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What to consider before pursuing a price maker strategy

How to transition to price maker

LET'S MAKE A DEAL-ER:

BUY-SIDE REQUIREMENTS FOR PRICE MAKING IN FIXED INCOME MARKETS

Authors: Anna Shtromberg & Kevin Molloy

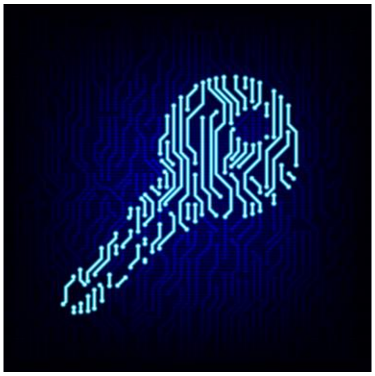
ViableMkts Principals

anna@viablemkts.com
kevin@viablemkts.com

Throughout 2016, the topic that gained momentum in the corporate bond market was the need for the buy-side to embrace price making as a strategy. Several prominent buy-side firms claimed that they had started taking steps to shift their behavior from a pure price taker to one of a price maker by directly posting prices and responding to RFQs. The anticipated benefits of price making for buy-side are clear. Access to greater market liquidity, and the improvement of portfolio performance through reduced trading costs. As more buy-side firms are considering a similar strategy, they are faced with several fundamental questions.

Key Questions for Potential Corporate Bond Price Makers

1) Do we have the right business model to pursue this strategy?



The extent that a buy-side firm can adopt price-making into their corporate bond trading process is directly dependent on their current business structure. There are aspects of price-making that may or may not be congruent with the responsibilities and trading behavior of your firm. Determining the areas of your workflow that would benefit most from price-making techniques is the first step towards developing a strategy.

2) What are the trading technology requirements for price making?

Current buy-side technology and infrastructure does not provide the key tools required for successful price-making. Identifying the high-priority technology solutions for your price-making activity and formulating a plan for technology development is essential.

3) How could price-making activity impact relationships with dealers?

Altering your trading behavior to be more self-reliant can potentially change the way some dealers view your organization. Are you a competitor or still a client? Understanding the nuances of which practices are considered acceptable from a dealer's perspective is critical for maintaining solid relationships with market makers while evolving your trading capabilities.

For buy-side institutions that are formulating a price-making strategy in corporate bonds, a full examination of these key questions can serve as a guide that helps you optimize the benefits of price-making while avoiding the pitfalls.

Different Strokes

Before we move further, it is important to acknowledge a common mistake that has distorted meaningful conversations about new trading behaviors and market evolution. There is a significant difference between a Price Maker and a Market Maker. Failure to acknowledge this fact leads to numerous "What chu talkin' bout Willis?" moments that we'd like to avoid in this article.

A Market Maker is an entity that derives revenues (and potential profits) by providing other market participants with the opportunity to trade. In theory, **serving the trading needs of others is a market maker's singular business focus.**

A Price Maker is a buy-side institution that can directly manage their own order flow by posting prices and responding to RFQs (when an inquiry fits their needs).

The fundamental difference between price making and market making is almost identical to the difference between a restaurant and dinner party.

Like Market Makers, restaurants are designed to respond to the needs of others. To do so, they must advertise what they offer with a menu (post markets), have the ingredients to produce the meals (hold inventory), and meet the spontaneous dietary requests of their customers (improvise). In addition, this is done on a daily basis.

A dinner party host decides the time of the party, number of guests, and most importantly, the meal. Yes, dinner parties allow others to eat, but the opportunity is limited because ultimately, the dinner guests are beholden to the host.

Price makers allow others to trade, but those opportunities are extremely finite because ultimately, market participants are beholden to the trading needs of the price making entity. It's not for this discussion, but **thinking market liquidity will materially improve with the addition of more price makers is not sound.**

Tiiiiime is on my side ♫

Determining your price making strategy in the corporate bond market begins with examining your trading behavior. Price making is exclusive to electronic trading platforms, so you must **measure your current level of electronic activity and calculate the total amount of your order flow that could be traded electronically.** This analysis requires a mastery of the corporate bond e-Trading landscape because despite what some believe, there is life beyond an all to all RFQ model. In fact, the ECN platforms are essential to price making.

The next phase of your examination process is the biggest factor in dictating just how much of a "price maker" you can be. While the benefits of price making are obvious, there is a major risk, **what if you don't complete the trade? (aka "execution risk")**

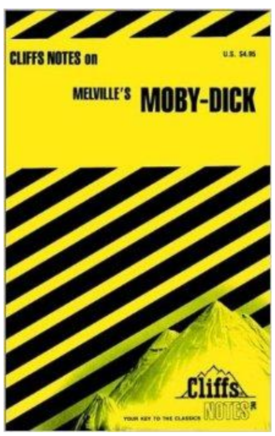
A buy-side firm's tolerance for execution risk is a direct function of time. Those institutions that have enough time on their side to patiently wait to trade, can fully adopt price making as a part of their long-term trading strategy. In contrast, **buy-side firms that have limited flexibility in how long they can wait for a trade to occur, are poorly suited to employ price making** as a meaningful method for trading corporate bonds.

Endowments, hedge funds, prop-trading firms and certain types of insurance companies are generally not required to provide immediate liquidity to the investors they represent. These types of buy-side institutions have an edge in price making capabilities because of their inherently high tolerance for execution risk.

Actively managed bond funds are on the other end of the spectrum. They must outperform the market to demonstrate value, so holding cash is not ideal. In addition, most funds offer same day redemptions, so they are required to provide investors with immediate liquidity upon demand. If you are a buy-side institution whose trading decisions are primarily driven by cash flows, your low tolerance for execution risk will make it difficult to leverage price making to meet the liquidity needs of your clients.

We’re gonna need a bigger boat…

The requirements for becoming a successful price maker may be completely foreign to some traditional buy-side accounts. Fundamentally, a **buy-side execution trader must transition from a workflow model where they trade what they want, when they want to trade it, to a process that involves trading when opportunities present themselves**. Sourcing opportunities is a function of implementing the right trading solutions.



The required components start with the **aggregation and organization of pricing data** because making prices accurately begins with seeing prices. Now, some may try the Cliff’s Notes version of price aggregation which is to use a model-based pricing feed from a vendor. This may look like a viable methodology for making your own prices, but model-based pricing information lacks the detail required to be a successful price maker, namely, the ability to know what it will take to be the best bid or best offer in the market.

Another critical trading tool is an application that can manage incoming electronic inquiry from All-to-All RFQ platforms and ECNs. This solution will allow you to field inquiry from multiple systems through a single screen, and give the end user the ability to filter electronic order flow based on the commercial value.

Finally, **buy-side institutions must have a technology solution for broadcasting their orders and resting prices on multiple venues.** You know, the price making part of being a “price maker”. This is a difficult component to master because passive trading requires constant management of your prices to ensure that they are in line with where the market is trading. Without the assistance of technology, a fully manual process will undoubtedly end up in off-market executions. In other words, your most active trading will be the result of being on the wrong side of the market.

I’m not going to be ignored!

Click Image

Acquiring the ability to become a successful price maker is great, but depending on your broader trading needs, **it may be wise to ensure that your new trading behavior doesn’t threaten your existing dealer relationships.** Failure to be considerate could result in these types of confrontations with some of the more sensitive liquidity providers:

There is no written rule book for indicating what types of behaviors would potentially threaten dealers, but the key commandments have been codified over decades.

THOU SHALL NOT:

- **Compete directly for voice order flow**
  This major violation only comes into play if a buy-side entity starts utilizing a sales force to get trades done. Unlikely for anyone but ETF authorized participants.
- **Use the price of one dealer to complete trades with thy neighbor**
  Utilizing one dealer’s quote to trade with another dealer is bad, using that dealer’s quote to trade with another buy-side client is heresy.
- **Provide two-way markets**
  The act of maintaining a bid and offer is assumed to be the exclusive domain of the sell-side. It is assumed that any buy-side entity that is making two way markets is leveraging the information they get from dealers to tighten the market’s bid/offer. This is probably the worst thing a buy-side firm can be accused of doing by a dealer.

As long as your price making strategy steers clear of these activities, there will be minimal conflict with traditional dealers. Notice how competing for RFQ order flow is not on this list? **In general, dealers don’t feel threatened by the new all to all RFQ protocols because the quality of RFQ order flow is very poor**. They just hate the RFQ platform pricing model.

I love it when a plan comes together

For some buy-side fixed income firms, realizing the performance benefits of price making will be a differentiating factor that distinguishes them from the competition. However, effectively transforming into a price maker is not accomplished by hiring former sell side traders and hoping for the best.

The path to achieving your price making dreams can be wrought with waste, costly delays, and debilitating mistakes. However, **buy-side institutions must form a long-term plan to transition to become proficient price makers.** This starts with performing the necessary analysis to determine the appropriate strategy and then supplementing your plan by developing the right trading tools and technology infrastructure.

Ultimately, price making is not about trading what you want, **it's about improving your capabilities to trade when you want.**