Note from the IIAC President and CEO

Observations from the SIFMA Annual Meeting
October 1-2, 2018

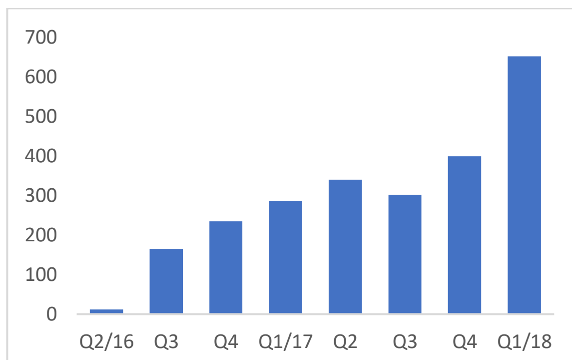
Two key highlights of the one-day plenary and panel break-out sessions at the SIFMA Annual Meeting on October 1-2 were an updated perspective on fixed income trading and the broker-dealer wealth management business. Discussions on specific business operations of SIFMA-member firms were interspersed among several plenary sessions related to the U.S. financial market/economic outlook and the political landscape, with the country on the verge of mid-term elections in November.

Break-out panel sessions of particular interest focused on recent changes to business models in secondary fixed income trading and the wealth management business in response to changing investor demand and new technology applications. These insights are important not just to understand how the U.S. industry is evolving in rapidly changing markets, but to foreshadow the direction Canadian dealers might take in the coming year or two, given similar adjustments in investor behavior in our markets.

Defining the future of fixed income markets

The U.S. fixed income markets have undergone a remarkable transition in the ten years since the financial crisis. Prevailing low interest rates, regulatory reforms imposing higher capital/liquidity requirements, and fee compression at asset managers, have forced dealer market-makers and institutions to shift to massive "electronification" of debt markets in the U.S., particularly in government bond markets, with most small-sized transactions executed on electronic trading platforms. Most liquid corporate bonds similarly trade in small transaction size through electronic platforms, while illiquid corporate bonds are largely executed on an agency basis. Buy-side and sell-side participants have developed electronic pricing algorithms linked to multivariate trading platforms. This "low-touch" electronic trading provides operational efficiency, lower cost and decreased risk as these trades can be priced and settled quickly. The expanding platform trading also leaves traditional bond traders to focus efforts on riskier value-added large transactions.

U.S.: Total number of investor odd lot inquiries responded to by a bank algo on MarketAxess ('000)



Source: MarketAxess

Automation has changed odd-lot trading (less than $1 million per trade). As large banks prioritized bigger trades, investors' requests for prices in smaller transactions increasingly went unanswered. Now, a number of banks have developed their own algorithms to price odd-lots for electronic trading. MarketAxess Holdings Inc., the largest electronic bond trading platform, has seen the number of banks using algos to price odd lots double from four to eight participants. According to MarketAxess, investors are getting a better price experience for small trades and dealers are executing more trades (that might otherwise fall through the cracks) at lower cost. The improvement in the ease of buying and selling odd lots has enhanced liquidity for these transactions.

The U.S. Securities and Exchange Commission (SEC) Fixed Income Market Structure Advisory Committee (FIMSAC) recently agreed to a one-year pilot project to raise block trade dissemination caps on corporate bonds in the TRACE transparency system from $5 million to $10 million for investment grade bonds and from $1 million to $5 million for high-yield grade issues. At the same time, FINRA will continue to disseminate post-trade data immediately upon receipt (i.e. within 15 minutes) for trades that are less than their respective dissemination caps, while delaying the public dissemination of trade reports above those caps for 48 hours.

The increase in dissemination caps will provide traded volume data on larger-sized transactions than before, providing more information to refine algo-pricing models. The FIMSAC cautiously agreed to the pilot project judging that, at least in the short-term, the increased traded volume data from higher caps will not jeopardize market liquidity.

The panel discussion also focused on corporate bond exchange-traded funds (ETFs). It was noted exchange-traded derivatives based on underlying corporate bonds have expanded at a rapid pace in recent years, reflecting relative yield, diversification and liquidity. Growth of the instrument has accelerated as the pool of ETFs expanded beyond bond indices to defined sub-sets based on specific corporate bond characteristics or "factors". ETF liquidity has been much more robust than the underlying corporate bond market. For example, in the 2008 crisis as liquidity in corporate bonds deteriorated, Blackrock noted that its investment grade corporate bond ETFs "continuously traded on exchanges in an orderly fashion". However, concerns remain that this liquidity could evaporate quickly if, for example, a shock prompts massive selling and steep price declines in corporate bonds and investors try to get out at the same time. Banks and investment dealers have limited scope as market-makers to absorb panic selling — particularly by asset managers faced with substantial exposure to falling asset prices, accelerating withdrawals of client funds and limited liquidity to avoid major asset sales.

The FIMSAC has placed priority on monitoring ETF liquidity in difficult market conditions. The U.S. authorities and multilateral organizations, like IOSCO and the FSB, have had similar concerns for some time about the systemic market implications from massive and growing ETF holdings at large asset managers. In particular, could ETF liquidity quickly evaporate causing asset values to plummet, spilling over to an already illiquid corporate bond market and trigger broadly based asset declines in the marketplace?

Asset managers: Synergizing product creation and distribution at broker-dealers

In the last several years broker-dealer wealth platforms have widened the shelf of investment products and financial services as advisors have moved to the epicentre of wealth services, taking on the role as "financial quarterback" of the client for the full range of services for the ageing baby-boomer, and the increasingly influential millennial.

The wealth services platform has broadened in two dimensions: i) the product shelf has expanded from individual stocks and bonds to a wide and diverse array of mutual funds and ETFs to include insurance, derivative products, commodities and alternative investments in real estate and private equity, and ii) the range of financial services has expanded beyond advice, financial planning and tax expertise to estate planning, including wills, insurance needs, philanthropic advice, etc., for small investors and wealthy self-employed clients. The wealth offerings have also expanded to investing options such as robo-investing and self-directed accounts to a variety of client accounts from various fee-based accounts to transactional accounts.

The large asset managers, with expertise in investment products, portfolio construction, research capability and technology have an increasing important advisory role with broker-dealer firms in identifying investment products, constructing client portfolios for advisors, and streamlining/rationalizing the broker-dealer product shelf by eliminating mutual funds that have fallen short of performance expectations or failed to gather client assets. The product shelf across the retail firms had built up steadily in recent years and was expensive to maintain with firm research on product performance limited to a small sub-set of mutual funds. For example, Merrill Lynch went through a massive rationalization of its product shelf in 2016, reducing mutual funds accessible to advisors from 3,600 to 1,800.

In effect, this shelf rationalization process, now fairly-widespread across the investment industry, signals financial advisors are becoming more identified as “managers of managers”. Financial advisors and firms are placing considerable emphasis on third party experts, such as asset managers, like Investco, Vanguard and Blackrock, to streamline the product shelf and recommend new high-quality investment products that meet the broker-dealer advice proposition. The firms also rely heavily on these third-party experts to provide an ongoing assessment of the investment products offering, enabling the advisor to put greater focus on client relationships. The asset managers have, at the same time, developed expertise and specialized teams to advise on platform rationalization and mutual fund product research.

Yours sincerely,

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