HUSTLE AND RETAIL FIXED INCOME ORDER FLOW: THE MERGERS NO ONE IS TALKING ABOUT

The evolution of the modern-day US equity market has been shaped by the goal of promoting and protecting the retail investor. Active participation from retail investors is so valuable that brokers have been paying for retail order flow for almost 30 years. In fixed income markets, the retail investor gets scant attention in any conversations about the future of market structure. However, consolidation activity last year may finally be the catalyst that brings the fixed income retail investor out of the shadows.

VIABLE MKTS

March 2019

What's driving the coming change in the retail fixed income market?

Will the new market bring opportunity?

Author: Graham Agee

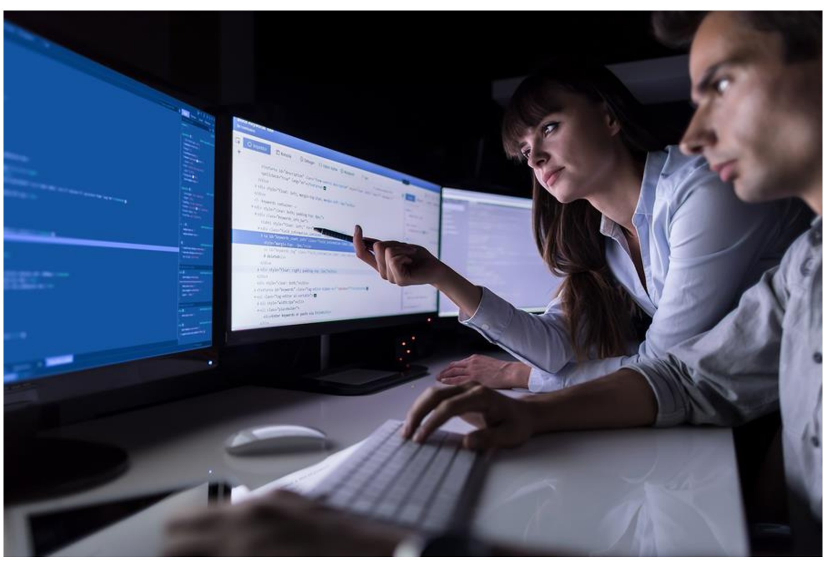
Principal ViableMkts

graham@viablemkts.com

In the Early Days

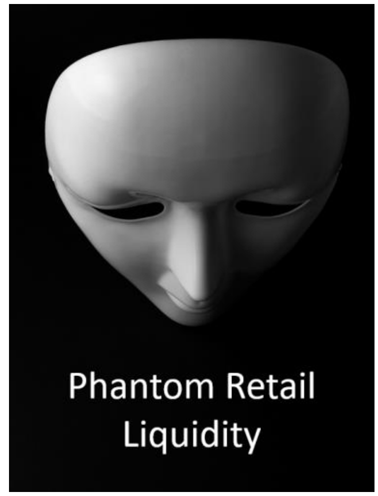
The retail fixed income market was an early adopter of electronic trading beginning around 1999 and has grown into a marketplace that also includes financial advisors, wealth managers and broker dealers. The initial firms providing electronic trading platforms included BondDesk, TradeWeb, BondPoint and TMC.

Collectively, these platforms increased access to liquidity by organizing executable quotes, fostering greater price transparency and improving operational efficiencies. Perhaps the biggest beneficiary in this environment has been the regional broker dealers, who like Citadel in the equity markets, were able to interact directly with valuable retail order flow.



To compete for, capture, and maintain retail order flow, the electronic trading platforms built out highly sophisticated front-end desktop functionality that could support the different workflow needs of individual retail investors and highly regulated financial advisors. Currently, the combination of retail fixed income trading platforms post approximately [9,000 live and executable corporate CUSIPS] on a daily basis, often with extensive depth of book showing on both sides. Over 200 liquidity providers and well over 100,000 offerings across corporates and municipals.

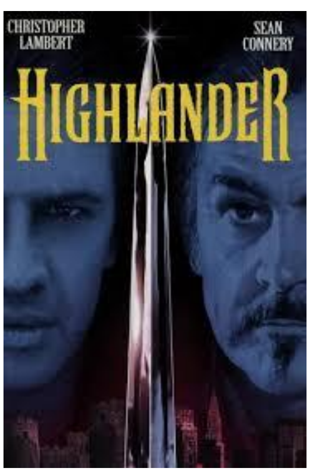
More Markets More Problems



While the numbers look like an achievement in electronic efficiency and market development, beneath the surface lies a different story. The platforms have the same community of market makers, so the aggregated markets represent a larger pool of liquidity than what is truly available for trading.

Meanwhile, if retail investors and registered reps rely on the execution venue to provide their front-end, they are committed to a single platform. Due to competitive forces, none of these platforms allow their end-users to access markets from their rivals. As a result, retail orders do not consistently interact with the best price.

And then there were two...



Last year, two major acquisitions by ICE have created the potential for material changes to the retail fixed income ecosystem. In January 2018, ICE completed its acquisition of Virtu Bond Point for $400 million. For an encore later in the year, ICE purchased TMC Bonds for $685 million, however, when you factor in the acquisition of BondDesk by Tradeweb in 2014, the market has quickly consolidated from five independent liquidity pools to three (ICE, Tradeweb, LSE MTS BondsPro). In addition, while MTS BondsPro has ample pricing and trading activity, the platform does not offer the customized front-end to support investment advisors, so pure retail order flow has only two liquidity pool options (ICE and Tradeweb).

Now Yous Can't Leave

It may appear counter-intuitive, but this lack of choice has the potential to be the forcing function that increases access to retail fixed income order flow. Maintaining the necessary front-end functionality to support the proper regulatory and compliance workflow of a financial advisor is capital intensive. The competitive environment of the past insulated the large wire houses from having to bear that burden. For example, a few years ago, Wells, one of the largest providers of fixed income retail order flow, migrated from Tradeweb Direct/BondDesk to TMC to lower costs.

In this current environment of consolidation, **the threat of migration is not material (where are you going to go?), so the possibility of trading cost increases to reduce platform technology overhead is highly plausible**. Another potential consequence is a slow-down in the pace of innovation for front-office technology. Without competition driving the development of new functionality, end-users could face a prolonged period of stagnation. These prospects are forcing wire houses to ask an important question: **Should we be building our own EMS for retail fixed income trading?**

Get Busy Building or Get Busy Paying (More)

While it is technologically possible to aggregate all available fixed income electronic liquidity into a single interface, doing so would require a wire house to take full responsibility for building and maintaining a proprietary front-end that will support the complex needs of a financial advisor. This is intimidating, but getting it right means keeping transaction costs low (limit platform price increases), while finding the best available prices (across all platforms) and improving overall workflow efficiency (trade more bonds).

The wire house that can successfully break out of the single platform structure first, will hold a major advantage over their competitors. To close that gap, other wire houses will have to follow suit, ultimately creating an environment where market makers can access retail order flow based on their price, not their platform affiliation.