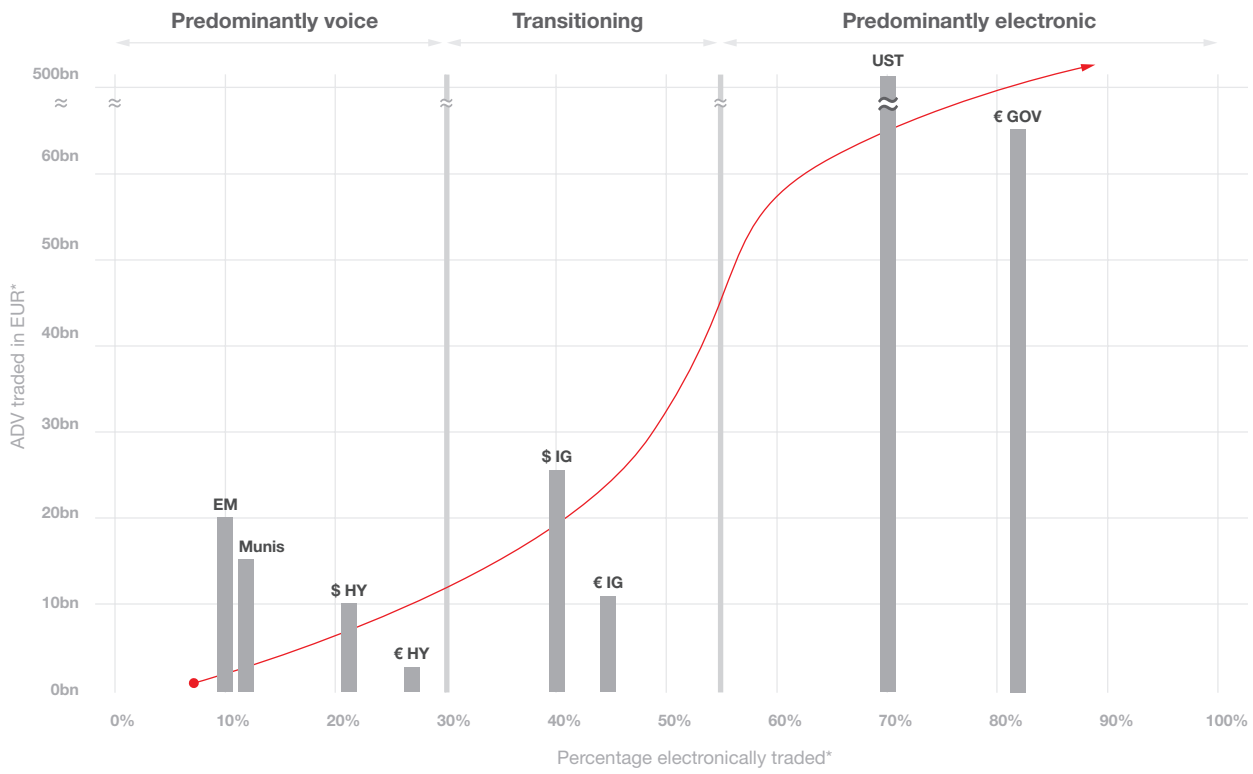
Since the COVID-19 pandemic began, our respondents' organizations have not only increased the use of RFQs, PTs, and ETFs for credit trading, but also voice — which points to a division between low- and high-touch trading.

How has COVID-19 changed the way your firm is using products for credit trading?



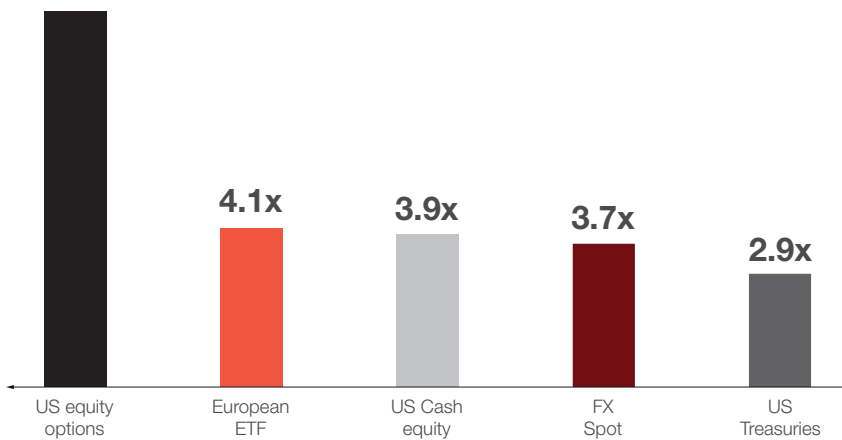
In credit markets we can clearly see that we are reaching the inflection point in € IG and \$ IG

Trends in financial markets: Electronification



We are currently transitioning towards the inflection point in credit markets, a point already reached in other markets as highlighted in the graph above. Once an asset class reaches the inflection point, the volumes executed in the subsequent 10 years increase tremendously; in the case of ETFs, for example, this was a factor of 4.1. This is due to innovation, new trading protocols, and the use of algos on the buy- and sell-side. The transition to new and more efficient protocols enables new and more efficient ways of trading, without the concerns around data leakage. This is evident in bond switches within an investment portfolio, where in the past portfolio managers had to source price levels separately and often manually through chats with all available liquidity providers. Today, they can adopt auto-execution algorithms which will hit the best firm/live price provided by the most competitive dealer from their network.

9.7x Volume increase from electronification

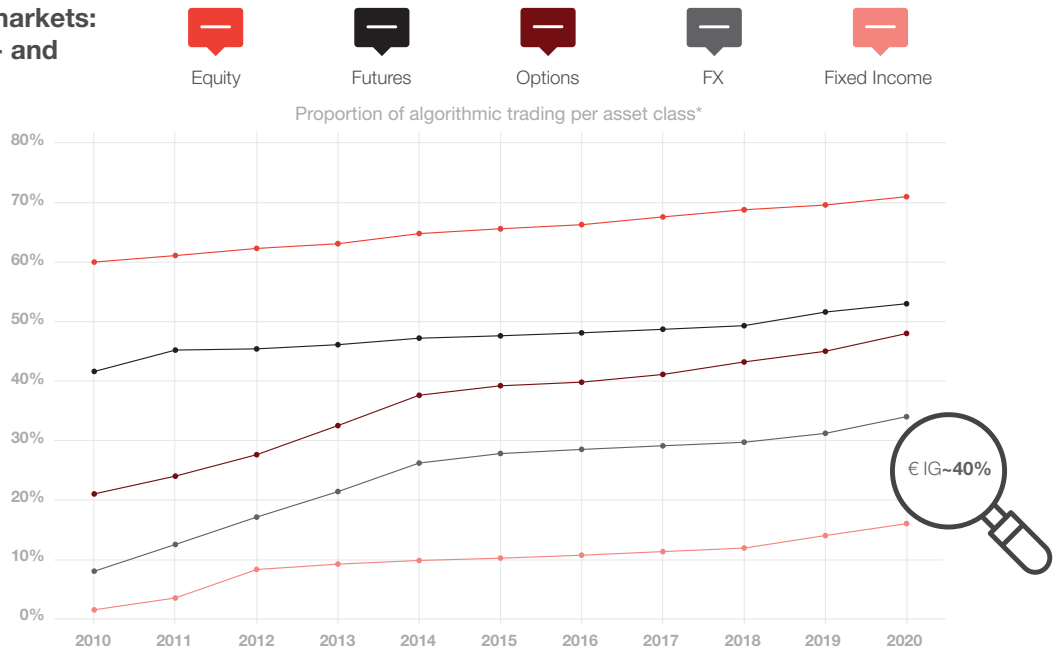


◀ Time span: 10 years after inflection point* ▶

* Source: MarketAxess, Flow Traders Data 2021

The use of algos is the principal mechanism driving innovation and traded volumes in asset classes that have passed the inflection point. In credit markets, the adoption of algos is relatively low compared to other asset classes, but a rise in algo usage is becoming evident with well over 10 sell-side algos already active in € IG. This equates to 40% of the total volume, bringing it in line with ETFs and FX. This growth trend will continue.

**Trends in financial markets:
use of algos by buy- and
sell-side**



This research confirms our observation that the credit market is undergoing a major transition and is rapidly reaching the point of inflection.

With more restrictive legal mandates requiring portfolio managers and traders to demonstrate best execution for their credit trading, it is no surprise that the majority of our respondents highlighted algorithmic pricing and trading as an important factor for improving the credit market.

No longer limited to low-latency markets such as cash equities and FX, algorithmic trading is now part of the corporate credit space and part of the credit markets that are less liquid, such as EM and HY.



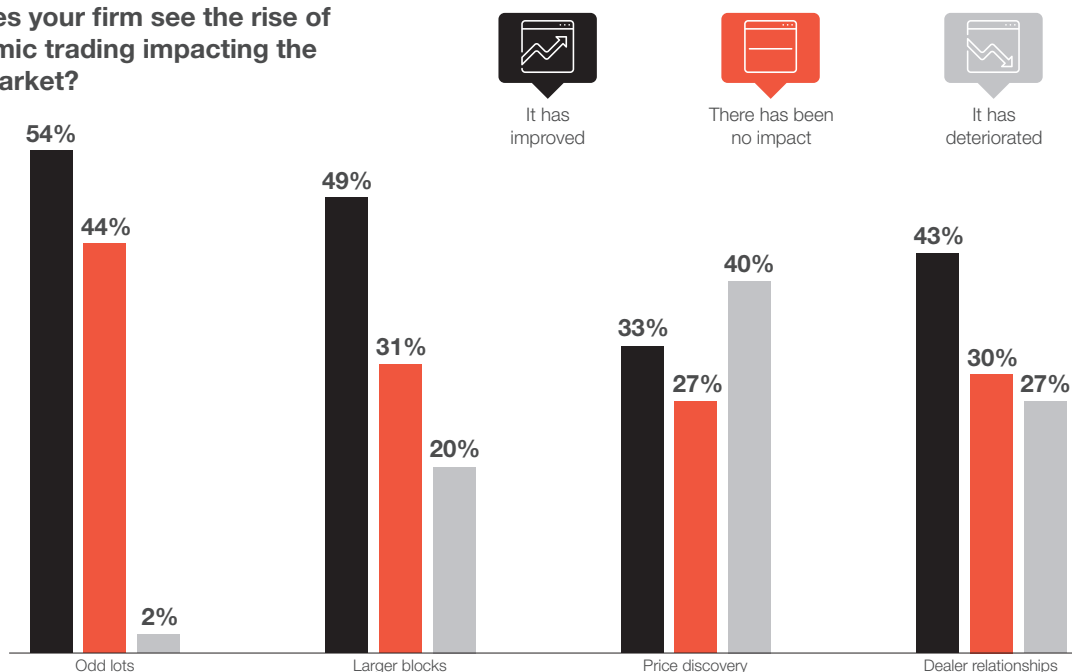
This improvement is not just limited to smaller trades with less significant market impact, but is also felt for larger block transactions. Almost half of our survey respondents (49%) reported that the improvement was notable for all order sizes, with over half (54%) seeing execution benefits for odd lot orders.

New alternative liquidity providers are expected to complement existing banks and brokers, while new trading venues and protocols will further reduce the execution costs in corporate credit. Ultimately, the journey to faster and cheaper credit trading is underway.

A third of respondents (33%) highlighted that those liquidity providers who have adopted algorithmic pricing improved price discovery. An even greater number of participants reported that using algorithms leads to positive effects on dealer relationships, as they enable the buy-side to use auto-execution techniques for smaller and low-touch trades, saving time and focus for the value-add conversations needed for more high-touch trades.

The majority of our respondents said the rise of algorithmic trading has mostly improved the credit market, except in the area of price discovery.

How does your firm see the rise of algorithmic trading impacting the credit market?



Consequently, additional benefits from higher-quality data and firm pricing can be leveraged to create and execute smarter trading strategies. The key drivers behind trades being routed through electronic and automated venues are:

- 1. Cost savings:** There have been reductions in direct costs, such as trading (particularly for smaller trades); and in indirect costs, such as information leakage and price discovery.
- 2. Improved transparency:** Price dispersion is being reduced, price discovery is becoming more rapid, and analysis of best execution and trading costs is more efficient.
- 3. Increased speed of execution:** Electronic trading platforms allow for live prices, which reduce the quoting time to seconds.
- 4. Regulatory compliance:** This is proving a catalyst for more data, analytical transparency, and an increased incentive to migrate to electronic trading.
- 5. A broader market and continuous access:** Increased connections between market participants across new and existing platforms provide real-time access to a broader group of liquidity providers while driving innovation.

Platforms facilitating electronic execution through equities-style CLOB, ‘all-to-all’ (allowing any member, dealer or client to negotiate and trade with any other member) or an automated RFQ model support the new trading trends.

The dominant platforms have each made a push to make RFQ smarter in their own ways. For instance, Tradeweb rolled out an industry-leading cross-netting protocol for IG dollar trades with treasury hedges, and MarketAxess has developed a robust composite pricing feed that can be used for trade cost analysis and RFQ auto-execution.

Highly correlated to the growth in PT, ETF utilization as a key instrument of portfolio management saw an overall increase of 40% compared to the previous year. The transparency, low cost and trading efficiency of ETFs are often listed as the main drivers to their adoption.

However, despite the development of electronic trading protocols and the advancement of algorithmic pricing and trading, 74% of respondents saw liquidity in larger blocks deteriorate over the last year. This is likely to be due to the heightened volatility and constrained liquidity prompted by the pandemic.

45% of respondents saw transacting on a different line item to get exposure as an appropriate measure to mitigate larger block execution challenges. In addition, 29% of survey participants said they often split blocks into smaller trades to minimize price impact.

74% of our respondents said their firm has been impacted by the decrease in sourcing liquidity from larger blocks in one bond.



We also asked survey participants about the impact of CSDR, given its potential to affect liquidity — especially on the offer-side. While CSDR deals mainly with the regulation of Europe’s settlement systems, it contains a section on ‘settlement discipline’. This includes actions to improve settlement efficiency, such as cash penalties for failing trades and provisions for mandatory buy-ins. However, the ESMA has advised the European Commission to postpone the implementation of settlement discipline.



The newly introduced CSDR requirements are a severe challenge for all market participants. While CSDR is expected to come into force in February 2022, and preparations for its implementation are in full swing, the new settlement requirements for OTC transactions are demanding and require internal systems to be adapted. Most market participants strive for further automation of the settlement process and have dedicated teams working on the analysis of historic trades in order to better assess risk, and flag the potential impact of liquidity protocols caused by the new regulation. The common denominator is that everyone wants to ensure that there is adequate liquidity in the market at all times. Ultimately, market participants will be ready to comply with the new rules, although it is not yet certain exactly what those rules will look like.

Nevertheless, according to our survey it was clear that significant work is underway to make sure back-office systems and data are in order, liquidity impact measured, risk management overseen, and pricing impacts foreseen. Our respondents highlighted that automation was seen as a solution to the constraints imposed by CSDR.

Since CSDR might change the liquidity requirements, especially on the offer-side, we asked our respondents what measures they have taken or plan to take to consider related liquidity changes. Here is what they told us.

We have a dedicated team working on analysis of historic trades and the potential impact of liquidity protocols that are followed by us.

We are looking to increase the periodic review and probably automate it to gain more control over buy-in and failed trades.

The process of creating a new penalties avoidance system to manage liquidity is being tested for efficiency and completeness.

Automation and artificial intelligence will be used to highlight any potential threats and suggest corrective measures.

The flow of cash and the threats are calculated objectively. There are dedicated teams to source market information and make comparisons to gauge the liquidity potential.

We are harmonizing all the rules and compliance policies to help us manage all that is related to CSDR.

Chapter Two: The Future of Credit Execution Strategies

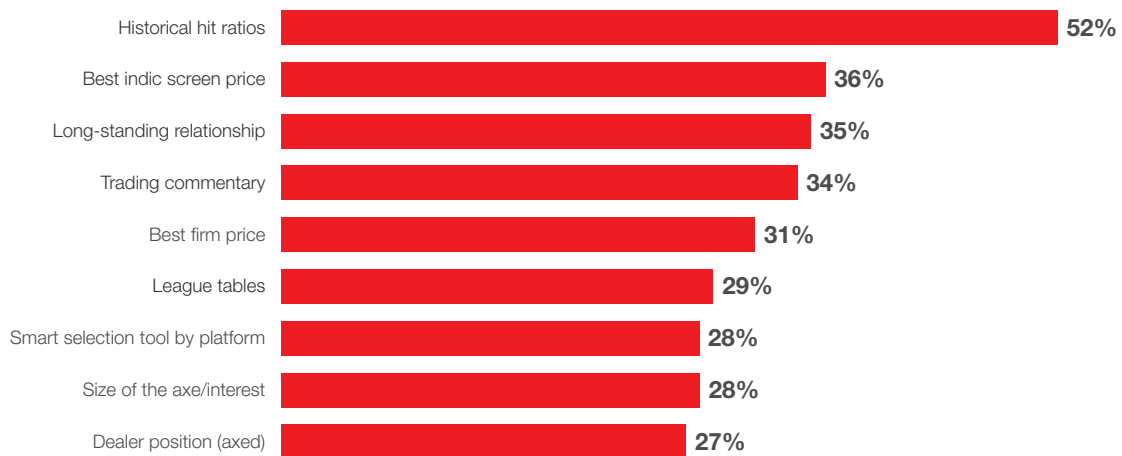
Credit data can be a challenge given disparate sources, a lack of liquidity, and opaque and fragmented markets. Data utilization varies further depending on the trading workflows employed by the data user. The effectiveness of automation trading technology to improve execution strategies is directly related to the interpretation of the trader who uses it, and the trading workflows they are used for.

We asked our survey participants to highlight what drives their decision to include a dealer in an RFQ. According to most of our respondents, historical hit ratios were the standout benchmark for selecting dealers at their buy-side organizations. Moreover, data provided by platforms and dealers – particularly pre-trade indicative and firm prices – were notably highly-used criteria.

Nonetheless, longstanding relationships remained key to at least 35% of all buy-side survey participants.

52% of our respondents said historical hit ratios were one of the most important drivers for selecting dealers.

What are the most important drivers for selecting dealers at your firm?



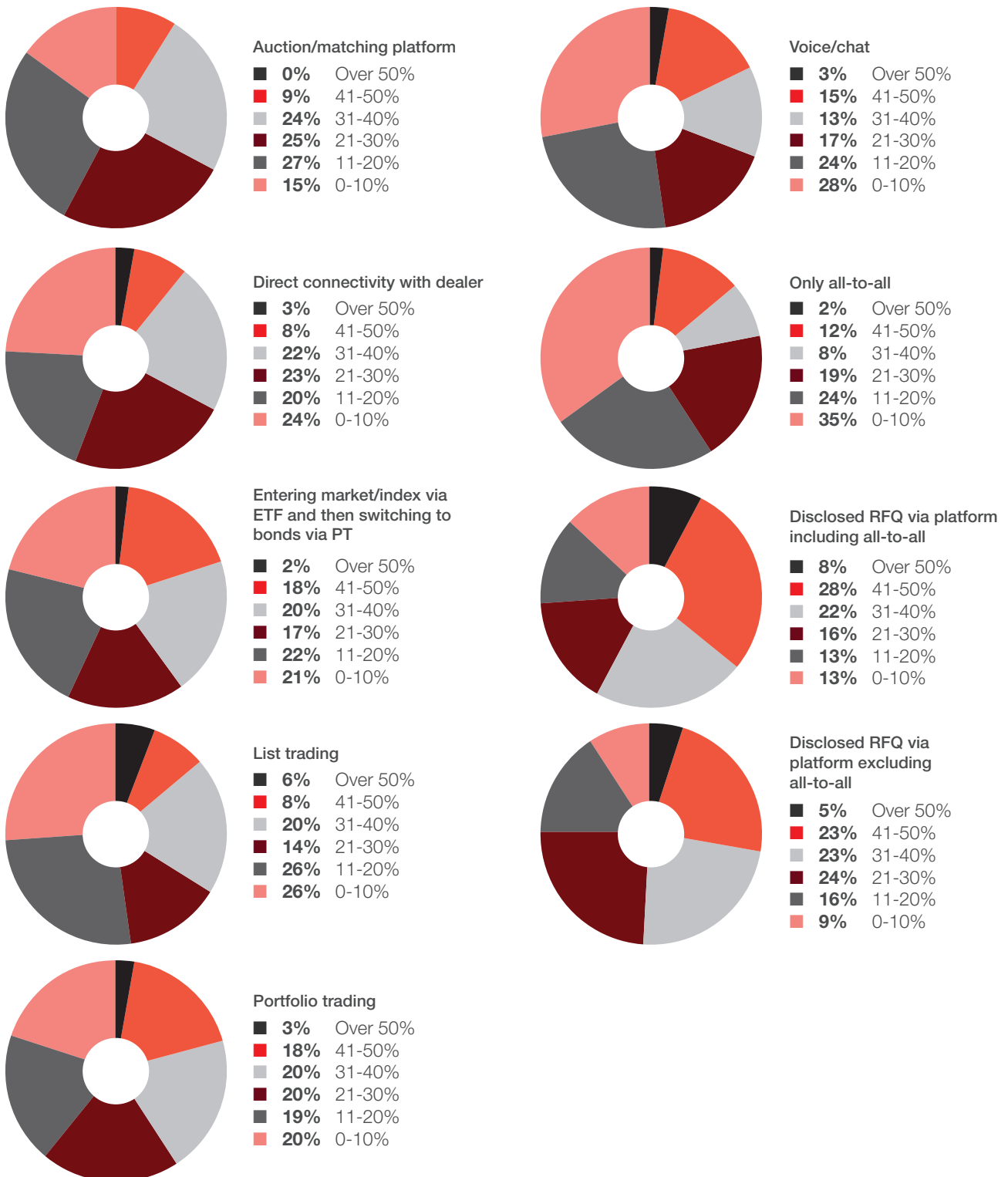
As workflows become increasingly automated and the trader’s desktop becomes a data-driven collection of tools for greater execution optimization, the need for high-quality, reliable market data, aggregated across different sources, becomes paramount. Platforms such as LedgerEdge and Neptune, together with various liquidity providers and buy-side market participants, are attempting to provide innovative ways to distinguish quality data from noise. LedgerEdge, for example, is leveraging innovation from distributed ledger technology derived from blockchain processing and crypto markets to build a system that rewards participants contributing high-quality data. The buy-side values axes/position data highly, but often faces the challenge that the axe data is dispersed. While Neptune is solving this by aggregating axes/position data across dealers and venues, information leakage from revealing side and size to the market continues to be a concern for the buy-side. This can only be partially mitigated by new trading protocols and technology. These include the new or existing smart execution algorithms developed by platforms like MarketAxess, Tradeweb and Bloomberg.

The rapid rate at which the credit universe has innovated is clear from our survey, but it is unlikely that a universal solution for trading will arise in credit. Based on our survey responses, it is evident that we can expect a range of electronic protocols to be used according to the needs of the buy-side traders and the integration with their own trading technology.

Most of our respondents still demonstrated a certain dependency on voice and chats, as well as an increasing uptake of list trading and all-to-all protocols to execute trades today (highlighted in Chapter One). This proves that our respondents' view on preferred execution mechanisms remains relatively varied across the different execution possibilities.

The top-3 ways our respondents are trading credit products: all-to-all, voice/chat, and list trading.

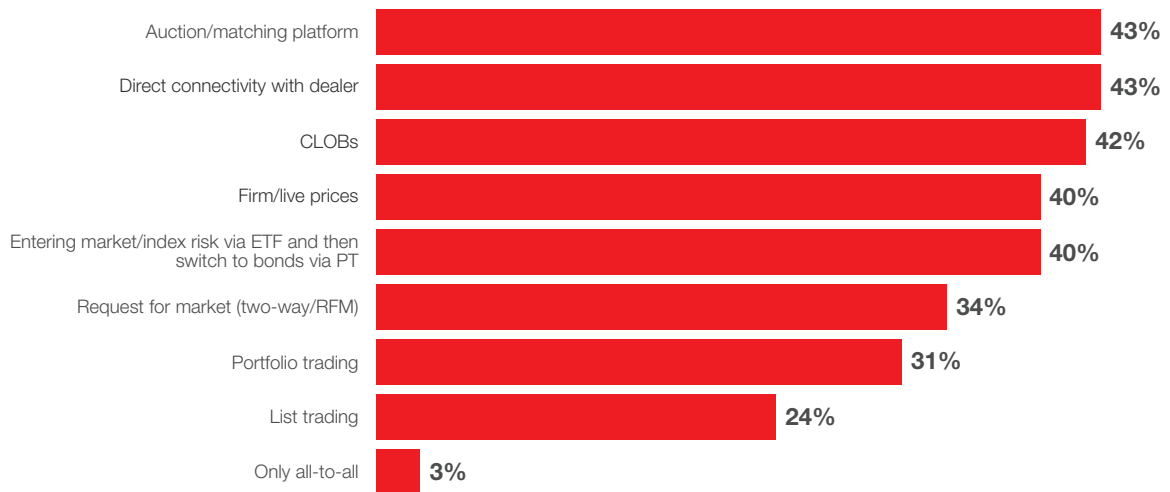
How is your firm trading credit products?



In our survey, 43% of respondents said that they would like to use more auction or matching protocols going forward, and 43% said they would like to use more direct connectivity with dealers. A further 42% said they want to use CLOBs more, which is closely related to the fact that 40% said they want to use firm/live prices more frequently. It is also worth noting that 40% said they prefer to switch between ETFs and bonds more regularly, which is an approach we see regularly. RFM and PT trading were also mentioned.

The top-3 credit execution strategies our respondents would like to use more: auction/matching platforms, direct connectivity with dealers, and CLOBs. This was closely followed by firm/live prices, which we expect to gain in importance.

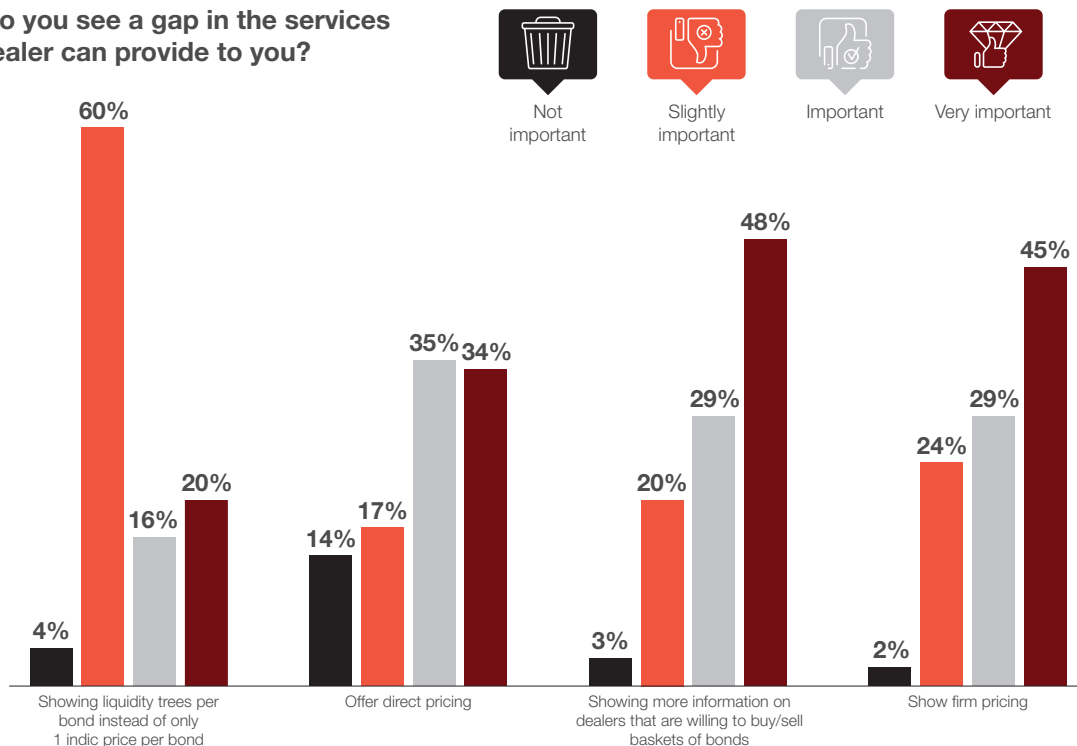
Which Fixed Income trading strategies would you like to use more?



Overall, 74% of respondents' preferred reality is one in which more robust firm/live pricing is disseminated to determine relative value pre-trade and to accelerate price discovery and execution. At the same time, 77% of respondents mentioned that more information on portfolio axes is important or very important. Direct pricing is very important for 34% of respondents, and there is significant interest in liquidity trees (different prices for different sizes).

The majority of our respondents said they want to see more information on dealers that are willing to buy/sell baskets of bonds.

Where do you see a gap in the services that a dealer can provide to you?



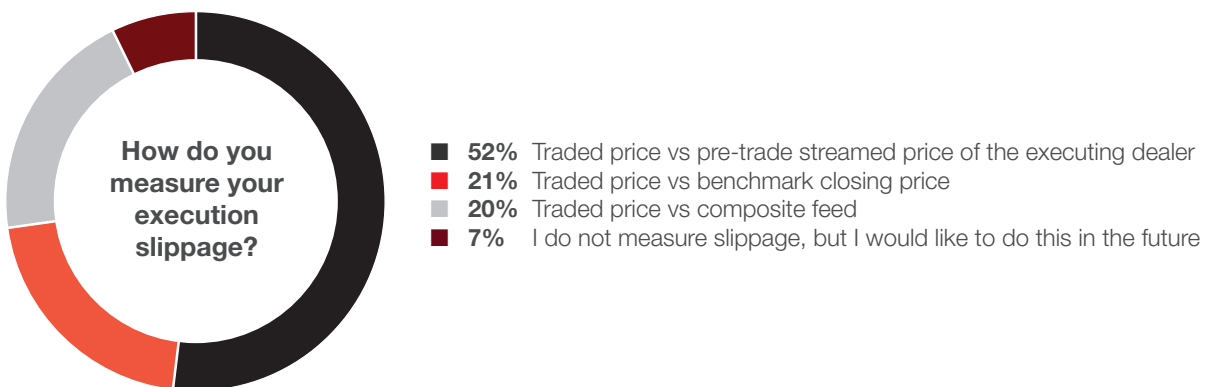
One of the pitfalls of trading today is slippage – the bane of every financial trader’s life. In an ideal world, a trader’s execution methods should yield negligible slippage – where the overall pre-trade price estimates match perfectly with the executed prices in one’s blotter.

So what prevents the trader from achieving that utopian zero-slippage execution? The lack of high-quality pre-trade feeds, reactionary evaluated pricing, and poor trade data transparency all lead to challenges. As do the various protocols, execution strategies and preferences when calculating slippage.

A single way of calculating slippage is just as unlikely as having a single protocol for transacting in credit markets. It will depend on the availability of the data and the trader’s access to it, as well as their interpretation and usage. Our survey showed that execution slippage is predominantly measured via the pre-trade dealer streamed price or runs (52% of respondents) and, to a lesser extent, via an evaluated pricing source closing print (21%) or a live third-party composite feed (20%).

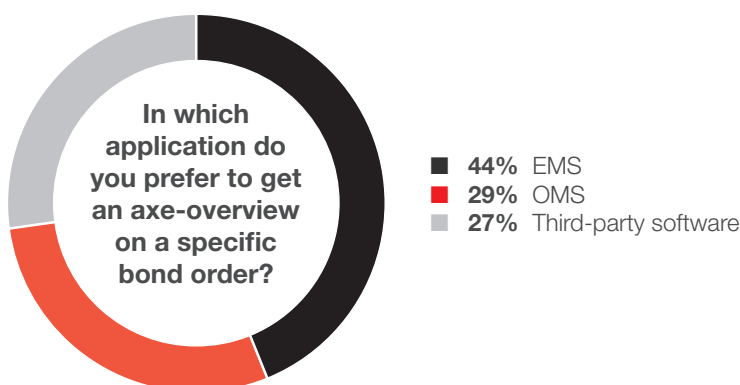
The accuracy and quality of pricing was one of the constant themes in our survey. As a critical part of pre-trade dealer selection and slippage calculation, new liquidity providers and platforms will need to provide actionable markets that can withstand various trading regimes. New and existing platforms will also need to develop tools that can validate the quality of the information being exchanged to truly reduce the transactional costs in the credit market.

52% of our respondents measure slippage by traded price vs pre-trade streamed price of the executing dealer.



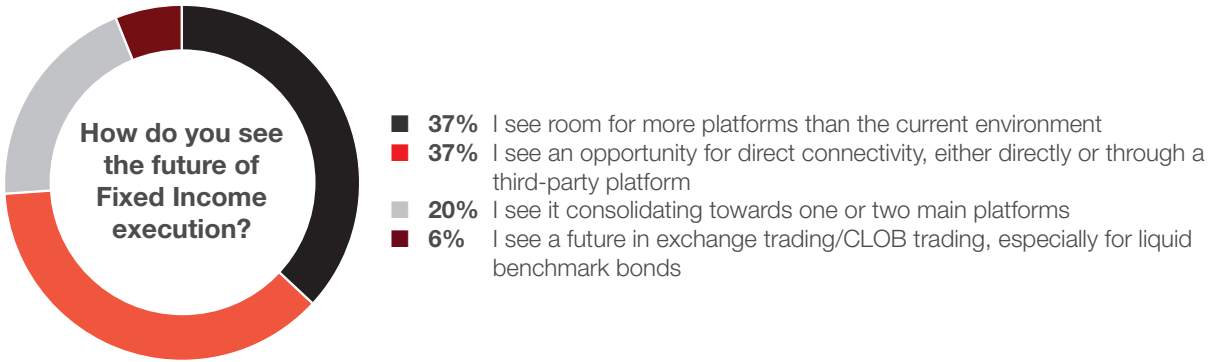
Platforms and dealers trying to innovate in the debt markets will also need to operate within the existing ecosystem of OMS and EMS providers. 44% of respondents said they preferred to see axes and other indications of interests in their EMS, 29% cited OMS, and the remaining 27% indicated a preference for using third-party platforms. To complicate the ecosystem further, respondents also saw the horsepower and intelligence of their OMS (cited by 80%) and EMS (cited by 86%) as one of the most important limiting factors.

The majority of our respondents prefer to use EMS to get an axe-overview on a specific bond order.



37% of respondents see more room for platforms in the current environment, while 37% mentioned direct connectivity either directly or through a third-party platform. Consolidation towards fewer platforms was only mentioned by 20% of respondents, while exchange trading of bonds currently seems far off as it was only mentioned by 6% of respondents.

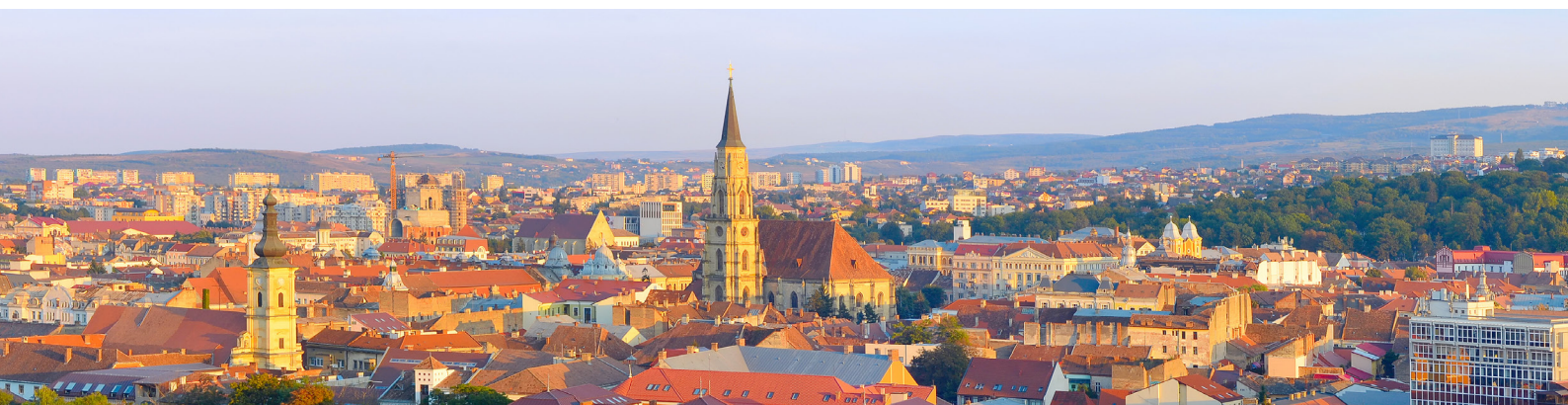
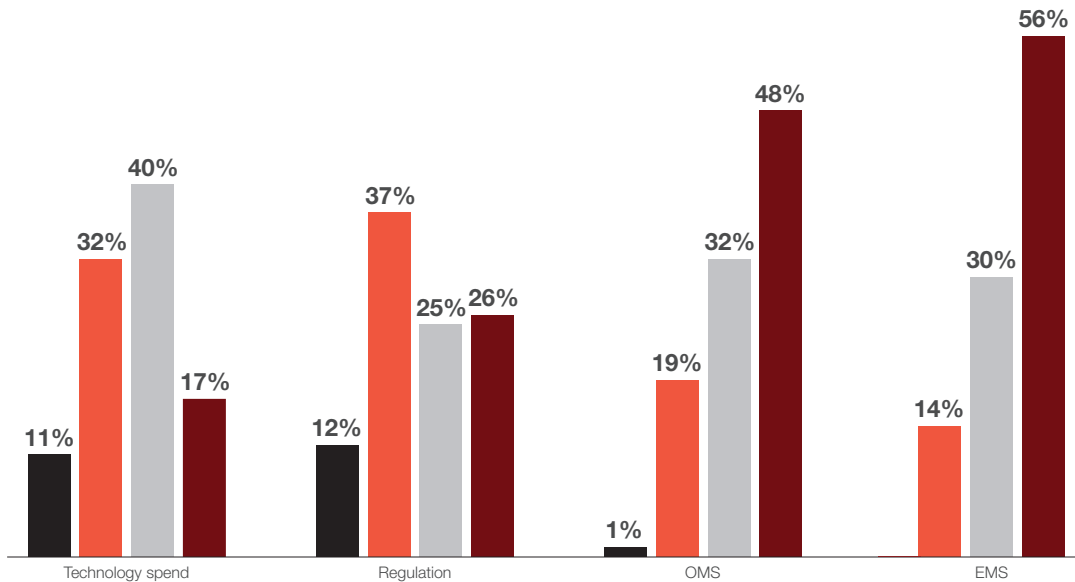
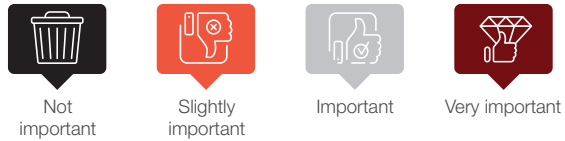
74% of our respondents see room for more platforms and greater opportunity for direct connectivity in future Fixed Income execution.



A lot is said about direct pricing, but there appear to be quite a few limiting factors. EMS was mentioned in 86% of the cases as an important or very important limitation, while OMS was mentioned in 80% of the cases as an important or very important limitation. Regulating (51%) as well as technology spend (57%) are also clearly important limitations. It seems that direct connectivity, based on the reasons mentioned above, faces some serious challenges.

The majority of our respondents said EMS is the most limiting factor to get direct pricing.

What is currently the most limiting factor for you to get direct pricing?

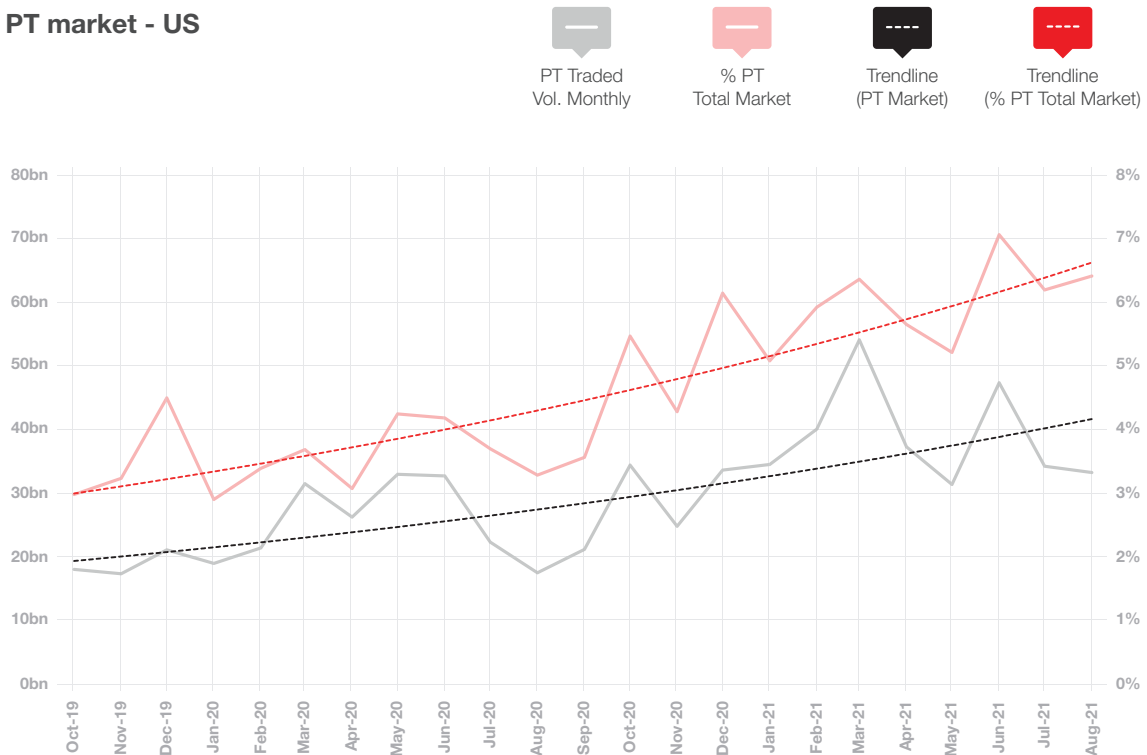


Chapter Three: Portfolio Trading

The simultaneous execution of a group of bonds is not new. We have observed this in ETF markets for many years with the creation and redemption of Fixed Income ETF baskets. However, this bundled execution technique has recently been gaining considerable traction in credit markets due to investors' appetite for transparent, cost efficient, and guaranteed execution of portfolios.

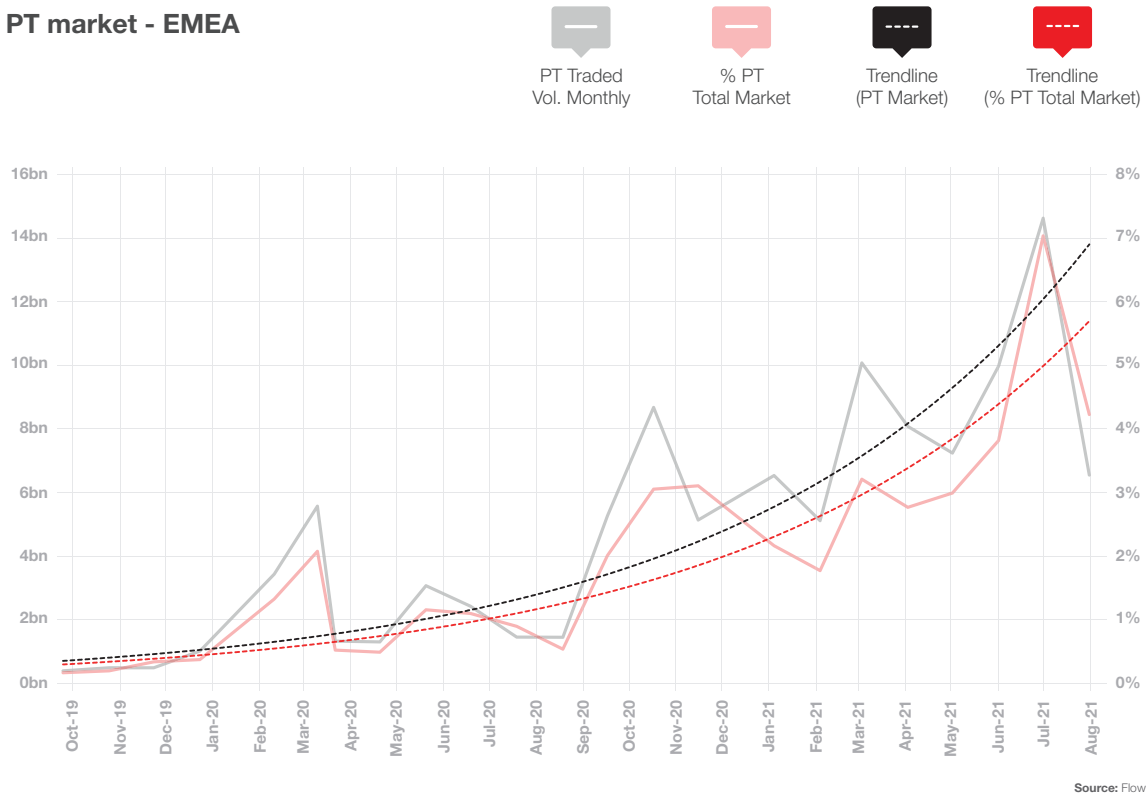
In the US, growth in PT has been evident for the last two years, growing from 2% of the total credit market to 6% of the total market, with monthly trading of \$50 billion. This is a significant increase of a relatively new protocol, attained in a relatively short period of time.

PT market - US



PT is now broadly implemented across several Fixed Income markets, including subsectors and currencies generally considered less liquid (EM, € HY and £ credit), but also in larger and more diversified portfolios across rates and credit products. As mentioned, over the last two years the European PT market has been catching up with the PT growth already observed in the US. At the end of 2019 it was essentially zero percent, but it has now reached a similar percentage of total credit trading as in the US, or around 6%.

PT market - EMEA



Source: Flow Traders Data 2021

In credit markets, ETFs can be created or redeemed by authorized participants like Flow Traders, either by delivering/receiving in kind (i.e., a portfolio of bonds, which is called a creation/redemption basket), or by delivering cash which then results in a PT by the issuer. These baskets are ideal for PT.

In an earlier survey, respondents told us that their PT usage was up by 50%. Their firms' AUM varied from \$500m to \$50bn, and many will be using PT not only to re-balance portfolios, manage in and out flows, and move large positions, but also to execute certain quantitative strategies in combination with firm/live pricing. Respondents were also unanimous about the benefit of PT, citing three reasons:

1. Better average pricing on the list of bonds (cited by 64%) as illiquid bonds can be combined with more actively traded bonds and benefit from the liquidity to achieve better pricing.
2. Time saving (cited by 61%) as it enables parties to transfer diversified bond risk more quickly and efficiently than before.
3. Certainty of execution on all bonds (cited by 59%) by parceling up instruments that would otherwise be illiquid on their own.

The majority of our respondents see the benefit of getting better average pricing on the entire bond list in portfolio trading.

What do you see as the benefits of portfolio trading (all-or-nothing)?



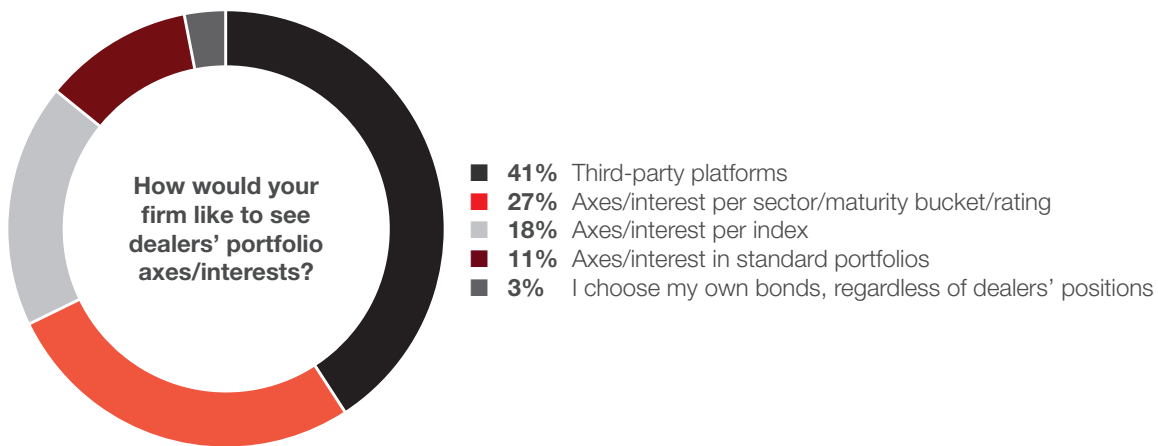
PT is now often seen as one of the better choices to access the entire suite of liquidity available in credit markets. Key examples of PT uses are managing fund flows and strategic allocations. These trades often have two legs (both sell and buy) and can be completed concurrently to further minimize costs.

Our respondents were positive about PT, noting ‘the feasibility of bulk transactions’ and ‘the impact on trading costs’, to name only two.

Nevertheless, PT still presents challenges. How do traders determine the value of hundreds of individual bonds and combine them into one tradeable price?

The answer is through technology. That said, several respondents talked about the lack of real-time data, the desire for more automated trading methods, a better understanding of the type of risk that can be transferred, improvements in speed, and also better visibility on axes.

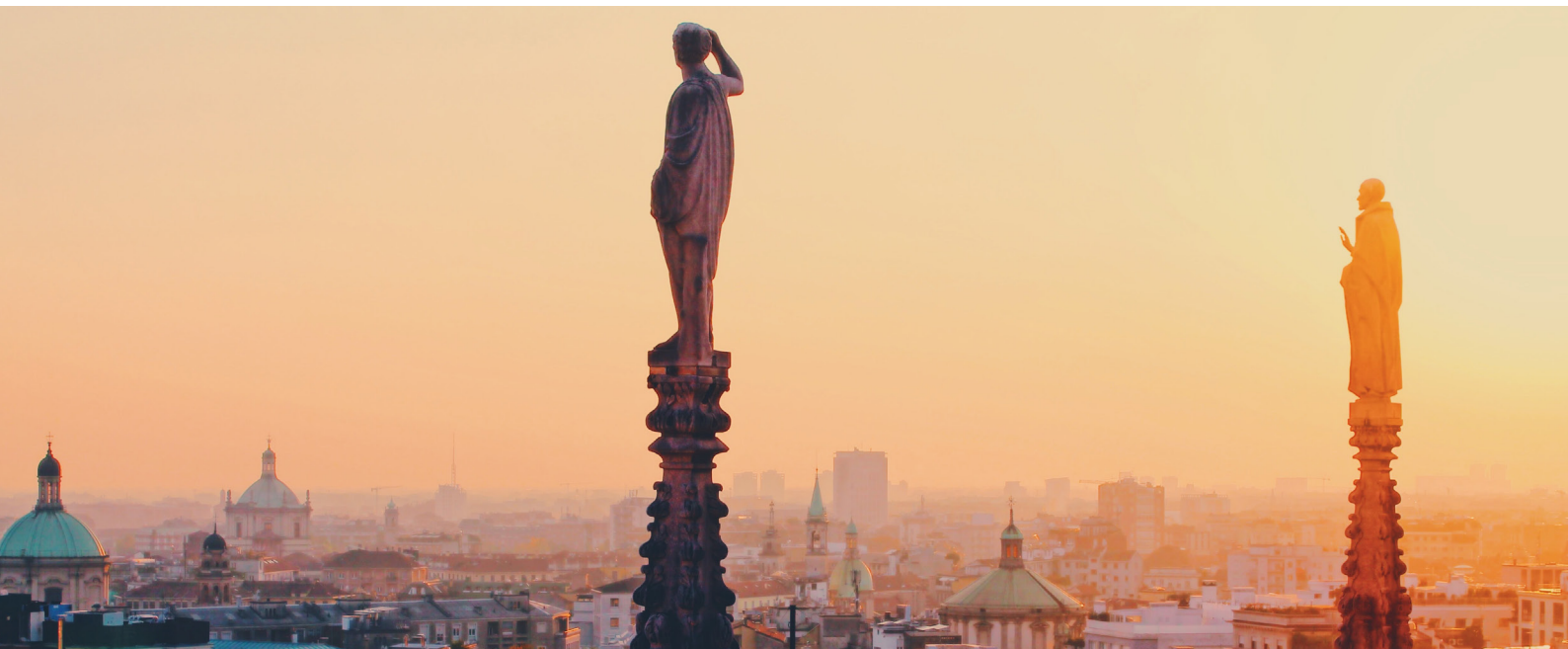
41% of respondents’ firms would like to see dealers’ portfolio axes/interests on third-party platforms.



In a market where just 1% of bonds trade daily and 35% of bonds trade on five or fewer days per year, PT is an important way to overcome the liquidity of the individual bond positions by making the total liquidity of a portfolio trade exceed the sum of its parts.

The ETF ecosystem will add additional liquidity to the credit markets as many bonds are traded by ETF market makers on the back of their Authorized Participant (AP) activities. As ETFs are used as hedging tools for PTs and, as on exchanges, they are traded without going to the bond market, this creates another way for liquidity to enter the bond market. We think this mechanism is one of the main drivers behind the success of PT, and it has the potential to transform individual bond trading.

All major Fixed Income platforms are investing in the electronic of PT to make the price discovery and execution of PTs more efficient and transparent for both the buy- and sell-side. However, we believe that there is a lot of room for enhancements, such as live PT pricing or automated distribution of PT axes.



We asked our respondents who use portfolio trading about their experience and whether there are any improvements they would like to see implemented before they decide to use it more. Here is what they told us.

I think that the control on the volume of trade is quite effective. The experience has not been lacking in any way.

Rebalancing portfolios becomes easier, but market volatility can be a problem when a certain amount is being expected.

The pricing structure of some securities is difficult to contemplate as the market pressures change along with the risk exposure.

The current uses of portfolio trading could be optimized, with additional features for understanding the underlying risks.

I like the portfolio trading solution we have but would like to see it provide more flexibility to respond faster to market conditions.

I like the addition of high profile algorithms but the lack of total control is what I would like to change here.





Conclusion

Electronification will continue to shape global financial markets and further impact credit markets, resulting in electronic trading expanding and becoming more mainstream. We expect this will lead to multiple positive implications for the broader financial ecosystem, including lower costs, greater transparency, increased innovation and more efficient trading methods.

The two most important innovations in current credit markets are algorithmic trading and portfolio trading, both of which offer significant advantages for the buy-side, leading to greater price efficiency and state-of-the-art execution strategies. The adoption of these two trends will continue as more market participants embrace the benefits.

Electronification also leads to the introduction of new trading protocols, such as firm/live markets, request for market, and central limit order books, which contribute significantly to the overall transparency and efficiency of the market.

Investors must also begin to think differently about how to build portfolios, how to trade and what to trade. Consequently, they must determine how to navigate the credit markets – from trading in a new market structure, to re-assessing liquidity, to determining which products will best deliver a desired outcome.

Some firms have a long way to go to modernize their trading infrastructure. Many are still dabbling with algorithmics as a nice-to-have alongside old-fashioned line traders.

But for those firms that truly grasp the potential of this change in approach, algorithmic trading is taking over credit execution on both the buy- and sell-side, leading to clear benefits such as new and more efficient methods of execution. The regulatory burden (from CSDR, for example) requires even more focus from the buy-side on process automation and optimization. This is another area in which electronification can contribute significantly.

Whether these are the consequences or the accelerators of additional electronic trading, the results and benefits are clear: increased transparency within the markets, significant cost savings, and efficiency gains for investors.

PT, in particular, has a long growth trajectory, especially since live/firm executable baskets, automatically executed quantitative credit strategies, and multi-asset re-balances can all be managed seamlessly via the portfolio channel.

And with today's data quality and access to new platforms, axe aggregators, data vendors and trading protocols, it is clear the market has reached the inflection point in its search for efficiency.

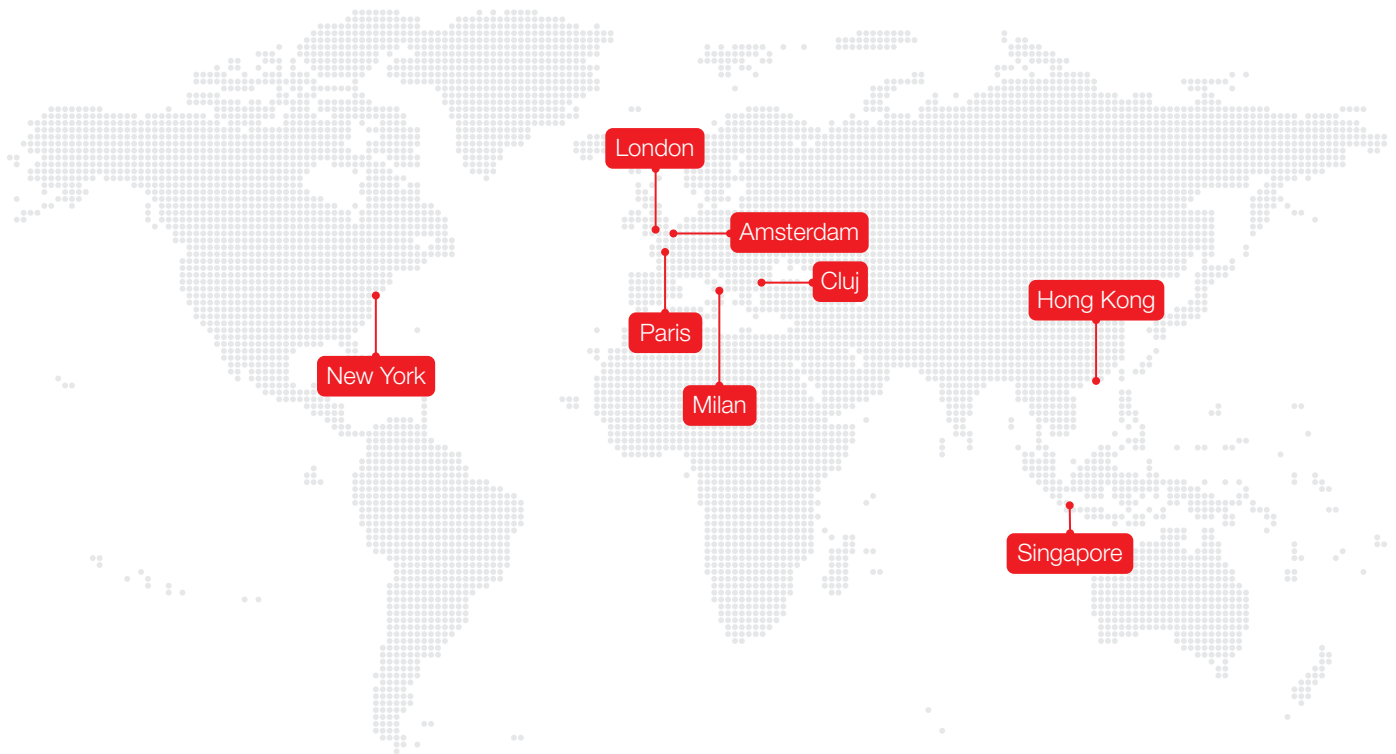
The move towards greater digital credit trading is exciting, bringing with it numerous opportunities – and challenges – for investors, banks, borrowers, and policymakers alike.

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Flow Traders is a leading global technology-enabled liquidity provider in financial products. Founded in 2004, the organization initially specialized in Exchange Traded Products (ETPs) and has now applied its extensive expertise and data-driven infrastructure to expand into other asset classes. Flow Traders’ footprint covers trading desks in Europe, the Americas and Asia and can provide liquidity across all major exchanges, globally, 24 hours a day.

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