

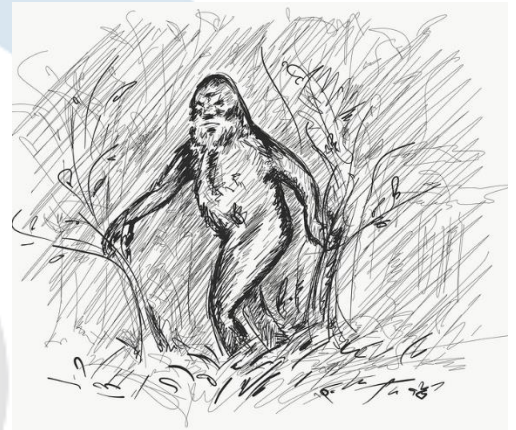
BondCliQ

The Inside Market February 2019

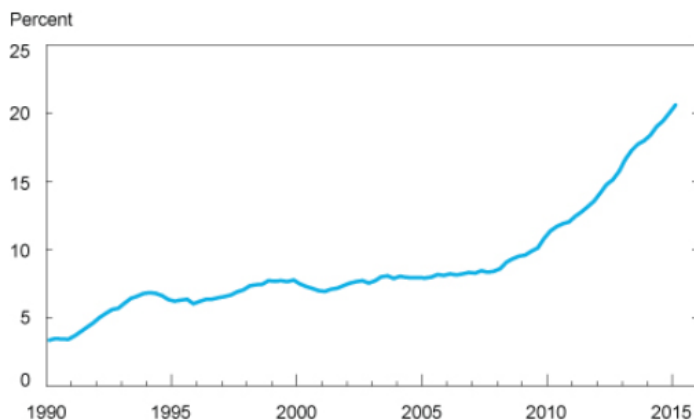
As a new solution provider, we intend to make your assessment process easier by clearly and consistently articulating our approach to improving the US corporate bond market through our monthly blog post (The Inside Market). This post will touch on just a few topics, but there will be many more to come. 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).

Bigfoot and Buy-Side Liquidity

This is a bit personal, but for a very long time I absolutely, positively believed in Bigfoot. Looking back, I blame my favorite uncle's sense of humor for convincing me that Bigfoot was roaming somewhere in the forests of Huntington Long Island, just waiting to grab my cousins and me. Eventually a pivotal question completely shifted my view on the existence of Bigfoot: [If Bigfoot exists, why haven't we found ANY bones?](#) However, this is not the case for a large population of Bigfoot enthusiasts who hold fast to the belief that this creature exists even though "there has never been any real biological evidence, like bodies, bones, skin, hairs, or DNA found."



Mutual funds' ownership share of corporate bonds has increased rapidly



Source: Federal Reserve Board, "Financial Accounts of the United States."

Note: The chart plots corporate and foreign bonds (held in the United States) owned by mutual funds and exchange-traded funds as a fraction of the total amount of corporate and foreign bonds (held in the United States) outstanding.

The concept of [Buy-Side Liquidity](#) is the "Bigfoot" of financial market structure. **There has never been any statistical evidence that buy-side to buy-side trading can create meaningful liquidity in any financial market...ever...in the entire history of financial markets.** However, this idea is consistently raised as the ingredient for a better corporate bond market and continues to spawn [new ideas for trading solutions that remove intermediaries](#) (dealers) from the trading process. On the surface, it is logical to assume that buy-side to buy-side trading can generate reliable liquidity. Based on the numbers, as the size of the corporate bond market has increased, so has the ownership share of asset

managers. **If the buy side holds the bonds, why can't they just trade with each other?**

The answer can be found in the breakdown of a typical asset manager's workflow. For a buy-side to buy-side trade to happen, Asset Manager ABC must have a standing order to sell a specific CUSIP within the same time period that Asset Manager XYZ has a standing order to buy that same CUSIP. **The critical catalyst to any potential buy-side to buy-side trade is that one asset manager must have a redemption or need/want to change their portfolio composition while the other has an inflow (cash) or the opposite need/want to change their portfolio composition at the same time.** This restriction is what makes Buy-Side Liquidity impractical and unreliable for consistent trading. The asset manager's first, second, and third priority is to serve their customer, not the trading needs of another buy-side institution. Ultimately, we will be consistently led to the same conclusion: **Intermediaries (dealers) will always be an essential ingredient to a well-functioning market.**

True-believers will hold on to the notion that a large network combined with the right type of trading protocols will yield the hard evidence of the existence of meaningful Buy-Side Liquidity in the corporate bond market. Thankfully, over the past seven years, the largest corporate bond trading network in the world, [MarketAxess](#), has been diligently working to produce ample Buy-Side Liquidity through their [Open Trading](#) solution. An exchange during the most recent MarketAxess earnings call (Q4 2018) provides insight into the state of buy-side liquidity:

ANALYST QUESTION: Okay. Sounds good. And then in Open Trading, I guess, the percentage of Open Trading today that's buy side to buy side, I know it's a pretty small percentage, but any color there and trends?

ANSWER RICHARD M. McVEY: I wouldn't call it (buy-side to buy-side trading) small, it's - as there has been in past calls, there are the three main pools of liquidity that are coming through Open Trading; the alternative market makers, the expanded dealer community participating in orders and then the buy side. But the trends have been pretty stable in terms of buy side participation in Open Trading liquidity provision and it's an still important source that - it's running around a quarter of the volume that is done on the system.

Translation: Despite the network, the technology, and the resources of MarketAxess, 75% of Open Trading volume is generated by the dealers (not sure who counts as an alternative market maker). Furthermore, the 25% of Open Trading volume that does come from **buy-side to buy-side trading is approximately \$370mm in daily volume, or 1.3% of overall market volumes** (this is using MarketAxess data). Organic liquidity is a definite positive, but at the margin, is this the optimal way to create material liquidity in the US corporate bond market?

To Improve Liquidity We Need Improved Liquidity Providers

We believe that the only proven method to meaningfully increase liquidity for the buy-side is to increase the liquidity capacity of market makers. Therefore, the BondCliQ approach to improving the US corporate bond market is quite different than other initiatives. We are not designed to replace the dealers or diminish their role in the market. In contrast, **BondCliQ helps dealers leverage the invaluable institutional pricing information that they collectively create.** By incorporating pre-trade data into their market making process, dealers will be able to provide block liquidity to their customers with more confidence. In the coming months, it will be interesting to see how fast dealers adapt to this new data set and the positive impact it will have on the quality of institutional pricing and liquidity for asset managers.

In the meantime, I look forward to the next Bigfoot sighting that somehow missed being recorded or new wave buy-side liquidity solution that will change the world but has no actual details.

-Chris White (CEO – BondCliQ)