

Asymmetric Information in Bond Market Trading

January 25th, 2019

Investopedia defines Asymmetric Information as:

“when one party to an economic transaction possesses greater material knowledge than the other party. This normally manifests when the seller of a good or service has greater knowledge than the buyer”

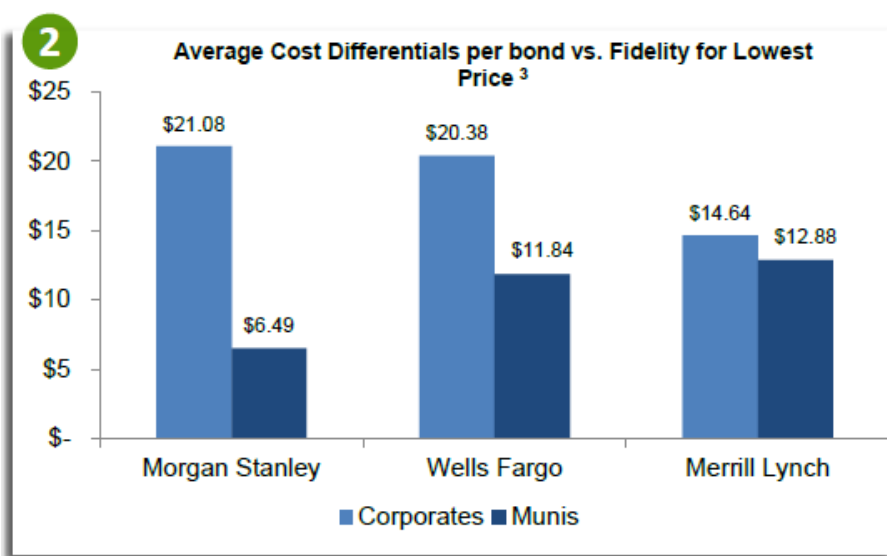
Access to bond markets historically has required the use of full-service brokers as the gatekeepers to execute trades. Limited trade reporting requirements and the legacy principal trading methods allow the broker to simultaneously buy a bond from the market themselves, then sell it at a higher price to fill their client orders. This is done without any disclosure of the riskless principal profit that this type of broker makes on trade orders.

New regulatory rules and advances in technologies are putting more power into the hands of the bond investor to know the true cost of market access through their broker. Regulatory trade reporting is bringing visibility to actual market activity, and FINRA’s Rule 2232 requiring disclosure of hidden markups to some clients has been put in force. As more bond trading moves through the wholesale Electronic Trading Platforms (ETPs) giving buyers the ability to see and participate in ‘street’ markets directly without an intermediary gatekeeper taking advantage of asymmetric information.

Cost of Information Asymmetry

Fidelity Brokers commissioned a research study last year from Corporate Insight to determine the cost differential on retail bond trades done through Wells Fargo, Morgan Stanley and Merrill Lynch, vs. trades done directly with the ETPs. The study showed a \$15-\$21 price differential per bond, for the full-service brokers using hidden riskless principal markups. That could mean \$150-\$210 for a \$10,000 face trade, or upwards of \$1,500 for a trade over \$100,000. Fidelity provides the same direct ETP market access as Interactive, but for a slightly higher trading fee for corporate and EM bonds.

See: https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/BondPricingStudy.pdf



Information Asymmetry in Trades

Each bond trade is unique. Translating these findings to your transactions is difficult. What it does highlight is that the cost of market access is often hidden, and difficult to determine when brokers do not disclose riskless markups. The information asymmetry gives a distinct advantage to the broker's salesperson, who is under no fiduciary obligation to give you the best execution pricing or even disclose their cost from the trading market. The broker's revenue is conflicted with your best execution price. The Electronic Trading Platforms do have their shortcomings, and a live trader/broker is sometimes necessary, especially specialists on smaller, less liquid/transparent bonds. Bids/offers in some of these issues may never make it to the ETPs, but may rest on the desk of the broker who knows the holders and buyers of those specific issues. Less idiosyncratic issues that have a wider audience of investors are more suited to the efficiency and disclosure of the ETPs.

Bond investors can level the informational deficit with the following:

- **Before the Trade**

Electronic markets are able to quickly post bids and offers globally and facilitate the live execution of trades against any counterparty on the system. As more and more market participants join these ETPs, pricing transparency is greatly improved for the benefit of bond buyers. These ETP levels are sometimes referred to as the 'screen' or 'market' when you see a quote. Trinvest has live access to ETPs that can show tens of thousands of bond quotes daily, with easy search and review functions. Unlike Bloomberg's ALLQ, many of these ETPs offer live, executable order entry. Check your available market quote screens or check with us before the trade to confirm that you are getting the best available markets for your bond orders.

- **After the Trade**

Post trade price reporting has improved significantly in the past 10 years, principally with the development of the FINRA TRACE system. Brokers are required to report all bond trades (buys and sells) to the regulator within 15 minutes of the trade. FINRA has now contracted with data management company Morningstar to make this information much easier to search and analyze. You can now quickly find trades with your price execution to compare with other trades that day. Unfortunately, this detailed reporting is only available for TRACE eligible securities (with cusips), which may not include most Euroclear bonds. There are other sources of trade reporting for Euroclear bonds that I can cover in another report.

For additional information on reported trade data on TRACE eligible bonds, go to <http://finra-markets.morningstar.com/BondCenter/>

TRACE Reporting Data

Below is the TRACE reporting for the Reg S version of the PETRTT 19. Unrer 'Renumeration', the code M means hidden markup.

Bond Trade Activity Search Results

From to [Glossary of Terms](#)

Issue: PCTT4195592			Description: PETROLEUM COMPANY TRINIDAD AND TOBAGO							Coupon Rate: 9.750				Maturity Date: 08/14/2019									
Execution																							
Date ▾	Time	Settlement	Status	Quantity	Price	Yield	Remuneration	ATS	Modifier	2nd Modifier	Special	As-Of	Side	Reporting Party Type	Contra Party Type								
1/25/2019	12:34:49	1/29/2019	T	200000	95.750		M		—	—	-	-	S	D	C								
1/25/2019	12:25:31	1/29/2019	T	200000	95.200				—	—	-	-	S	D	D								
1/25/2019	12:16:48	1/29/2019	T	1MM+	94.500				—	—	-	-	S	D	D								
1/25/2019	09:49:19	1/29/2019	T	300000	95.310		M		—	—	-	-	S	D	C								
1/25/2019	09:41:02	1/29/2019	T	300000	95.190				—	—	-	-	S	D	D								
1/24/2019	08:57:31	1/28/2019	T	500000	95.000		M		—	—	-	-	B	D	C								
1/23/2019	11:51:06	1/25/2019	T	843000	95.387		C		—	—	-	-	S	D	C								
1/23/2019	11:51:06	1/25/2019	T	843000	95.370				—	—	-	-	S	D	D								
1/22/2019	13:49:01	1/24/2019	T	100000	96.360		M		—	—	-	-	S	D	C								
1/22/2019	13:48:14	1/24/2019	T	100000	95.360				—	—	-	-	S	D	D								
1/22/2019	11:15:15	1/24/2019	T	100000	96.250		M		—	—	-	-	S	D	C								
1/22/2019	11:15:14	1/24/2019	T	100000	95.750				—	—	-	-	S	D	D								
1/22/2019	10:29:14	1/24/2019	T	100000	95.700				—	—	-	-	S	D	D								
1/22/2019	10:29:14	1/24/2019	T	100000	95.950		M		—	—	-	-	S	D	C								
1/22/2019	10:25:41	1/24/2019	T	100000	95.180				—	—	-	-	S	D	D								
1/22/2019	10:25:41	1/24/2019	T	100000	95.195				—	—	-	-	S	D	D								
1/22/2019	09:48:57	1/24/2019	T	1MM+	94.850		M		—	—	-	-	B	D	A								
1/22/2019	08:32:40	1/24/2019	T	100000	95.250		M		—	—	-	-	B	D	A								
1/18/2019	11:09:46	1/22/2019	T	250000	95.750		M		—	—	-	-	S	D	A								
1/17/2019	09:34:25	1/22/2019	T	500000	95.000		M		—	—	-	-	S	D	C								
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Fintech is leading to rapid changes in how we do business, even in bonds. Our platform gives clients direct access to the street inventories, without the undisclosed intermediary markups that are the norm. Transparency, liquidity and choice are improved. Our objective is to find the best price execution possible, using markets from hundreds of global brokers.

Mark Scott, CFA