Structural Advances in the Bond Market Benefit Individual Investors

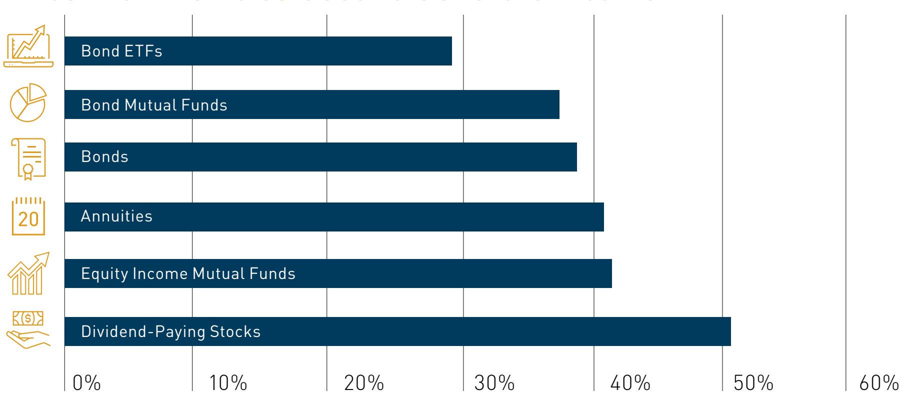
While the bond market has traditionally been driven by the investment activity of institutional investors, over the past 15 years there have been a number of structural advances in the market that have led to enhanced accessibility and pricing transparency to investors at all levels.

Advisors know that bonds play an important role in constructing a diversified portfolio because, in addition to generating predictable income, they offer risk diversification in times of broader market uncertainty. In this article, we discuss some of the important benefits of bonds highlighted in a recent Incapital Financial Advisor survey, structural enhancements that have improved price transparency, and finally the impact technology has had in making bonds more transparent and accessible for individual investors.

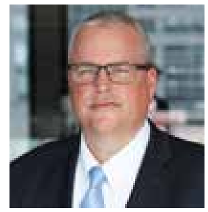
Fixed Income Investing Survey

The explosive growth of Exchange Traded Funds (ETFs), coupled with a robust equity market, drove Advisors to using more of these products in their portfolios in recent years. In addition, when it came to the income portion of the portfolio, our *2018 Fixed Income Investing Survey: Refocusing on the Benefits of Bonds*[1] showed that Advisors used a wide range of products other than bonds to generate income, including equity income mutual funds, bond mutual funds, and bond ETFs.

Investment Vehicles Used to Generate Income



[1] https://www.incapital.com/FixedIncomeSurveyReport



Paul Mottola
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Paul Mottola is Co-Head of Incapital's Capital Markets division. The division encompasses all fixed income trading, dealer and institutional sales, and the capital markets practice, including the fixed income and equity syndicate business, and the firm's industry-leading InterNotes® program, offering individual investors access to new issue corporate debt offerings.

Mr. Mottola joined Incapital in 2018. He is an approved FINRA dispute resolution arbitrator and currently serves on the SIFMA capital markets committee.

Throughout his career in financial services, Mr. Mottola has held various leadership positions, including 20 years at Merrill Lynch, where he was Head of the Equity and Fixed Income New Issue business within the Global Wealth Management Division, and six years at Barclays Wealth and Investment Management as the Head of the Fixed Income and Equity Trading business, and the broader Capital Markets platforms. Most recently, he was a Managing Partner at PCM Management Consulting, LLC, providing consulting services for broker-dealers and investment advisors. Mr. Mottola earned a bachelor's degree in finance from Providence College; he also earned an MBA from Monmouth University.

Bond ETFs and bond mutual funds do not provide income in the traditional sense. They convert coupon payments into periodic dividend payments that are not necessarily predictable. Conversely, bonds provide fixed income streams paid as fixed coupons at regular frequencies, mostly semi-annually, regardless of market volatility, although subject to issuer default risk. Other coupon formats, such as floating rates, are also available. Furthermore, bond ETFs and other equity-like investments generally have no defined end date, leaving them exposed to interest rate risk. In contrast, bonds that have a fixed return date generally have diminishing interest rate risk as the bond gets closer to its maturity date.

Have Advisors been so focused on other investment products that they have not been assessing the enhancements and innovations in the fixed income markets, making bonds more transparent and accessible than ever before?

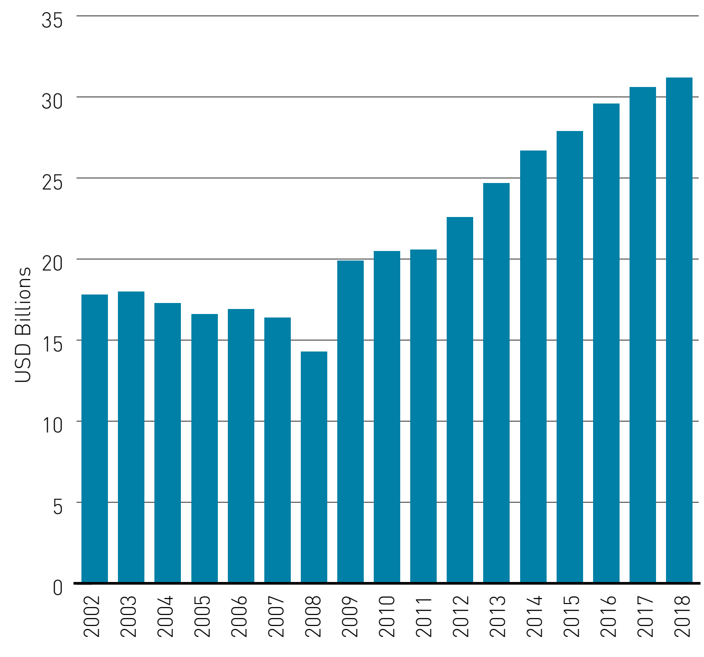
In our survey, Advisors noted that they had some major concerns specific to bonds:

- **68%** said they had difficulty determining which individual bonds to select;
- **68%** said they found it a challenge to access individual bonds;
- **65%** said they had difficulty monitoring individual bonds; and,
- **52%** admitted that bond investing is not their area of expertise.

Bond Access Has Improved for Individual Investors

While Electronic Communications Networks (ECNs) were developed in the late 1990s (primarily for the equity markets), bond trading was slower to come on board, primarily due to market complexities, lower trade frequency at the security level, and the overall size of the market as measured by the amount of securities outstanding. The launch of innovative retail bond trading solutions has improved price transparency and enhanced access to market liquidity, while driving up the average daily trade volumes in corporate bonds and providing Advisors with more advanced tools to help them manage bond portfolios for individual investors. According to SIFMA (Securities Industry and Financial Markets Association), in 2003, when ECNs were in their infancy, the average daily trade volume for U.S. corporate debt was $18 billion. In 2018, that number jumped to over $31 billion.

Corporate Debt Average Daily Trading Volume



Source: SIFMA

In a recent report, ICE BondPoint, one of the leading electronic trading platforms for fixed income, stated that there were over 350,000 live and executable bids and offers on their platform, along with having over 425 firms that either participate or provide liquidity to the platform. These types of ECNs have served to modernize the access and efficiency of the bond market, providing individual investors (through their Advisors), the opportunity to construct diversified portfolios.

Bond Prices and Fees Are More Transparent

In 2002, TRACE (Trade Reporting and Compliance Engine) was developed as a tool to implement new SEC rules requiring more transparency in all U.S. corporate bonds and secondary Over-the-Counter (OTC) fixed income transactions. Since that time, FINRA has continued to issue new guidance and regulations to improve the reporting of trades; via a Market Data Center, Advisors can access real-time pricing to assist their clients in their investment decisions. Data feeds include end-of-day transaction and activity reports, market activity and performance indicators, and enhanced historical data such as transaction price, size, and yield, as well as buy/sell indicators.

Additionally, FINRA put new rules into place in 2018 (amended FINRA Rule 2232) that require enhanced trade confirmation disclosure for retail customer trades. The confirmations are now required to show the associated trade mark-up and markdown in instances where the firm executed an offsetting principal trade. This development further enhances market transparency for individual investors, providing them with more information and tools to assess transaction efficiency, and to compare and contrast the fees/costs associated with other security types.

Advisors Going Back to the Basics of Bonds

In our *2018 Fixed Income Investing Survey*, Advisors indicated that due to the evolving market environment, they would be looking to increase their fixed income exposure. Of the surveyed advisors as of October 2018, many believed their clients would increase allocations to fixed income in the future.

Separately these Advisors noted that in this current economic environment, bonds offer features that are important to portfolio construction right now: predictable income streams; return of principal at maturity subject to issuer default; diversification from other, more volatile, asset classes; as well as tax efficiency and declining duration risk. Given what attracts Advisors to bonds, and their goal to move more clients towards fixed income, it is even more important they understand how much more transparent and accessible bonds have become.

Time for Individual Investors to Take a Fresh Look at Bonds

The misperception that access to individual bonds is difficult and inefficient has been discussed by competing income-oriented product sponsors. As we have described, the recent advancements in technology and transparency over the past 10 to 15 years have now leveled the playing field for individual investors. Advancements have provided investors with the opportunity to access bonds to help them construct more diversified portfolios, while also improving the overall transparency that is necessary to assess the costs of bonds and their execution efficiency. As Advisors start to take a fresh look at the benefits of single issuer bonds, they will discover a new world is emerging—one that has more price and fee transparency, more accessibility for trading and tracking performance, and with a vast array of issues focused on the needs and interests of the individual investor.

FI-WP-0719

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