Portfolio Trading:

Enhancing Liquidity through Electronic Trading in Fixed Income

FIXED INCOME | September 19, 2024

Executive Summary

Portfolio trading, a method of executing large baskets of bonds in a single transaction, is transforming the fixed income market. This innovation, in our view, significantly enhances liquidity across the entire bond market and offers another lever to pull for fixed income managers to access liquidity. Furthermore, we believe asset managers who leverage portfolio trading in implementing fixed income credit strategies gain a competitive edge by unlocking another source of alpha generation. Given the inherent inefficiencies in fixed markets despite recent advances, we believe a thorough understanding of one's role in such a transaction is essential to capturing the benefits of this growing form of trading. We believe the improvements

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which we outline here may be of most benefit to those managers with significant scale and resources, but who are also nimble enough to take advantage of the unique opportunities that are often presented by this new paradigm shift in credit trading. In our view, MetLife Investment Management's people and presence in the fixed income marketplace positions us well as participants on either side of this new frontier of electronic trading.

Portfolio Trading Improves Liquidity in the Bond Market Through Several Mechanisms:

Aggregation of Liquidity: Portfolio trading allows for the simultaneous execution of multiple bonds, effectively aggregating liquidity across different issues. This is particularly beneficial for less liquid bonds that might be challenging to trade individually.

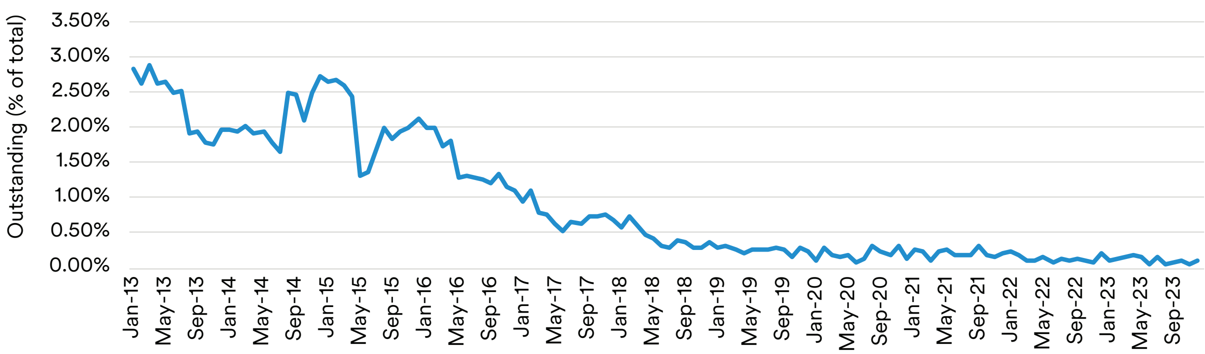
Speed of Execution: By executing large baskets of bonds in a single transaction, portfolio trading reduces the time to transact that would occur if these bonds were traded separately. This is especially valuable for institutional investors managing large portfolios who now have the ability to efficiently reposition portfolios either adding or reducing risk almost instantaneously.

Improved Price Discovery: The ability to trade multiple bonds at once enhances price discovery across the market. Traders can more easily identify relative value opportunities and arbitrage between different bonds, leading to more efficient pricing.

Increased Trading Volumes: Portfolio trading facilitates larger trade sizes, which can increase overall trading volumes in the bond market. This increased activity can attract more participants, further enhancing liquidity.

The increased trading volumes has also translated to more individual CUSIPs trading, with the number of issues not traded on steady decline. The percent of bonds outstanding that have not traded has declined to 10 basis points from 70 basis points in 2018 – an 85% decline in just over 5 years. Looking back even further to 2013, it's declined 97% from the highs of 2.90% of outstandings not traded.

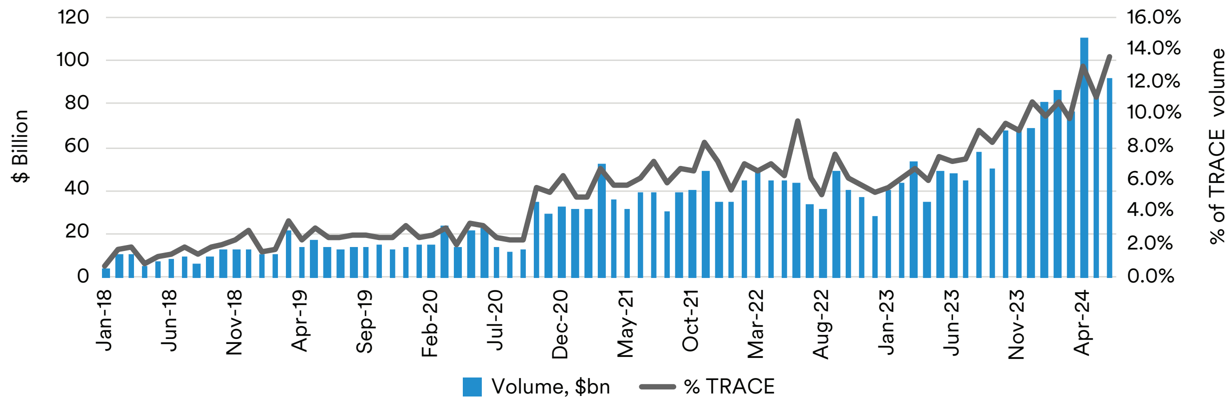
Chart 1 | Percent of Bonds Not Traded



As of 6/28/2024. Note: Portfolio trade volumes are estimated using Barclays proprietary machine learning algorithm applied to TRACE. The TRACE universe contains bonds included in major corporate bond indices. Source for all charts: Barclays Research, Bloomberg, CRSP MFs Database, TRACE.

As a testament to the importance and continued growth of portfolio trading (PT), on May 15, 2023, FINRA instituted a requirement for dealers to report their portfolio trade transactions to TRACE along with implementing a flag to denote 'Portfolio Trade'. This new flag bolsters transparency in the market and has provided another tool to help analyze developments in fixed income markets through more transparent execution. For example, in April 2024 PT volumes reached $110bn which represented nearly 14% of total TRACE volume, also the highest PT market share since the reporting has been in place. In our view, this underscores the theme that the market is growing more comfortable with the evolution of electronic fixed income trading.

Chart 2 | Portfolio Trading Volumes Have Increased 5x in the Last Five Years



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In practice, we find ourselves participating in the uptick of portfolio trading along with the industry. Depending on market conditions, portfolio trading can often provide an efficient method for funding new portfolios from cash. An even more cost effective application of portfolio trading is transitioning portfolios that are funded in-kind with corporate bonds. For example, we have found that executing a bi-directional portfolio trade has the potential to reduce transaction costs given the net notional risk to the dealer is de-minimis. For less liquid securities, we have often found that including these securities on a portfolio trade with more liquid issues results in improved pricing. In a similar vein, we also may find ourselves as an opportunistic acquirer of securities which have may been mispriced through a PT. The use cases for portfolio trading are diverse, and at MIM, we deeply value our trader's acumen, relationships, and ability to quickly identify and react to these potentially mispriced or stranded securities for the benefit of our clients' portfolios.

Conclusion

The integration of portfolio trading with traditional fixed income over-the-counter investing represents a significant opportunity for asset managers to efficiently maneuver risk, while simultaneously providing another tool to enhance liquidity. While challenges remain, particularly around data quality, standardization and pricing distortions - the synergies between these areas are likely to drive innovation in both trading technology and portfolio management practices. Asset managers who can effectively leverage portfolio trading capabilities to implement investing strategies will be well-positioned to meet the growing demand for avenues to generate alpha in the fixed income space. As this integration continues to evolve, it will be crucial for market participants to stay informed about technological advancements, regulatory developments, and best practices in innovative portfolio construction and trading.

Authors

JOSHUA LOFGREN, CFA
Portfolio Manager

BRAD GOTTENBERG, CFA
Portfolio Specialist
High Grade Fixed Income

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