

# Bond Case Briefs

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## Municipal Bond Market: A Tech Tipping Point Is Here.

The municipal bond market is reaching a tipping point. E-trading is going to push it over.

When I started in this business back when dinosaurs roamed the earth, all you needed to trade bonds was a phone, the Blue List and a Monroe-Trader bond calculator. For those of you already lost, the Blue List was a booklet, printed on blue paper and stapled together, with the municipal bond offerings of Wall Street dealers and, roughly, at the offering price. To determine what you wanted to bid, you punched the various bond attributes like coupon, maturity, call and so forth into your Monroe-Trader. That was about as high tech as it got.

There were no ubiquitous Bloomberg terminals on every desk. You got on the phone and haggled out a price for a bond based on very limited information. No one knew what anyone else was bidding or asking—the phrase ‘price transparency’ hadn’t been invented. It was a truly an over-the-counter market.

Fast forward to today. Technology is radically changing the financial markets. Goldman Sachs is hiring more computer programmers than traders and BlackRock is replacing portfolio managers with computers. In the municipal bond market we’re seeing some similar changes. The transition is a bit slow—this is the muni market after all—but it is coming and it’s going to come a lot faster than some might realize.

Currently, there are seven electronic trading platforms currently dedicated to municipals: Tradeweb, MarketAxess, MuniAxis, Bloomberg, MuniBrokers, TheMuniCenter and ClarityBidRate. Some have been around since the inception, others are new entrants. I’ve either spoken with each firm in detail or used them in live trading. Having seen their interfaces and been taken step-by-step through their features, it’s really remarkable how these firms have, each in their own unique way, captured, digitized and electronified the municipal bond trading process. It’s akin to video poker in Las Vegas—if they just added an animated graphic of a trader to interact with, you’d swear you were dealing with a real person.

These are very powerful tools each with some very distinct benefits. If you’re a municipal bond market professional who hasn’t had a demonstration of these yet, you are strongly encouraged to absolutely do that.

The overall impact of these platforms is more important than their specific features and functions. Electronic trading platforms are bringing the municipal bond market to a ‘tipping point.’ This is having immediate consequences and longer-term effects.

### **Three Drivers**

There are three drivers pushing this forward. The first is basic economics. Currently, the markets are in what seems to be a sustained low-rate environment. Combine that with the fact that asset management is a mature industry oversaturated with mutual funds, ETFs and SMAs (separately managed accounts). That means every basis point counts, either to cut costs or add to profitability or

preferably both, from management's point of view. E-trading offers efficiencies both in the trading process and in better price discovery in the trade itself.

Second is the trend toward index investing in the market. The MUB, which is a BlackRock-managed ETF that seeks to track the S&P National AMT-Free Municipal Bond Index, now has just a smidge over \$8 billion in assets under management. In fact, if you totaled up all the muni ETFs that are managed to track an index, it's more than \$25 billion. Add to that mutual funds that either are explicitly or implicitly managed to an index, the number more than quadruples.

Indexing means more standardization in the market, more categorization and ease of automation. Every portfolio manager and muni trader knows that a bond in the index trades better, is more liquid and has tighter spreads. Index bonds are a clearly established category with fairly standardized characteristics. In other words, perfectly suited for an e-trading platform. Where better to get economies of scale for index bonds?

The third driver is regulatory guidance. I covered this in some detail in the companion piece to this article, [Muni-Tech And E-Trading: Opportunities And Considerations For Investors](#). Each is a designated alternative trading system (ATS) under SEC Rule 600(b)(23). But that just meets the legal requirement. There are market rules bringing e-trading into the fore. For example, MSRB Rule G-18 and the SEC Rule 15c3-5 discuss best execution and management controls, respectively. There are others, such as the Volker Rule 619 and a host of SEC liquidity rules for mutual funds and other pooled investment managers. Between capital requirements, best execution, liquidity and trade transparency, suddenly electronic trading platforms, which can address all of those in one fashion or another, become a lot more attractive.

Those are the big three drivers—economics, indexing and regulations—pushing e-trading forward and also pushing the market closer to a tipping point. These are not meant to be the only factors. There are also market factors such as declining new issue supply and the dramatic increase in SMA asset growth.

### **Detractors and Skeptics**

As with anything new, there are detractors and skeptics, as there always have been during periods of great change. People fear change. Some detractors of e-trading—and fight the tide all you want, but it's here and it's growing—detractors say the muni market defies standardization and automation because it is so variegated and compartmentalized. There are retail markets and institutional markets, bank qualified markets, AMT markets, specialty state markets, high yield markets, discrete sector markets, regional markets, specialty credit-name markets. Then there are the almost mind-numbing variables and attributes differentiating each bond—coupon, maturity, call provisions, sinking funds, security features are just a few.

All that is true—for now. What indexing and e-trading are going to do are organize and standardize the market. That's a big forward looking statement. Even Nobel Prize winning Physicist Neils Bohr warned that "predictions are very difficult, particularly about the future."

But as Shakespeare noted, "What's past is prologue." This automating-organizing-standardizing transformation is exactly what happened in other markets—and not just financial markets—that suddenly found technology disruptors changing how they transacted. The muni market will be no exception.

Others point out, with some legitimacy, that none of these platforms have been through a market meltdown like we saw in 2007 -2008. Can the platforms handle it? For those of us who lived through

that period, I can tell you first hand, having people on the trading desks didn't function very well either. Nothing does well in a free fall. There's the old adage that it's only when the tide goes out when you see who's wearing a bathing suit and who isn't. The first time the platforms get hit with a wave of selling, we'll find out who is and who ain't.

### **The Biggest Impediment**

The advisor or Wall Street firm thinking about linking up an e-trading platform is caught in a conundrum. No one wants to be the one installing a platform that doesn't become the market standard. It is a big spend when a firm commits to a trading platform. Putting a new system in place takes a lot of resources—the data feeds for uploading inventory, correct pricing, the trade information capture and storage—there is a lot of middle-office work that requires integrating and testing. Staff have to be trained, from front office trading desk staff to the middle office operations and tech staff. It's great to be on the "cutting edge" so long as you don't get cut.

On the other hand, while no one wants to be the first in the pool, no one wants to be last to the party either. If you don't have it and your worthy competitor does, you better get it or risk falling behind. Call it technological peer pressure.

### **And Winner Is...**

To mis-paraphrase Pogo, we have met the winner and it is us. E-trading means better access, liquidity and transparency for all market participants. There is more visibility to find bonds, better price discovery, and more bids on selling bonds. Where better to find offerings than on e-trading platforms where dozens—heck, hundreds—of dealers, institutions, advisors are all listing bonds? Where you can screen for bonds by specific attributes in only a few clicks?

Focusing on liquidity, if you sum up all the trading volume each platform claims, apparently more than 180% of all muni trades clear over e-trading platforms. That's a bit of chest thumping bravado; the real number is closer to 20%. They can't be faulted for a bit of braggadocio—no clear winner has emerged just yet and each wants to claim an early lead. However, the overall point is taken: e-trading improves liquidity.

Another prospective winner is the borrower. E-trading may up-end the entire underwriting process. If you're a big borrower, a high grade borrower issuing into a standardized market with transparent components, do you really need investment bankers to the degree you do now? Research has shown, again and again, that the competitive bidding process for new issues is more efficient for borrowers. Now with an algorithmized (is that even a word?) and electrified market, a forward-looking borrower with even a modicum of tech-savvy can bypass the middleman and go straight to investors in an open-auction process. Those that can, will. They have already. Look at the initial work of Neighborly. That's just one model. Others are coming.

Plus, the more e-trading gets adopted and integrated, the more borrowers in the market—and some municipalities are getting pretty sophisticated in tech—will be advised by their bankers and advisors to conform their structures to market standards set by e-trading and indexing. It is entirely possible the rating agencies will contribute to creating some conforming rules as well.

Last, but hardly least, is the data collection and artificial intelligence applications emerging from e-trading. Data is dollars and big data is big dollars. Yes, big data is everyone's shiny new toy these days. However, as we've seen, big data and statistical analysis can find patterns and relationships that we mere humans with our intrinsic biases just can't see or just don't want to. Using that information to create algorithms to trade or set risk levels or any other number of things is where

artificial intelligence comes to the muni market.

One market participant made the snarky comment that this may be the first time “intelligence” and “muni market” were used in the same sentence. He can crack wise all he wants, but it’s widely known that at least one top-bracket firm has been collecting retail trade data since the late 1990s. Now their muni retail trading process is fully algorithmic. Every trade in a certain band size gets bid or offered based on the data and the algorithm. No need for a retail desk. It’s all done through AI.

### **The Tipping Point**

E-trading and indexing are going to be the drivers that tip the municipal bond market from the old over-the-counter model to what other markets already are and have been—an exchange-based model. No, the municipal bond market is not changing into the New York Municipal Bond Exchange, nor will it become fully automated with everything traded by AI driven bots. The muni market is and always will be a credit risk market. At some level, there will always be a need for a banker, a salesman, a research analyst, a trader and a portfolio manager. But as large parts of the market are going to become far more exchange driven, it’s just not likely to need as many of them.

Make no mistake, the tipping point is here: the traditional, over-the-counter market with liquidity by appointment-only simply cannot be maintained in the faster, tech driven investing world we are in.

### **Forbes**

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