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Corporate bonds: 'a void that needs to be filled'

The world's biggest investors who want to sell corporate paper are using new credit trading platforms – open marketplaces aimed at fixing the growing problem of secondary market liquidity.

Platforms like Electronifie, Bloomberg and Bondcube (owned 30 per cent owned by Deutsche Boerse), are busily gathering up investors willing to transact bilaterally with each other and agree on a price.

Regulator changes have restricted the banks' ability to trade on their own account and have also made it unprofitable for them to make markets, said Robert Camilleri, investment manager, Realm Investment House.

Now that banks are shrinking their bond trading desks - because of tougher capital rules - the cost of holding bond inventories has gotten too high.

“If the banks are deserting their traditional role as market makers for investors seeking to buy or sell corporate bonds, the corporate bond market will move to another trading venue," he said.

'Liquidity premium' too high

Cammilleri reckons when people talk about the lack of liquidity in the market, what they're really saying is that transaction costs are too high – that the 'liquidity premium' is too high.

Investors will seek assets with higher liquid secondary markets, as a result, investors are willing to pay a higher price, or accept a lower yield for these assets compared to assets without a deep liquid secondary market.

This is called the 'liquidity discount' or 'liquidity premium', the investor will pay or demand from a reduced promised yield or expected return for such assets.

In Cammilleri's view, it is important that the liquidity premium - the cost of transacting - comes down.

“What platforms are trying to do is reduce transaction costs i.e. the liquidity premium, by facilitating a venue where buyers and seller can come together.

The market is made organically, and the liquidity premium should be lower, having reduced the cost of the investment bank having to gather the investors and then stand between them in agreeing a price,” he said

The idea is that, as new technology makes that process more efficient, transactions cost will drop and the market will become more liquid.

New platforms not market makers

While the infrastructure might be new; the idea is far from unproven.

Camilleri pointed to the many bilateral arrangements between global investors over the years that bypassed the banks and investment bankers that continue to survive.

"Investment banks have limited amounts of capital to take trading positions; however there is nothing stopping them running a facilitation desk. Still in recent times, given the demand for bonds, it's far easier to originate to sell, rather than support secondary bi-lateral activity between investors," he said.

The arrival of new platforms are not market makers, they offer a much needed technological solution, to the growing I2I environment.

His firm uses Bondcube to provide price discovery and understand the liquidity premium in different markets.

"There is a void that needs to be filled. Investors are refusing to pay a high liquidity premium to buy and sell bonds, in the secondary market, which in Australia translates to a buy and hold stigma. Liquidity is like water and gravity, as banks shut of their valves, liquidity will find other channels or conduits," he said.

I2I trading just needs two people trading on a common platform to agree on price even though there is no guarantee that a deal will be struck.

Meanwhile, the size of the corporate bond market has continued to grow in size in recent years, as investors have sought higher income bonds in a low yield environment.

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