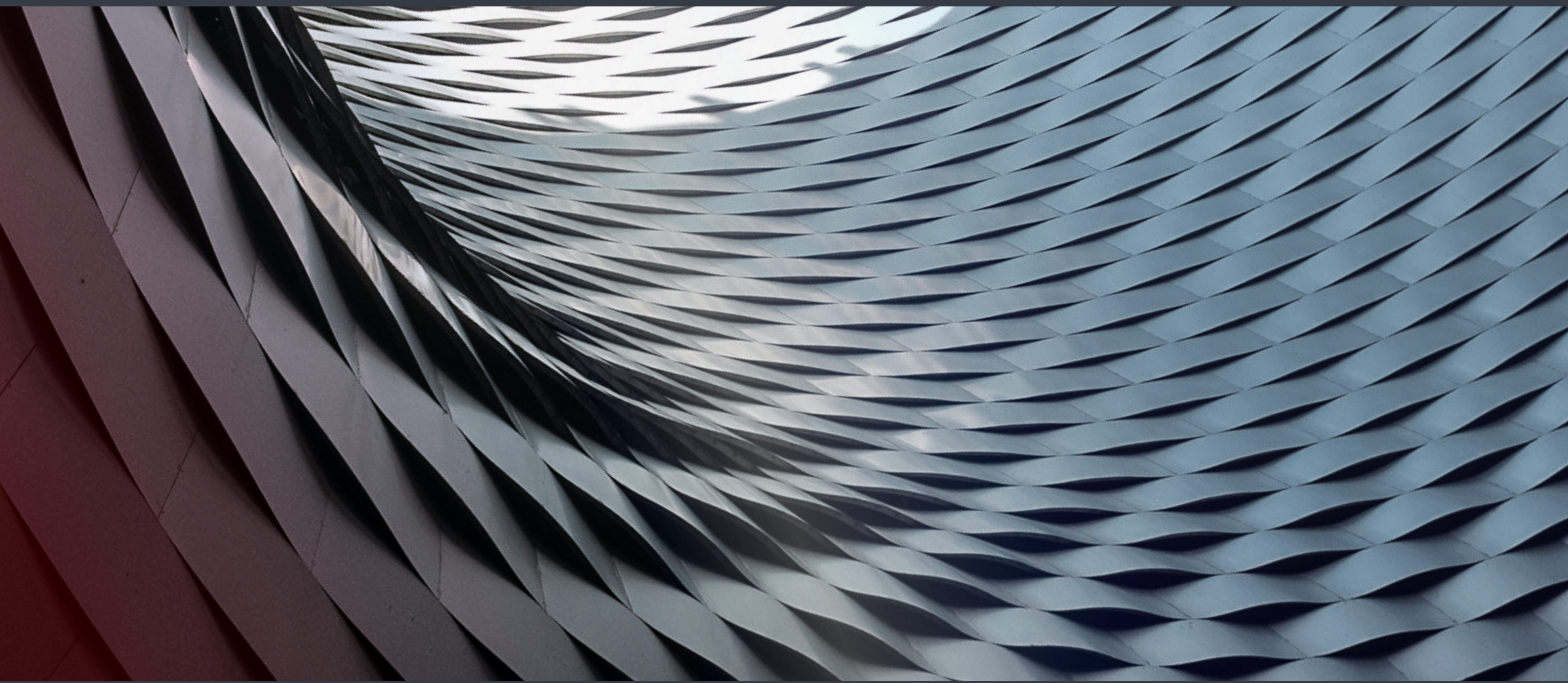
valantic

Report No.3 2022

Sell-Side Fixed Income Expert Network Report

Analyzing the impact of market volatility



Measuring the impact of market volatility
04

E-trading platforms and messaging systems
08

Investment in innovation
11

Research by acuiti management intelligence

Content

03

Intro

04

Measuring the impact of market volatility

- Execution methods
- Operational challenges

08

E-trading platforms and messaging systems

- Client demand for e-trading platforms
- Usage of messaging systems
- Demand for algos

11

Investment in innovation

- Barriers to investment
- Marketing new services
- Improving the client experience

15

The valantic FSA Sell-side Fixed Income Sentiment Index

Intro

Having got used to liquid markets and suppressed volatility for some time, we have seen a significant shift to lessened liquidity and increased volatility over the course of the last year. Many signs point to this being the trend for the foreseeable future, where we will continue to see a reduction in market depth and times of worsening electronic liquidity.

In our third edition of the Sell-Side Fixed Income Expert Network Report in association with Acuiti, we review the impact of market volatility on execution activity and identify some of the key operational challenges that have been faced in recent months. We also take the opportunity to investigate the trends around client preferences regarding how they source liquidity, be it directly from a single dealer platform or via the multi-dealer platforms, and the most effective methods of promoting services to clients.

Similar to last quarter, the network has continued to grow, as has the number of questions being posed to the network. Once again, we ask you to let us know if there are questions that you would like to put to the network or whether you would like to nominate a new member to the network itself.

We hope that you find the report informative, and we look forward to hearing your feedback and discussing your ideas further with you for the next report.

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Market volatility forces change in sell-side execution methods

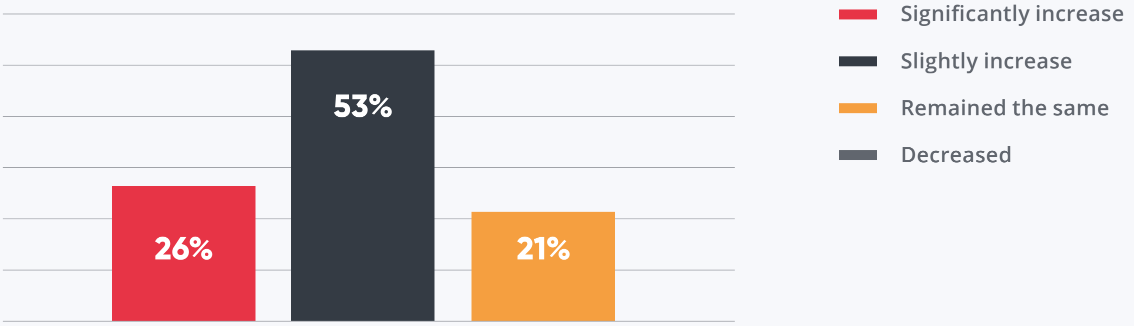
Volatility this year has brought both challenges and opportunities to all asset classes. As bond yields soar in the wake of rising inflation and fiscal tightening by central banks, fixed income has been at the center of the storm.

In this report, Acuiti and valantic FSA surveyed members of the Sell-Side Fixed Income Expert Network, a group of senior sell-side fixed income executives from across the globe, on how execution methods and trading operations have been impacted by the recent volatility. Each quarter, members of the Expert Network submit questions and topics for the quarterly survey.

Market conditions in 2022 have undoubtably created challenges for e-trading — both in handling volume spikes during periods of high volatility and sustaining liquidity during strong risk-off market movements. Despite this, Acuiti and valantic FSA's most recent survey of the fixed income market shows that the long-term trend of growth in the electronification of fixed income trading continues unabated. As volumes have increased, so too has flow to electronic trading platforms. Over three quarters of the Expert Network reported that flow to electronic trading platforms from their client base had increased during the first half of 2022 with over a quarter of the network pointing to a significant increase against a backdrop of significantly higher overall volumes.

This increase was also attributable to the superior liquidity that can be found for smaller tickets on electronic platforms (see below for further examination of the relationship between ticket size and trading venue). Interviews suggest that for execution desks dealing with multiple small tickets on a high-volume day, electronic venues are clearly a much more efficient platform for trading client flow.

How has flow to electronic trading platforms from your client base changed during the first half of 2022?



Market conditions in 2022 have also created some noticeable trends in trading behavior. **41%** of respondents said that the volatility of the last 12 months had changed previous relationships between trade size and execution method.

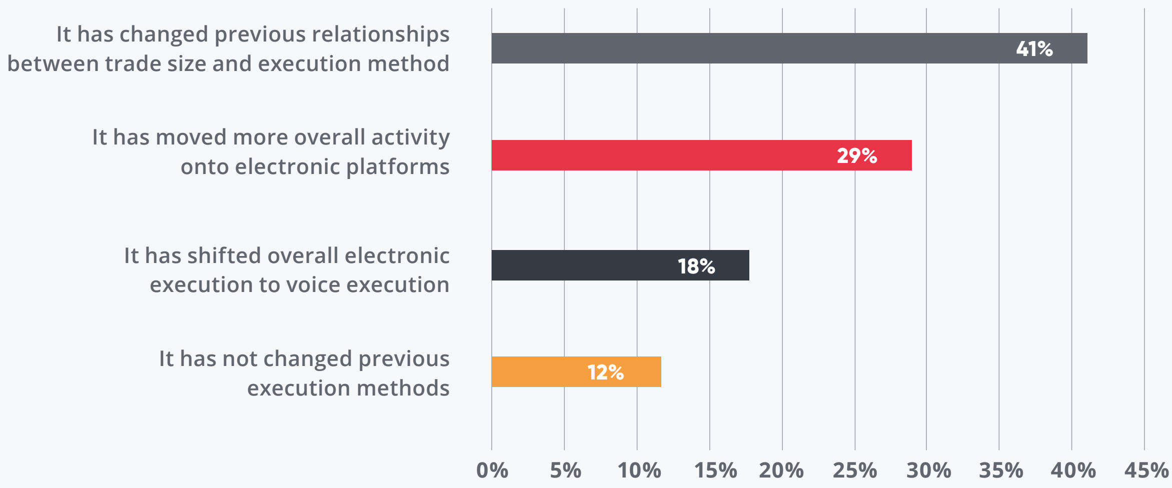
This trend has seen larger trades executed by voice but smaller trades electronically. This was a pattern that many market participants noticed during the Covid-19 volatility of March 2020 and now seems to be a fairly settled characteristic of fixed income execution during periods of volatility.

We see this being driven by a combination of factors. Firstly, during times of turbulence, traders often revert to manual execution, especially on larger or more complex trades (this was a finding in our last report, with respect to hedging, and features regularly in conversations we have with market participants).

These trades then also have a higher chance of moving the market, due to their size (a factor exacerbated in more complex markets, where liquidity is thinner). In volatile conditions, the danger of this only increases, given, as seen in graph 3, liquidity tends to worsen.

This short-term caution has not decreased interest in electronic solutions though as we see that interest in automated execution and hedging processes has in fact increased, with valantic FSA seeing more enquiries on the subjects from both existing and prospective clients.

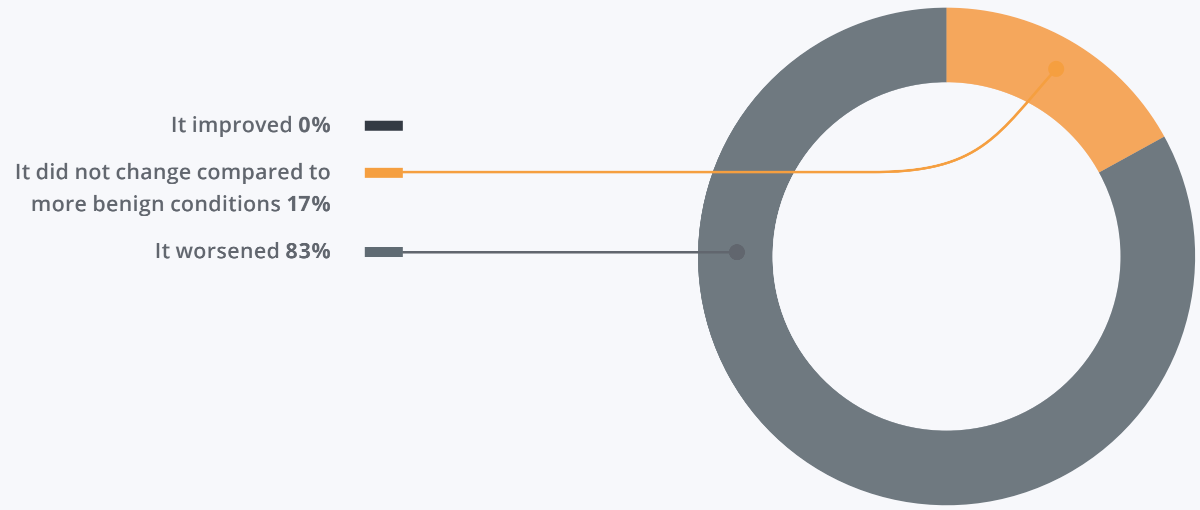
How has the volatility in the last six months affected client trading patterns in terms of execution methods?



On balance, more respondents reported that greater overall activity had moved onto electronic platforms over the last 12 months as a result of the volatility. Only **18%** said they had seen overall execution shifting from electronic to voice execution.

That's not to sugar-coat trading conditions though – **83%** of respondents said that electronic liquidity had worsened during volatility. This is hardly a pattern that is exclusive to electronic markets though, as liquidity suffers in most markets when conditions are turbulent.

How has electronic liquidity been impacted during periods of volatility?



We did find pullback from e-trading in some corners of fixed income, although these mainly related to particularities of platform rather than any wider caution around electronic execution.

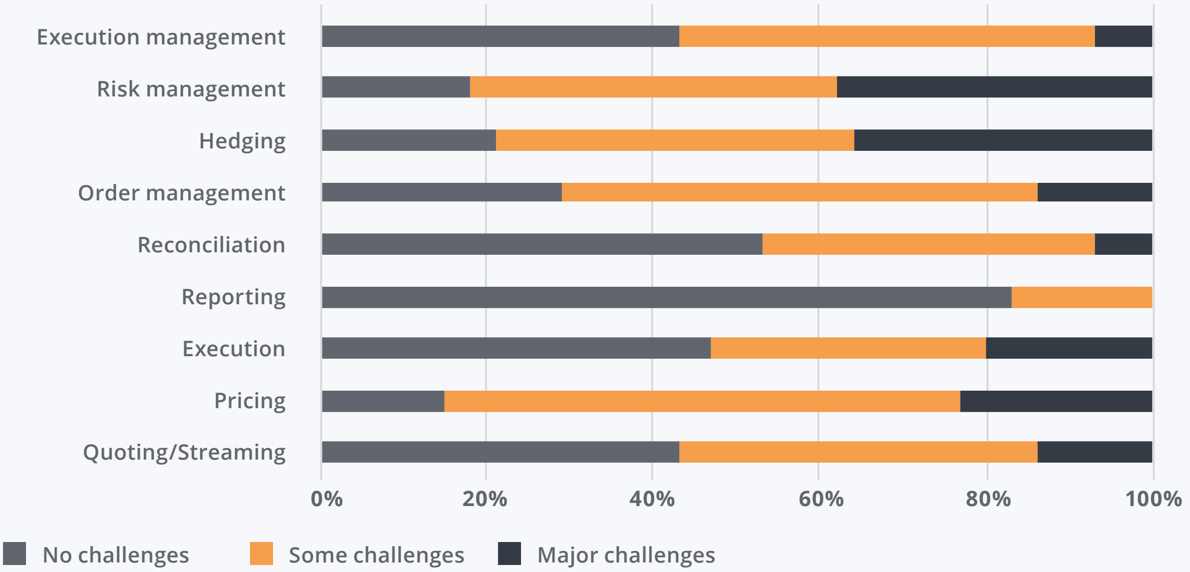
Members of the Expert Network reported that European and US traders on SEF venues in the interbank interest rate swaps market, for example, have reverted to voice trading at times during the last six months. In this market, electronic swap trades are either executed on a Central Limit Order Book (the interbank market) or a Request-For-Quote platform (used for dealer-to-client trades). Our interviews indicate that dealers have pulled back from CLOB venues in favor of voice execution this year, a trend that has not been as observable on RFQs.

Interviews suggest this is primarily due to the lack of last look functionality on CLOB, a feature that is available on RFQ and with voice transactions. This allows a counterparty to pull back or even change a price before execution. Last look's absence is often cited as an advantage of CLOB platforms, given how it can frustrate end users that see their prices pulled away at the last minute. Clearly, in volatile conditions this can protect traders from being caught out by sudden market moves.

Operational challenges

While the recent volatility has brought benefits to the sell-side in terms of higher trade volumes, many have faced significant operational challenges. Members of the Expert Network reported that the major operational pain points caused by volatility were seen in risk management and hedging.

What have the main operational pain points been for your e-trading businesses during the volatility?



This was a trend that we detected in our last report, with some trading desks tending to revert to manual management of hedging during periods of volatility. This was driven by fear that firms' automation of this function was not robust enough to keep the right hedging ratios in turbulent markets.

The expectation was that this behavior would change back to automation during more becalmed conditions. In the long term, executives across the sell-side are targeting greater levels of automation in the hedging process. Other operational processes were reported to have run more smoothly, with problems more common in the front office than the middle and back — over half of respondents reported challenges with execution, while **85%** reported issues with pricing. This aligns with findings in our last report, when the network pointed to pricing as its top priority for investment. This is an area with low levels of full automation, suggesting that it is ripe for development.

No one said they had major challenges with reporting however, with **83%** highlighting no volatility-related challenges at all in this area despite the high trade volumes.

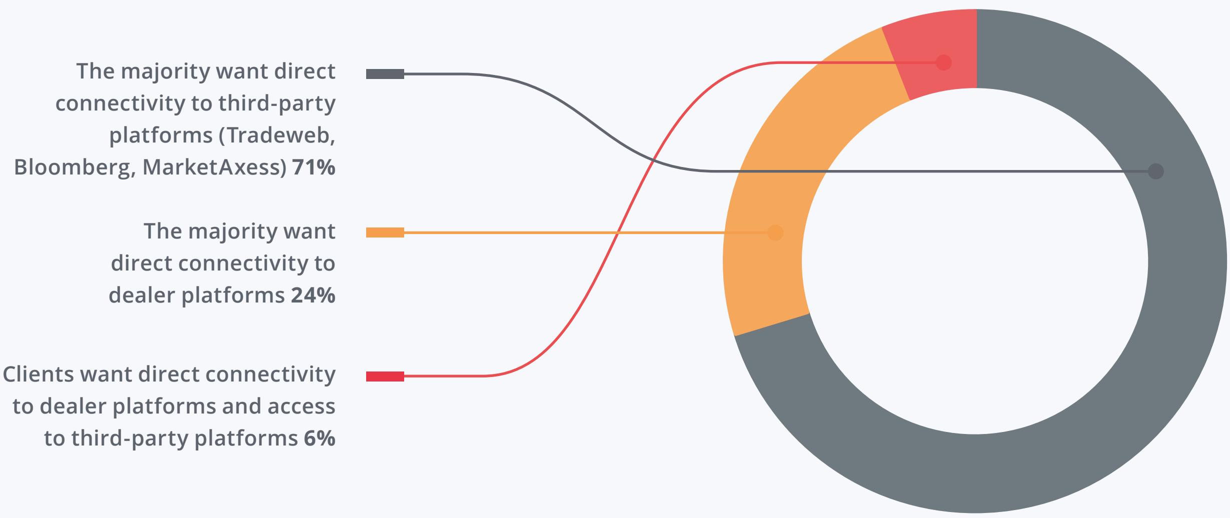
Third-party trading platforms set for further growth

This quarter, a member of the Expert Network requested information on client's preferences for third-party and dealer e-trading platforms.

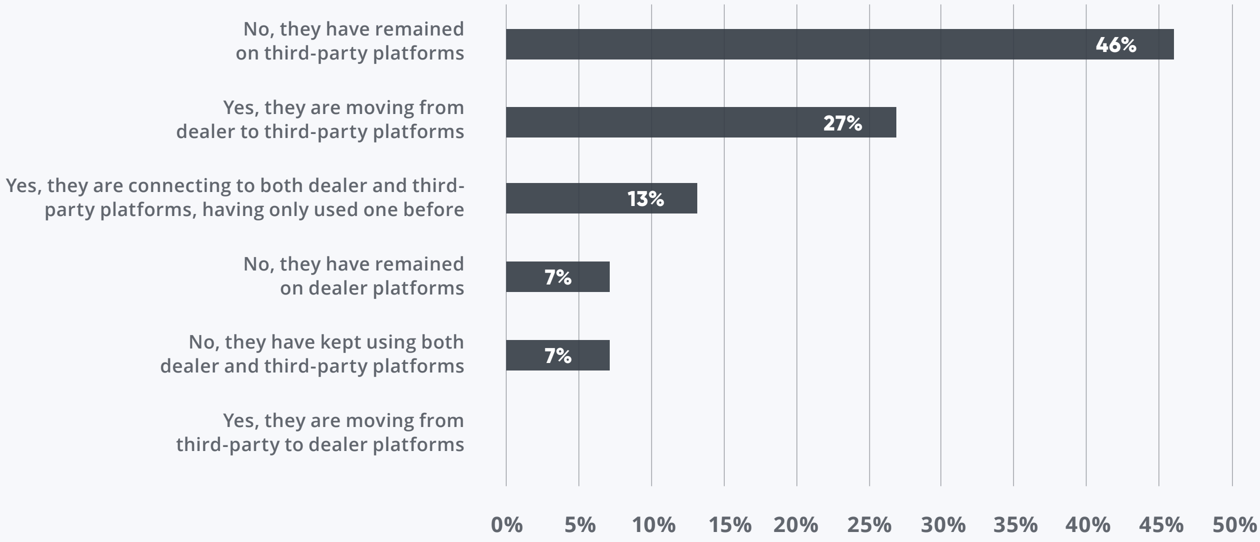
The survey showed that clients' overwhelming preference for set-up has been direct connectivity to third-party platforms such as Tradeweb, Bloomberg and MarketAxess, with **71%** of respondents saying this was what most of their clients wanted. By comparison, around a quarter said that their clients typically wanted direct connectivity to dealer platforms.

A very small minority of the network saw their clients historically requesting direct connectivity to third-party and dealer platforms.

Historically, what have your clients' preferences for e-trading platforms been?



Are those preferences now changing?



Already favorable momentum for third-party venues seems set to continue. Our data shows that those already using third-party platforms are most likely to stay put, while those clients who were changing format were mostly ditching dealer platforms to move to third-party. This point is compounded by the likely emergence of a challenger third-party venue based on recent news on the matter.

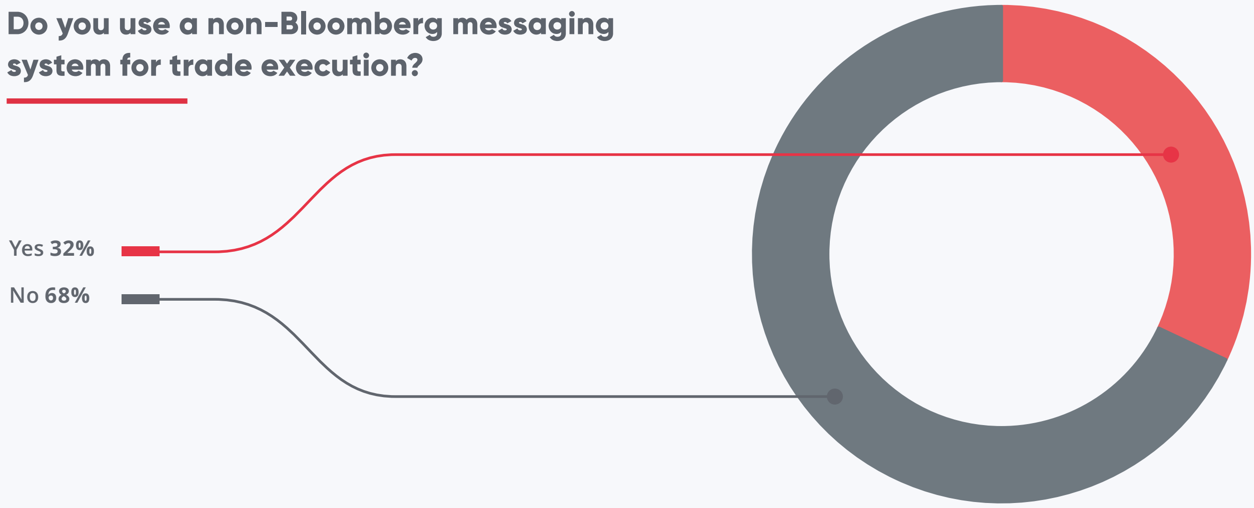
The greater diversity of liquidity providers on third-party multi-dealer platforms allows more counter-parties to trade against each other. Some significant buy-side firms have found huge benefits from the ability to put multiple dealers into competition with each other on pricing, as compared to voice execution, for example.

These multi-dealer platforms have their drawbacks however — principally on cost and also the potential deterioration of relationship between client and dealer. Recently, fees for using third-party venues have increased to an uncomfortable level for dealers which could lead to competition from newcomer venues trying to undercut the established platforms on fees.

Chat platforms

When it comes to messaging technology, we found that Bloomberg is still king in the fixed income markets. Only around a third of respondents used a non-Bloomberg messaging system for trade execution. Of those who did, about a third did so only for internal purposes. The main barriers to using these alternatives were lack of usage from clients and counterparties, internal resistance, and budget. We have seen these alternative platforms, such as Symphony, continue to invest and innovate to grow adoption, although it appears that they still have some work to do before they become the platform of choice.

Do you use a non-Bloomberg messaging system for trade execution?

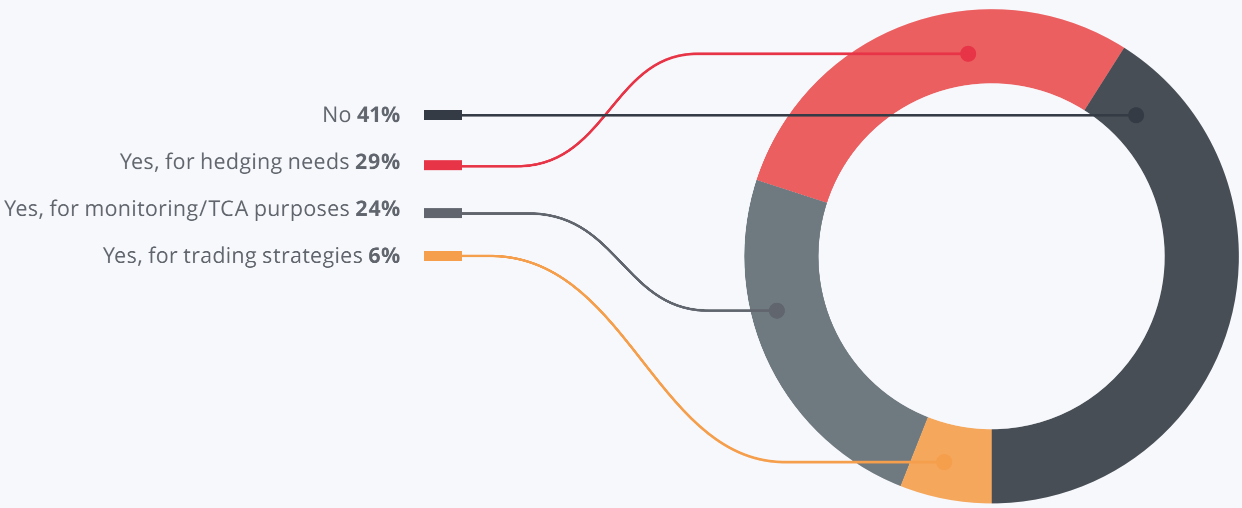


Demand for algos growing

While **41%** of the network said that their clients were not asking for more algorithms to use in their fixed income operations, almost a third reported demand for algos used to hedge positions, reinforcing the drive towards hedging automation. Demand for trading strategy algorithms was much lower with only **6%** reporting growing demand in this area.

Interviews suggest that this may be a confidence issue, with clients less willing to depend on broker-created algos for producing their own alpha. By contrast, the network seems increasingly comfortable with algos that cover more routine operations.

Are clients asking for more algorithms for their fixed income operations?

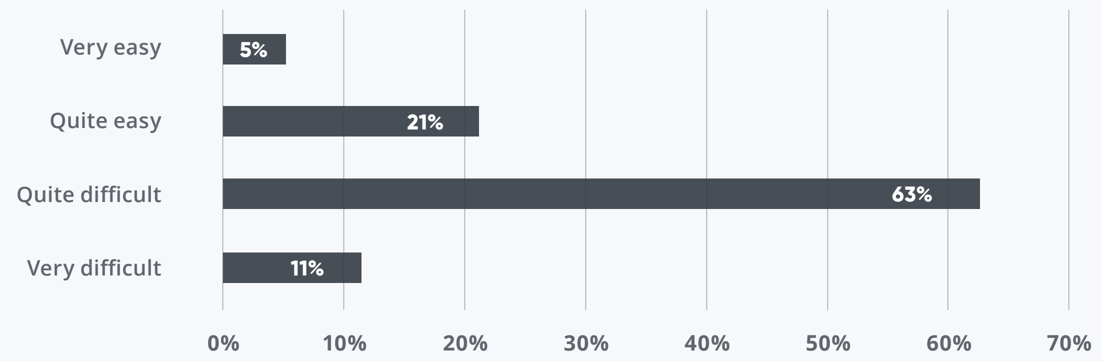


Investment in innovation held back by budget challenges

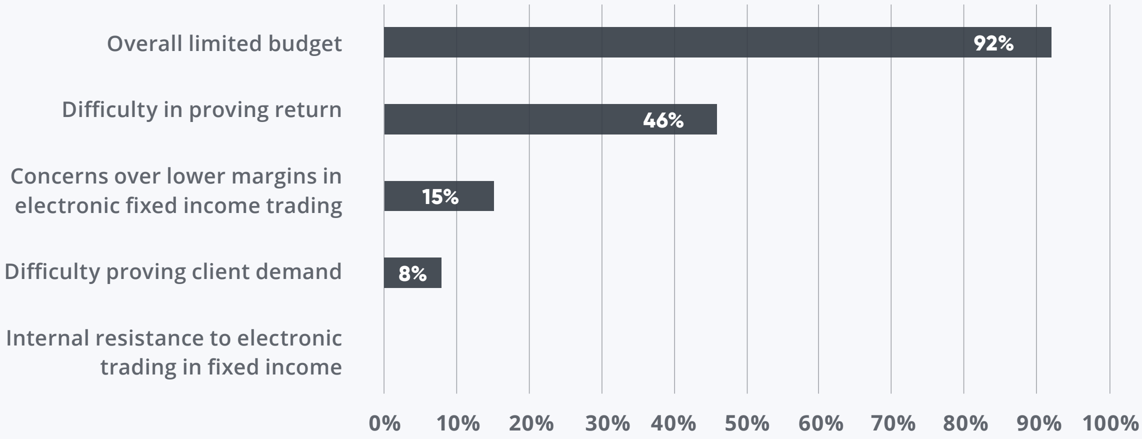
At the request of a member of the Expert Network, we polled the network on the challenges they face in investing in innovation, and the methods they use to promote new products and services.

As markets become increasingly electronic, firms across the sell-side need to invest to stay competitive — in our last report this was cited as one of the principal drivers of investment among firms. However, many executives reported challenges in securing budget for investment in electronic trading capabilities.

How easy do you find it within your organization to get budget approval to enhance electronic trading capabilities in fixed income?



What are the barriers to gaining budget approval?



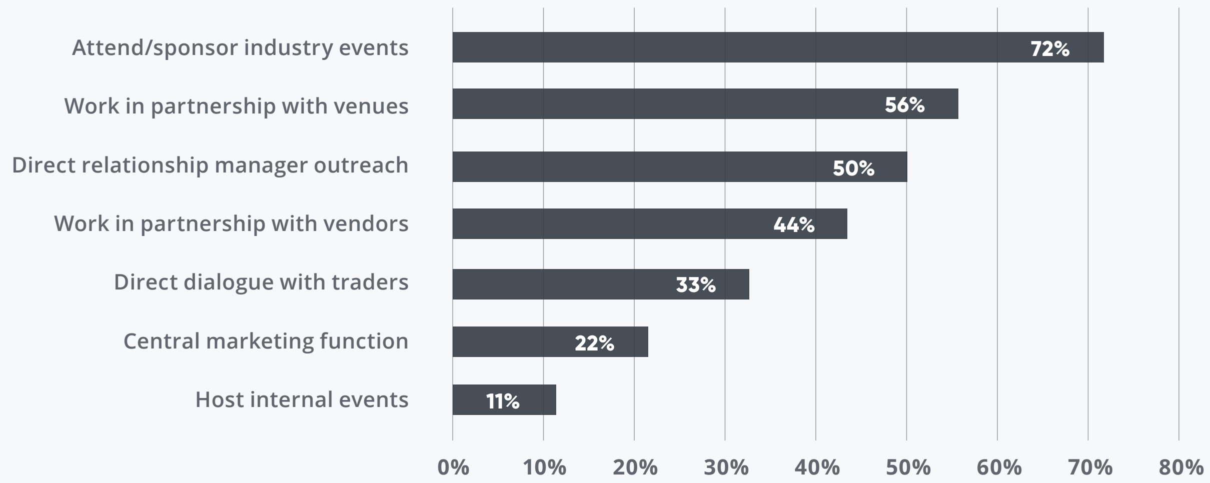
Overall limited budgets were the most common reason given for less investment. But a sizeable amount of the network also said that difficulty in proving returns on investment had been an obstacle to getting sign-off on bigger budgets for e-trading investment.

However, few in the network said that they had difficulty in proving client demand for electronic trading. No one reported internal resistance to fixed income electronic trading. However, all respondents reported barriers to gaining budget approval.

Marketing new services

When it came to marketing new tools or features, the majority of respondents said they did this through attending and sponsoring industry events.

How do you promote electronic trading with clients and/or market new tools/features?



Over half of respondents reported marketing new tools or features in partnership with venues, while half did so through direct relationship manager outreach. The latter method was also considered the most effective, which could make the case for hiring more staff in this area.

Significantly, no respondents reported attending or sponsoring industry events as the most effective method despite this being the most popular. Respondents that had the broadest marketing outreach were most likely to report that working in partnership with venues was the most effective.

Of those, which do you find the most effective?

1. Direct relationship manager outreach
2. Work in partnership with venues
3. Work in partnership with vendors
4. Direct dialogue with traders
5. Central marketing function

How are firms using technology to create a better customer experience for clients?

This quarter, we asked how firms were using technology to create a better customer experience for clients. Respondents said that they were deepening the data offering for clients, integrating data at every step of the customer journey, such as providing richer pricing, market depth, trade analytics, and trade impact, as well as expanding algo trading functionality.

Pricing was also an area where technology was seen as having potential to improve, with a focus on making this function more consistent and dependable.

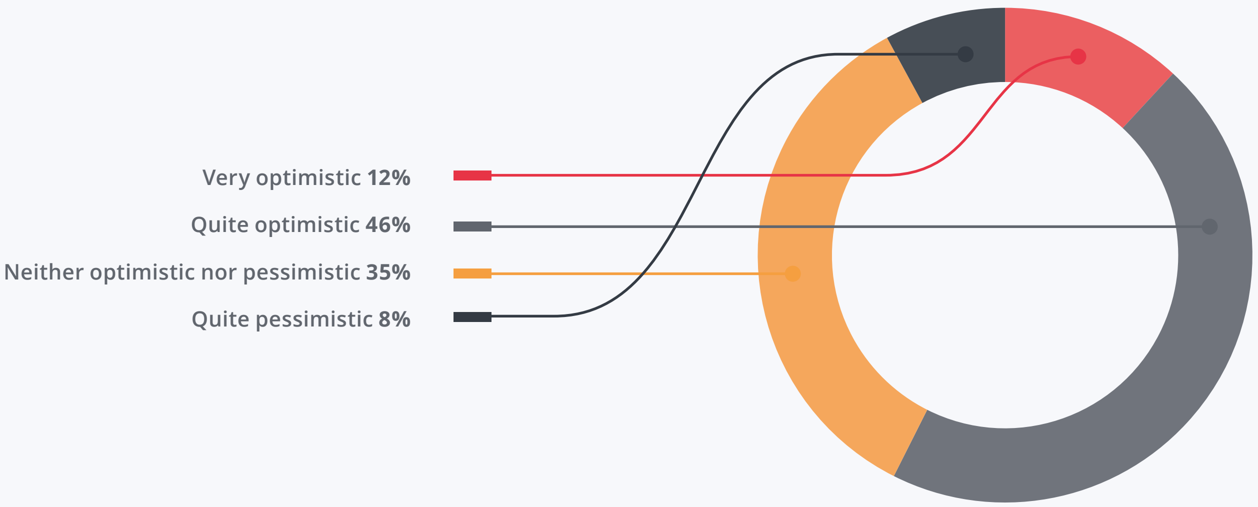
Avoiding re-input and facilitating confirmation were two aspects of the customer experience where technology was seen as a booster.

Other respondents said that they were focused on extending electronic execution to more products and geographies. This reflects findings from our first report, when the network cited fixed income ETFs, fixed income ESG products and electronic credit trading as markets with the greatest opportunity this year.

The valantic FSA Sell-Side Fixed Income Sentiment Index

The number of respondents with the Expert Network who were optimistic about the performance of their fixed income business over the next three months fell back marginally this quarter but remained high. Overall, **58%** of respondents said that they were either very **(11%)** or quite optimistic **(47%)** about the coming quarter, down from **60%** last quarter. However, the number of respondents who were pessimistic fell to **5%** from **13%** last quarter, reflecting the ongoing confidence in market conditions.

Overall, how optimistic are you about the performance of your fixed income business over the next three months?



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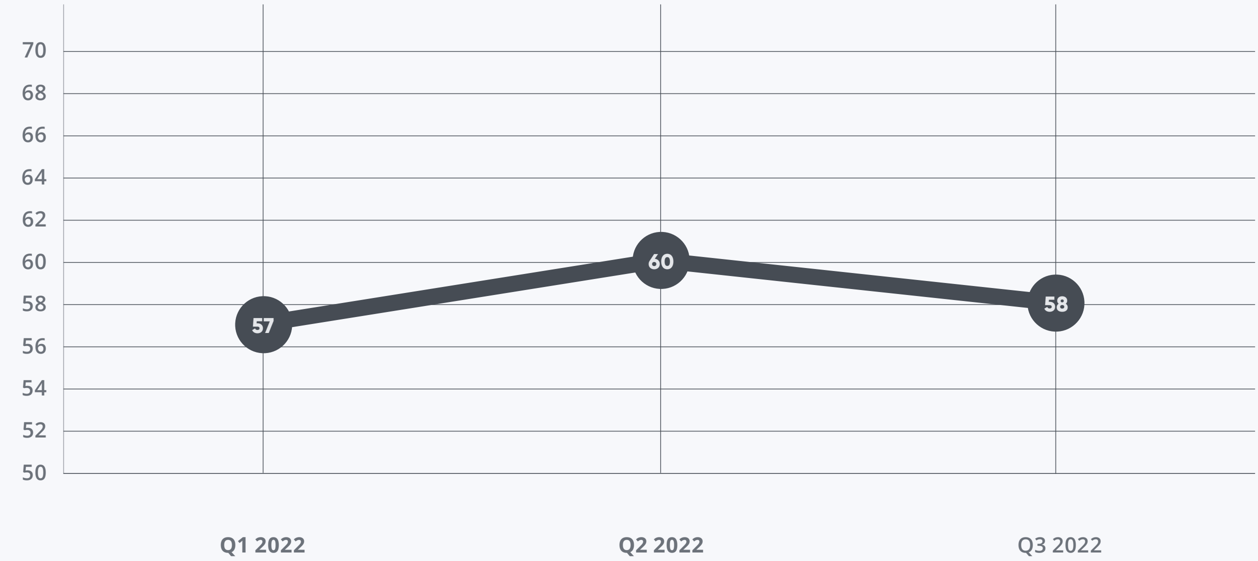
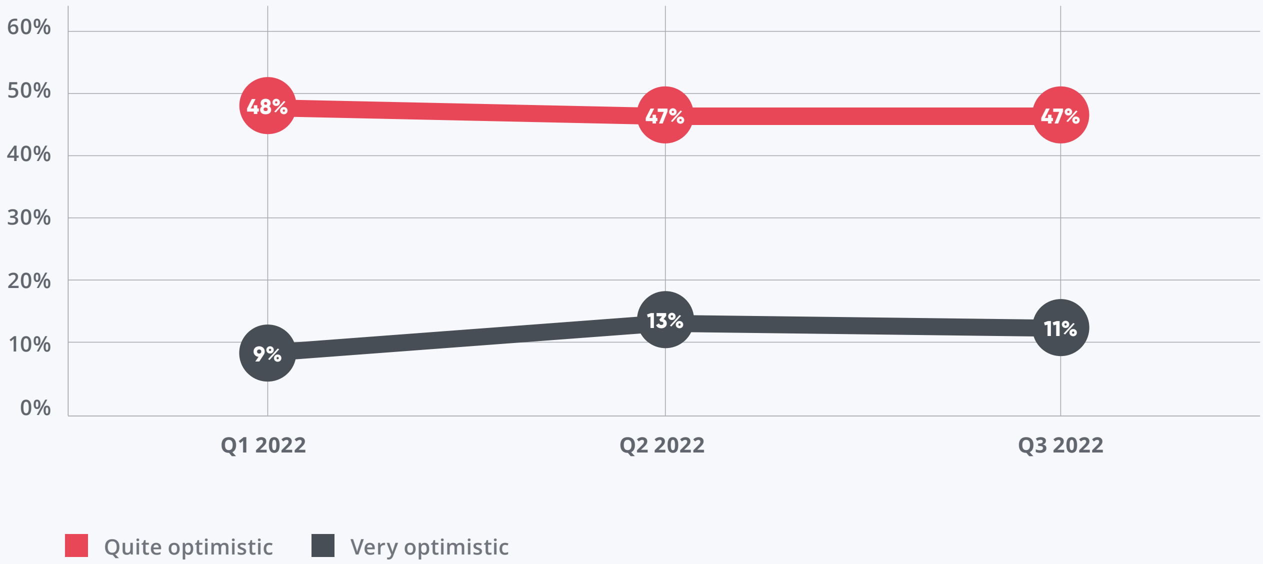


This index is calculated as a percentage of the total number of respondents from the Expert Network that were optimistic about their business performance in the upcoming quarter.

The valantic FSA Sell-Side Fixed Income Sentiment Index



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Our heritage in financial markets goes back over twenty years building highly robust electronic trading and workflow automation solutions across Fixed Income, FX and Equities. Today, we provide our platform as a series of composable building blocks that address the core business needs of our clients. These are used to create fully customizable workflows for our clients internal trading operations and to strengthen the electronic relationships with their customers.

We help our clients extract greater insight with our data-centric platform architecture and compelling HTML5 front ends. We supplement this with low-code development tools that enable our clients to further complement and customize our trading platforms.

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