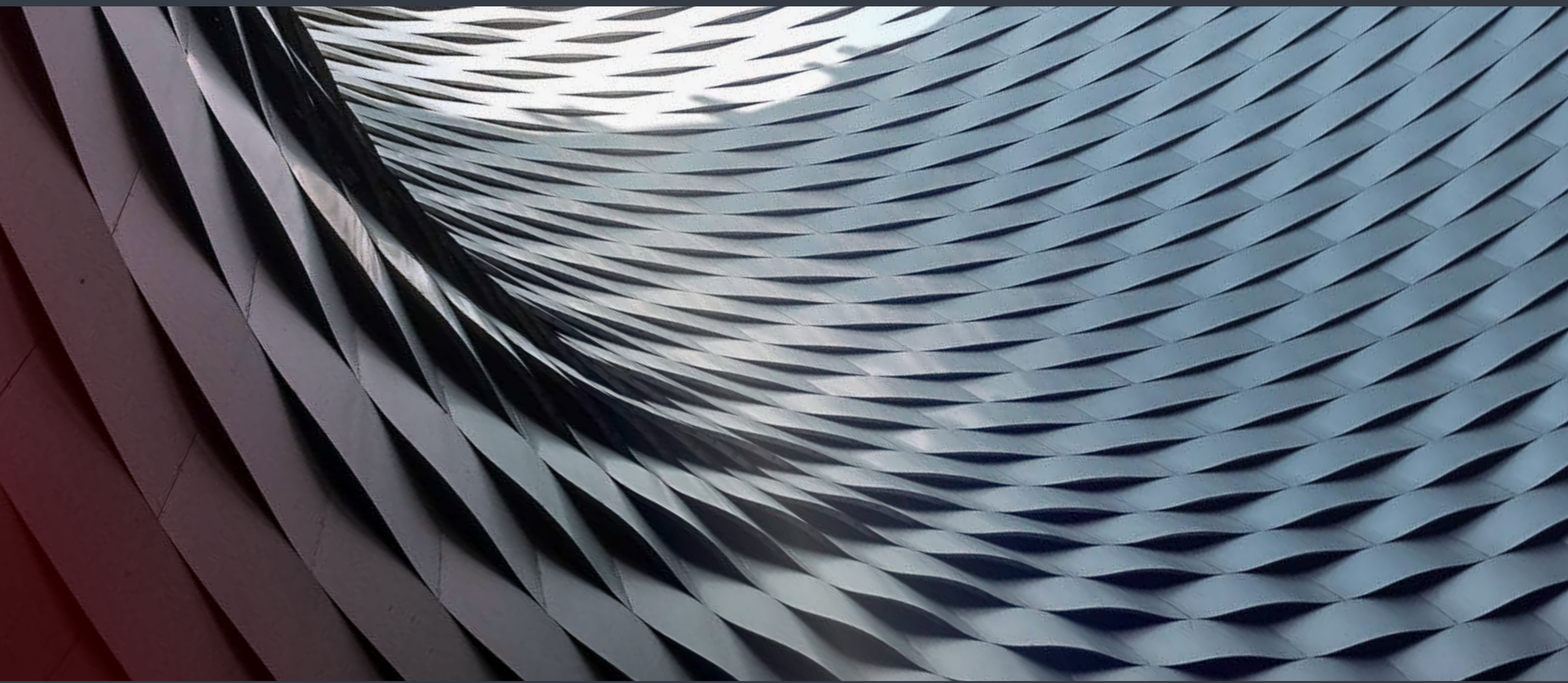
valantic

Report No.2 2022

Sell-Side Fixed Income Expert Network Report

Technology in fixed income markets



Research by acuiti management intelligence

Content

Intro

Welcome to our second Sell-Side Fixed Income Expert Network Report put together in association with Acuiti. Following the successful launch of our first report in Q1, we have continued to strengthen and grow the network to ensure that we are analyzing the views of a broader cross section of senior participants in the sell-side fixed income market.

Although the electronification of the fixed income markets has been ongoing for longer than two decades, it is only more recently that we are seeing broader adoption and smarter automation of the workflows. This quarter we have moved our focus to technology, reviewing the drivers and trends, and the areas that network members are looking to address in the next tranche of automation investment.

We have also taken the opportunity to dive into the buy, build, or buy and build debate, with arguments being presented for each case, and a winner starting to emerge. One clear point standing out in the report is that investment in automation continues unabated across front office and post-trade.

As we turn to planning the next edition of the report, 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 new members to the network itself. We look forward to discussing your ideas further with you.

Joachim Lauterbach
CEO, valantic FSA

Andy Browning
Head of Electronic Trading,
valantic FSA

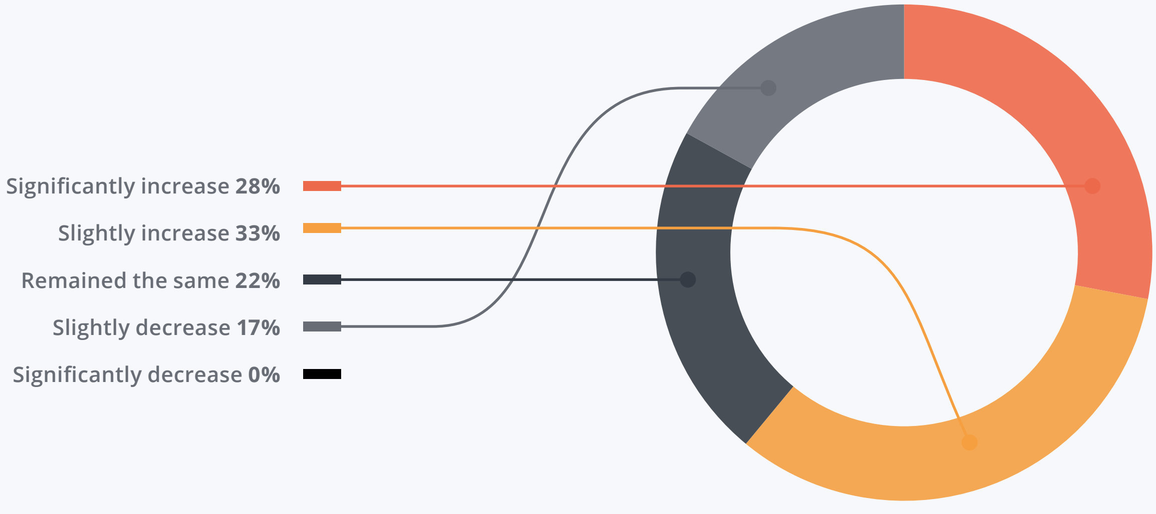
Sell-side ramps up technology investment to drive electronification and automation

Regulation, data availability and market infrastructure advances are all accelerating the electronification of fixed income trading. For the sell-side, this is resulting in an increased focus on automation and technology.

In this quarter's report, valantic FSA asked members of the Sell-Side Fixed Income Expert Network, a group of senior sell-side fixed income executives, how they were approaching investment in technology to meet the demands of the market.

The findings show that firms across the sell-side are increasing technology spend. Over the next three years, relative to the last three, **61%** said they were planning to increase technology investment in fixed income, with **28%** planning a significant increase.

How much do you expect your investment in technology for fixed income over the next three years to change relative to the last three?



The main driver behind these plans is the expansion of electronic trading capabilities, an increasingly essential part of any fixed income desks' offering to clients.

Firms across the sell-side are at varying stages of electronification and the motivations for investment suggest that many are simply seeking to keep abreast of a rapidly advancing market. This was reflected in the fact that, aside from the principal goal of expanding electronic trading capabilities, members of the Sell-Side Fixed Income Expert Network were mainly motivated to spend by factors such as addressing historical under-investment when trying to keep up with competitors.

This points to the fact that improved technology is considered by most a must-have to keep up with the market rather than a means of gaining an edge. As the pace of innovation increases and the sophistication of technology infrastructures grows, firms are likely to focus more on how their spend can deliver a competitive edge.

What are the top factors driving the increase in technology spend?

01. Expanding electronic trading capabilities

02. Keeping up with competitors

03. Addressing historical under-investment

04. Improving client service

05. Creating a competitive advantage

06. Improving ability to meet regulatory mandates

Buy, build or both?

As senior executives increase investment in technology, they are faced with the age-old question of whether to develop in-house or work with a third-party vendor. The factors behind this consideration, which include costs and the offerings on the market, are fast changing.

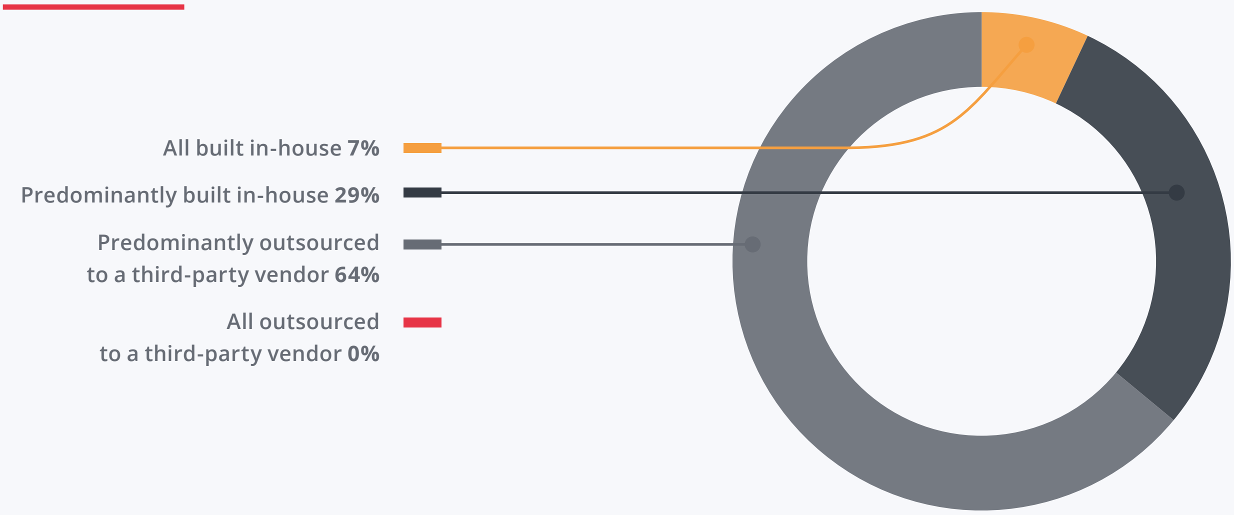
Both options have drawbacks and benefits. For those members of the Expert Network who favored an in-house build, maintaining full control over systems development and the firm's own infrastructure was the main reason cited.

Firms also saw this route as an opportunity to differentiate competitively, ranking this the second biggest motivation for an in-house build. In terms of overall technology spend though, competitive edge ranked relatively low as a priority, suggesting that for the industry as a whole, this motivates a minority of firms. The competitive advantage of an in-house build may also be dimming with the increased flexibility and capacity of third-paty systems. Respondents also cited concerns over becoming dependent on third-party vendors for their trading operations.

But while these are valid views on the advantages of building in-house, those benefits come at a high price both in terms of costs and complexity. Interviews showed that some consider in-house development a strenuous undertaking with a high chance of cost overruns and delays. Hiring the necessary teams of quants and developers consumes time and money. Those high costs often continue after the initial development ends with ongoing maintenance and enhancement needs.

As a result, only **7%** of firms in the Expert Network built all their technology in-house while **64%** of respondents said that they predominantly outsourced to a third-party vendor.

When thinking about technology investment, what best describes your company's approach?



The quality and sophistication of third-party software has significantly increased in recent years as the electronification of the market gathers pace, making the outsourced option more attractive. Respondents favoring third-party builds cited the speed of implementation and optimization of headcount as the main reasons for going down that route.

Another key motivation was taking advantage of broader industry knowledge. Third-party vendors service a wide variety of clients and needs. The best have built up unique insights into the plumbing of the fixed income markets. This knowledge is invaluable to fixed income desks trying to better understand how their peers are adapting to the same challenges.

Why do you choose to use Third-party vendors?

01. Speed of implementation

02. Optimization of headcount

03. Taking advantage of broader industry knowledge

04. Better product

05. IT cost reduction

06. Internal technology limitations

Firms are also increasingly adopting a "buy-and-build" approach in which they acquire core software from a third-party and then build extra functionality into it, to tailor the system more closely to their operations. Vendors' growing capacity to build bespoke functionality to augment core systems has facilitated this route in recent years.

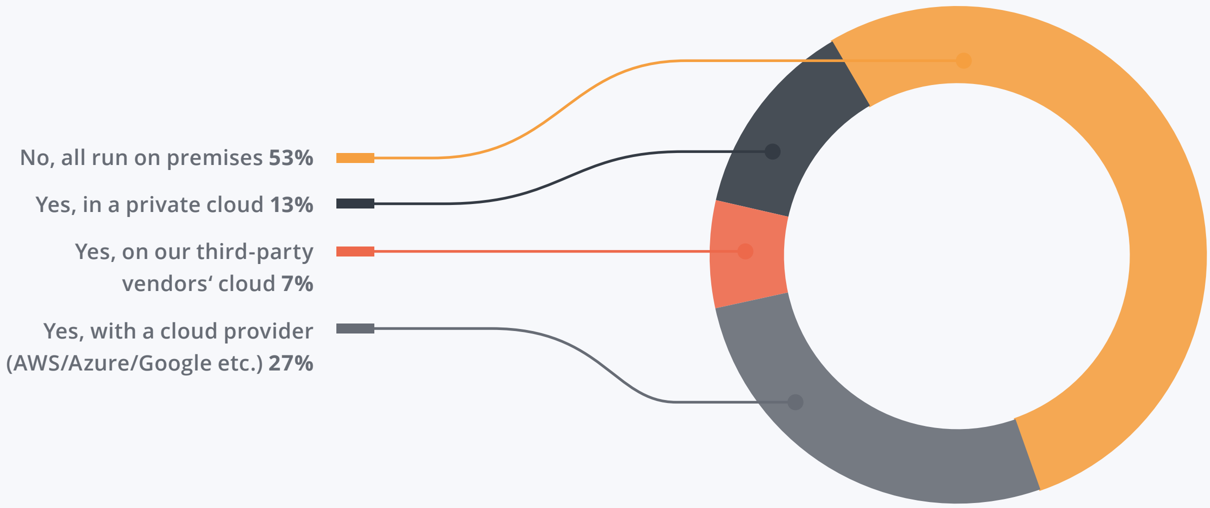
Almost half of the firms in the Expert Network (**44%**) were already going down this route, while **22%** said they would like to do so. This can be particularly advantageous for issues like internal client data, which require flexibility from third party systems to make sure that references are interoperable with other parts of the system.

The increased preference for vendor systems though is resulting in the fragmentation of systems. Survey respondents that engaged with third-party vendors reported a relatively high level of fragmentation with only **23%** working with a single vendor for their fixed income business. Meanwhile **46%** used between two and five systems and **31%** used six to ten. Of the firms using more than one system, **40%** said they were planning to consolidate vendors.

Cloud adoption is on the rise across the sell-side and fixed income is no exception. Hosted solutions can reduce costs and quicken the roll-out of platforms to market. Going forward, on-site installation is set to be a thing of the past, as the sell-side moves inexorably towards the cloud.

However, a majority of firms in the Expert Network still host all their software on their premises. In this aspect, the market is lagging behind other asset classes. But the trend is set to shift as firms follow other desks and upgrade their systems to favor hosted solutions.

Do you host your trading software in the cloud/hosted environment?



Where are firms investing?

01. Pricing
02. Quoting / Streaming
03. RFQ / RFS Management
04. Market Data/Data Analysis
05. Execution
06. Algorithmic Trading Tools
07. Post Trade Automation
08. Hedging
09. Reporting
10. Order Management
11. Reconciliations
12. User Interfaces

When deciding which part of their operations to invest in, firms marked pricing as a clear priority. This is a key competitive differentiator on the sell-side and an area where new entrants, such as electronic liquidity providers, have gained a significant edge in other asset classes. All firms have to maintain investment in this area if they are to build market share.

Quoting and streaming, as well as RFQ/ RFS Management, are highly important to the buy-side's experience with sell-side firms. Investment in making the price request process as smooth and efficient as possible is crucial for desks to offer to their clients.

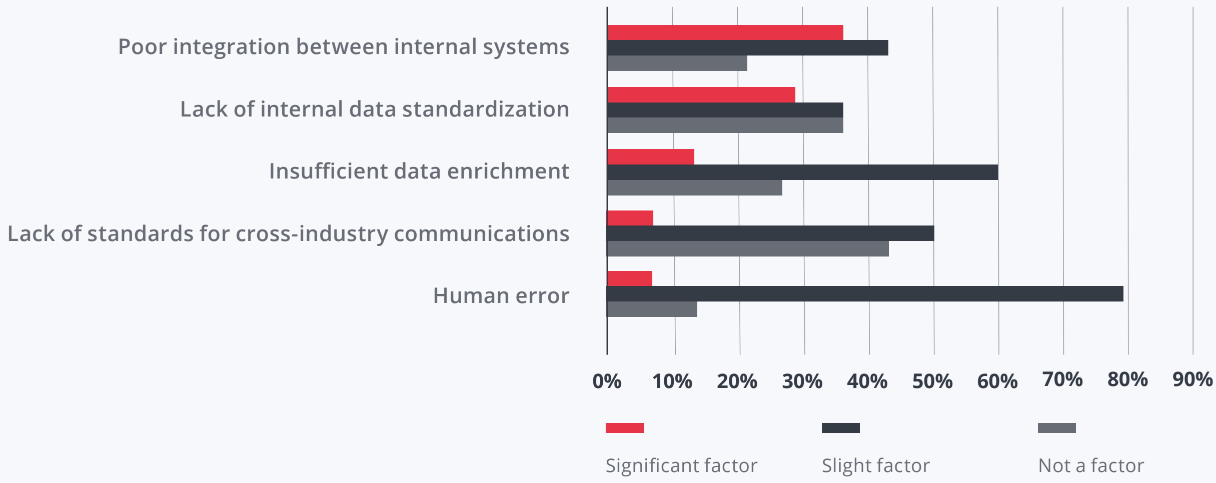
Demands for data and the tools for analyzing it also remain at the same high level. In valantic FSA's last sell-side fixed income Expert Network Report, firms reported looking at machine learning and artificial intelligence tools to gain an edge in analytics. This requires significant spend if firms are to differentiate the data offering provided by them from that of their peers.

Addressing trade breaks and increasing automation

In line with the increased electronification of trading comes the need to reduce trade breaks and increase automation post-trade. Over three quarters of the Expert Network said that the volume of trade breaks was an issue for their business.

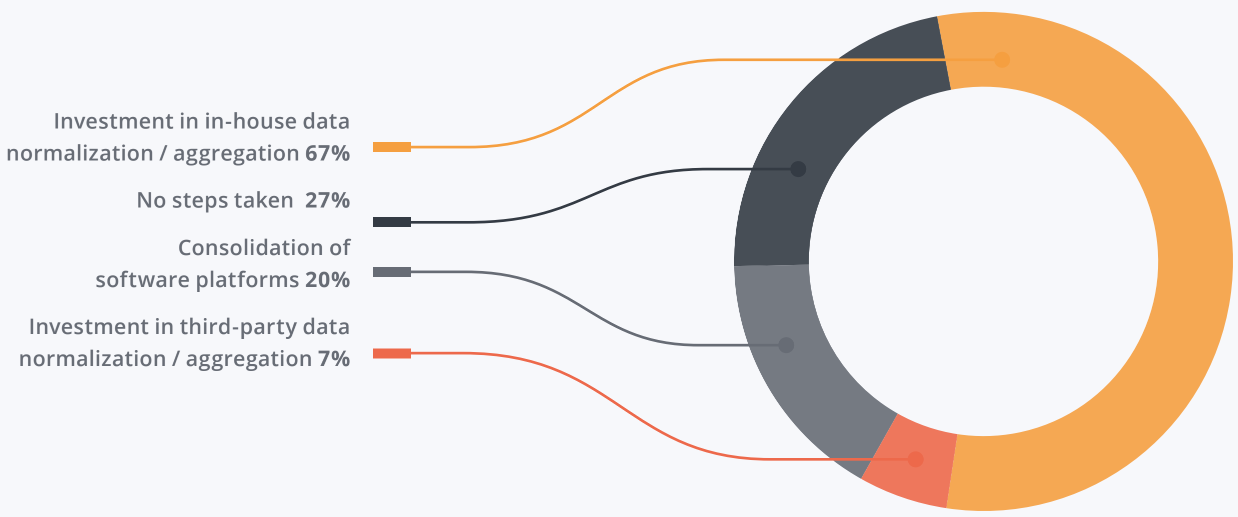
Poor integration between internal systems was cited as one of the two most significant causes of trade breaks. A lack of internal data standardization was the other key cause of trade breaks.

How much of a factor are the following as a cause of trade breaks in your organization?



A majority of firms looking to solve their data fragmentation problems were planning to invest in in-house data normalization **(67%)**. But a notable amount, **20%**, were looking to consolidate their software platforms to address the issue. A significant number, **27%**, had taken no steps to resolve this issue, a situation that is expected to cause further problems in the future as the volume of data increases.

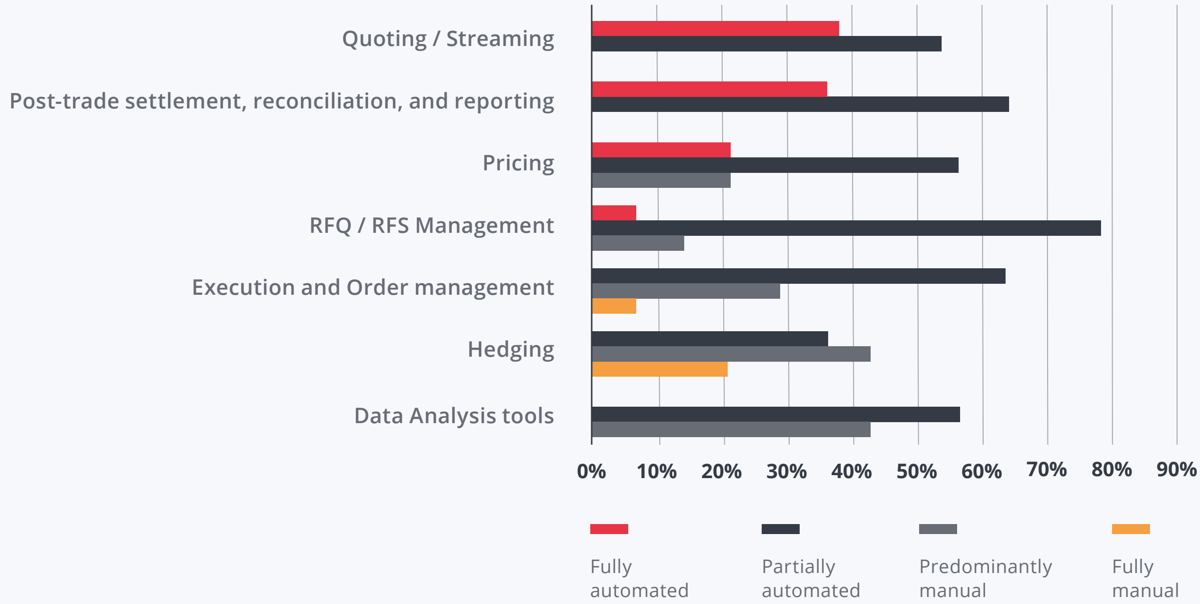
What steps have you taken/are you planning to take to address data fragmentation?



Targeting automation

As with reducing trade breaks, increasing automation is essential for the sell-side to be competitive as the market increases in technological sophistication. Aside from quoting and streaming prices, members of the Expert Network reported that post-trade settlement, reconciliation and reporting was the area where most advancement had been made in automation.

How automated are your processes across the following workflows?



By contrast, hedging was one of the three areas where no respondent reported being fully automated with **21%** still hedging on a fully manual basis. While executives do want to automate increasingly this part of their trading operations, those that were interviewed for this report revealed that during turbulent markets, there was still a need to revert to full manual execution.

Executives were concerned that automation capacity was not advanced enough to maintain the right hedging ratios during periods of volatility. The risk of running two outright positions was too high not to be handled manually by traders. The expectation was that in calmer markets, trading desks would reintroduce automation into their hedging processes and that these would become increasingly able to operate effectively during market volatility.

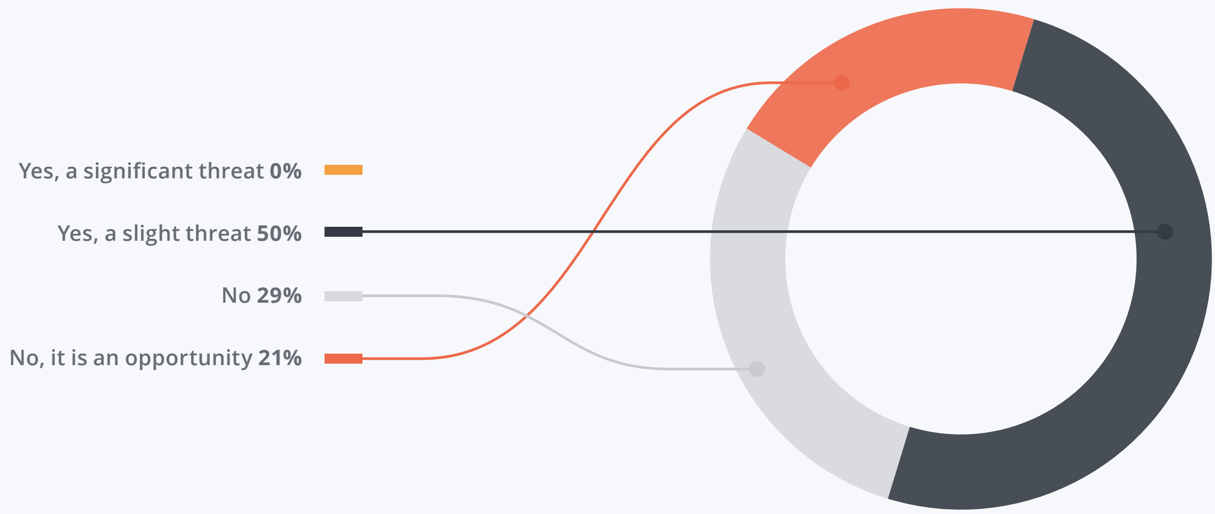
As with hedging, the challenge across the trade cycle will be to enlarge the scope of automated processes to cope with a broader range of market conditions and products. While many desks are comfortable with automating smaller trades, for larger and more complex deals, manual is still the favored method of execution.

Hot topics

Each quarter, members of the network can suggest topics or questions to be included in the quarterly survey.

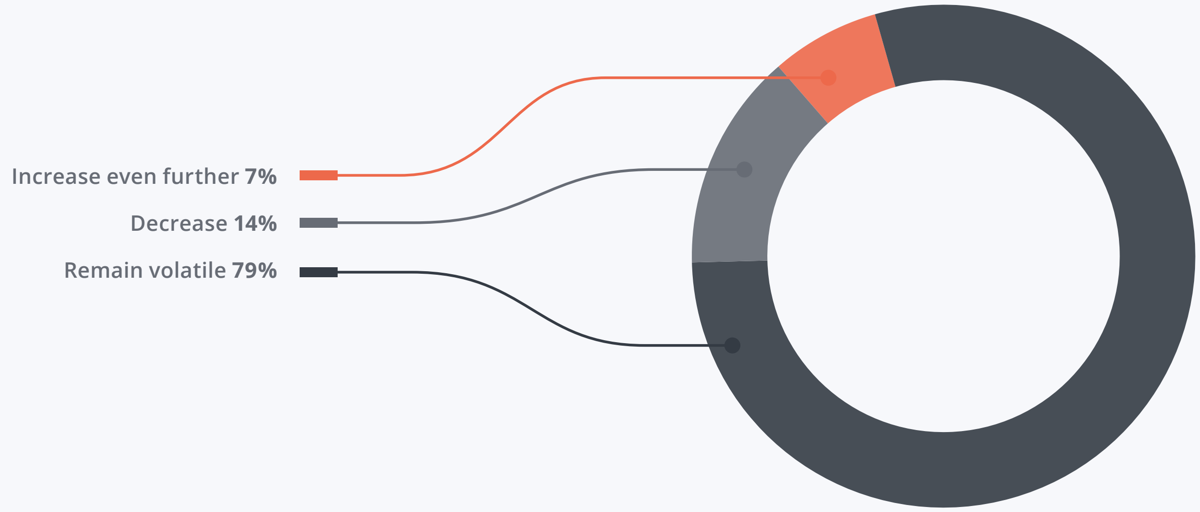
This quarter we covered volatility and the threat that third-party access to interdealer venues poses to the sell-side offering. We found that members of the network were somewhat concerned about the latter issue with half of the respondents saying it was a slight threat. However, a fifth saw it as an opportunity.

Do you see third-party access to interdealer venues as a threat to your current business?



In terms of the outlook for volatility, a large majority of survey respondents (**86%**) expect markets to remain volatile over the next 12 months with **7%** predicting even greater volatility than that seen in Q1 2022.

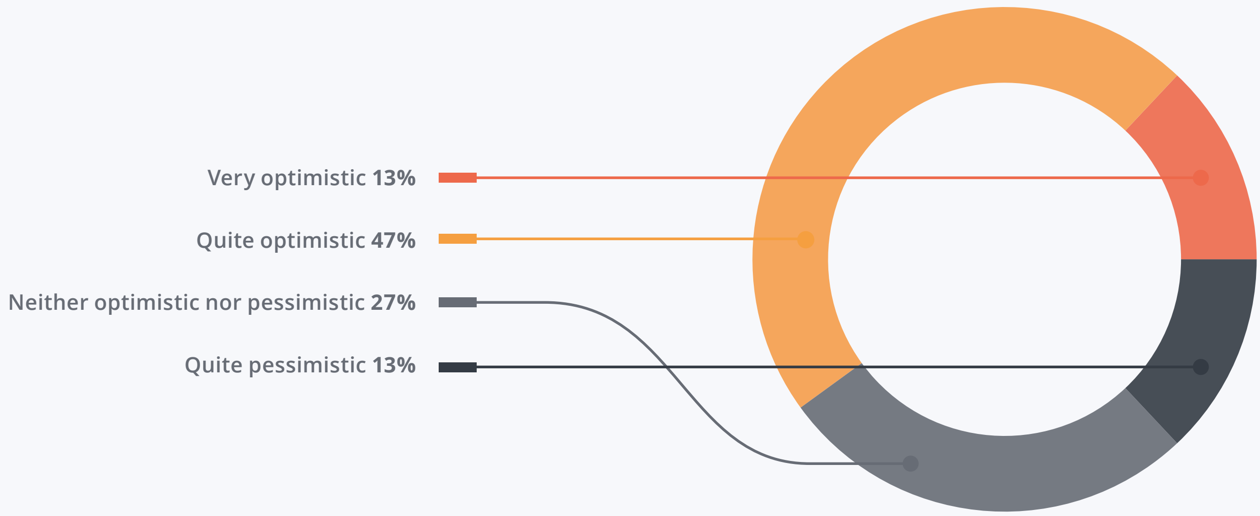
Do you expect the current volatility to increase, decrease or remain the same over the next 12 months?



The valantic FSA Sell-Side Fixed Income Sentiment Index

The valantic FSA Sell-Side Fixed Income Sentiment Index tracks levels of optimism within the fixed income markets on a quarterly basis. The first reading of the survey shows a positive score of 60 up from 57 in the last quarter as volatility continues to grip markets boosting volumes and revenues. However, the number of respondents that were pessimistic also grew this quarter as firms worry about the impact of falling prices on risk appetite in the medium term.

Overall, how optimistic are you about the business environment for sell-side intermediation in fixed income markets over the next three months?



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valantic FSA is driving the financial industry with smarter automation.

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.

Working in true partnership with our clients, our goal is to help them address their key business problems, while reducing their total cost of ownership through our complete SaaS and Managed Services offerings.