Bond Case Briefs

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How AI Is Leading To The Netflixafication Of The Municipal Bond Market.

I like Netflix.

The plethora of films and documentaries across numerous categories offer a seemingly limitless array of entertainment choices available to stream any time and any place. From sports to obscure indy films to UFO documentaries—if those can even be called documentaries—I can indulge in an occasional Sunday afternoon binge. All I need is an internet connection.

What I find most intriguing about Netflix are its algorithms. Lord knows what or how many variables the algorithms use to assess my eclectic viewing habits in making those "if-you-liked-that-yo--may-like-this" recommendations. Yet, and often with uncanny accuracy, the algorithm finds a film or series that I never heard of or much less likely I would have found on my own, yet I enjoyed watching.

Applying real-time streaming and algorithmic analysis to the municipal bond market only takes a short mental leap. It's the technology of the Alternative Trading Platform that's getting the market there. And at breakneck speed.

Follow The Money

But why is this all happening now? There is an old saying: if you want to get to the core of an issue, follow the money.

In the municipal bond market, the money to follow is investor inflows and outflows. Recently, these flows revealed a marked change. It's increasingly clear many investors are pulling their money out of mutual funds and putting it with separately managed account advisors.

Follow along. In 2021, the Federal Reserve Z Report showed open end municipal bond mutual funds hit an all-time high, totaling over $1,089 billion. But by Q-2 2024 that number was $775.1 billion—a 22% decline. It wasn't just from falling valuations to reflect rising rates.

Over that same time period, SMA advisors saw a very different landscape. In 2021, assets were $332.9 billion. Fast forward to 2023, assets were $494.6 billion—a 48.5% increase.

Quick aside: Note that the $495 billion SMA AUM figure reported here is based on voluntary disclosures to asset-trackers Morningstar and Cerulli & Associates. Screening numbers directly from the SEC ADV filings required of every registered investment advisor, ADVDB put the total of municipal bond SMA assets at roughly double that, even after accounting for possible duplication by counting subadvisors.

Shifting Trade Tides

This $161.7 billion dollar shift and the response of SMA managers to this sudden largess is profoundly affecting the market, the immediate impact most visible in trading patterns.

Here's how. Municipal bond mutual funds tend to invest in the long end of the yield curve, 20 year to 30 year to longer maturities and trade in big $1M+ blocks. In contrast, SMA portfolios are generally structured with bonds in one year to 10 year maturities and trade in odd lot blocks under $1 million, usually $100,000 or smaller.

Going back through the Municipal Securities Rulemaking Board (MSRB) Annual Reports from 2021 to 2023, customer bought and sold trades in odd lots of $100,000 or smaller increased a stunning 74%, from 14,983 trades per day to 26,068 trades per day. In 2024, at the end of Q3, the odd lot volume of 28,074 trades per day already exceeded 2023 totals. The MSRB is the market's chief regulator.

The number of bonds traded is one thing, the par amount of average daily odd lot trades is even more stunning. Remember, in bonds, par equals $1,000 face value so, for example, a 50-bond par trade is $50,000. In 2021, the daily average total par traded was $468.4 million. By the end of 2023, trades totaled $836.8 million, an 83% increase. At the close of Q3-2024, the $858 million average daily odd lot trade volume exceeded that of the entire prior year.

Real Dollars

Graphs and tables of trade statistics in annual reports is one thing. Actually managing those trades in real dollars is another. That job falls to senior management at SMA advisors, such as Matt Buscone, Co-CIO at Breckinridge Capital Advisors. Over the last decade, the firm saw its AUM more than double, from$20.8 billion to $51.1 billion (10/31/24). Currently, Breckinridge is one of the municipal bond market's top 10 SMA advisors.

To scale the internal operations necessary to oversee this growth of thousands of accounts and their accompanying mandates, technology is essential, he noted. No part of the process, be it valuations, allocations, or compliance, is possible without it.

Correspondingly, wherever he can apply technology to optimize workflow, analyze data, or automate a process, he does. In a competitive marketplace with intense pressure on expenses, fees, and top performance, the reliability, efficiency, and speed automation brings is critical.

That particularly applies to the core of his business— buying and selling millions of dollars of bonds for the clients' portfolios. Matt acknowledged the challenge of trading bonds, particularly in the odd lot sizes often required by SMA portfolios, demands connecting to end-to-end solutions offered by electronic trading platforms. Be it through traditional brokers or independent third parties, it is essential to running the business, he adds. Increasingly, it can't be done without them.

Netflixification

Enter the Alternative Trading System. As the MSRB puts it, "an ATS is an electronic trading system that is not regulated as an exchange but is instead a venue for matching the buy and sell orders of its participants."

Like movies on Netflix, an ATS streams thousands of bond offerings in real time. Money managers and broker-dealers alike can, with AI driven protocols in place, screen bonds being offered, list bonds to sell, bid, counter, and execute a trade. All it takes is an API (application programming interface) to a trading platform.

In the circle of trading life, all this digitized trade and pricing data also gets up-streamed nearly instantaneously into algorithm driven AI analytic models. As Netflix analyzes viewer choices, these models analyze the market to generate updated trading protocols set by fresh market levels. One aspect includes finding relationships between bonds—including a “if-you-liked-that-you-ma--like-this” bond recommendation service.

While the various ATS platforms were reluctant to give actual trading volumes, each noted that volumes were up considerably, particularly in odd-lot blocks. This was after adjusting for bonds listed across multiple platforms.

ICE was understandably quick to link the numerous benefits of an ATS with the massive rate of acceleration of electronification in the municipal bond market. Add the increase in SMA assets and AI driven algorithmic trading into the mix, it was no shock that muni market participants were fast ATS adopters. From ICE’s perspective, for years munis lagged the corporate market by at least seven years in technology. Now, the lag was under one year and closing rapidly.

Equally, Tradeweb Direct noted while institutional and investment professional participation was not totally surprising, the firm also saw an increase in self-directed individual investor trading. By one estimate, around 15% to 20% of platform trading was from what is described as the “retail retail” sector. This reinforced the firm’s view that while trading is the central function they provide, the real role of the firm is as a distribution network. Fair point.

Moreover, as some broker/dealers exit the market (Citigroup, UBS), not only do ATS fill the liquidity gap but also mitigate supply risk. No investor, from individuals to institutions, wants to be dependent on a dwindling number of brokers for bonds. An ATS connection offers supply diversification.

Liquidity
All well and good, but if you combine the laundry list of benefits the ATS platforms eagerly offered up—automation, distribution, speed, counterparty anonymity, accessibility, connectivity, best execution, trade data, efficiency, low cost, and price transparency—the overarching benefit can be summed up in one word: Liquidity

As in any market, liquidity means better pricing and tighter spreads—a fact that should be warmly welcomed by individual investors and their professional surrogates, denizens of the notoriously inefficient municipal bond odd lot market.

Trendsetter

The MSRB hasn’t missed any of this. Tracking ATS trading data and periodically updating this information in quarterly and annual market summaries, most recently through Q2 of 2024, their reports show at the close of the first quarter of 2024, almost 15% of all customer trades were executed with dealers associated with an ATS. In 2015, it was a mere 2.9%.

A review of ATS trading data is likely coming in 2025 in order to identify trends and changes in the market. The regulator’s first report on the topic, Customer Trading with Alternative Trading Systems (8/2022) may be updated if changes are discovered. It’s a safe bet changes will be discovered.

One more thing. Given the billions of dollars of bonds now traded annually on these platforms, perhaps an update of the term “Alternative” is in order. Maybe it should be replaced with the more appropriate and forward looking “Automated”.

Just a thought.

A Platform of Platforms

A fintech firm before fintech was a word, Investortools was founded in 1983, offering portfolio management tools to the then burgeoning mutual fund industry.

Seeing the asset growth in SMAs over the last decade, the company began offering portfolio management solutions for larger asset money managers in that space as well. Also noting that as more ATS platforms entered the market, separate connections to each ATS meant multiple processes for broker dealers and money managers. Costly and inefficient, it was the opposite of the desired outcome.

To provide their institutional-sized SMA clients savings on costly multiple ATS API connections, the firm launched its Investortools Dealer Network to offer better access to bonds and trading. It's a platform of platforms, an end to end solution where brokers, money managers, and ATS interact in real time directly, either with the ATS intermediating the trade or trading directly between dealer and money manager. With a simple, single API, the bond world is opened.

However, it is only a platform, just providing access between buyers and sellers. It does not execute any trades and does not act as a broker dealer (an ATS does). This structure wisely sidesteps the Securities and Exchange Commission ATS compliance regulations.

The Other Guys

All this automation is great for the multibillion-dollar SMA managers, but as you might imagine, it isn't cheap. So how does the more bespoke independent registered investment advisor find bonds?

Jeff Watkinson, a partner at Watkinson Capital Advisors (AUM: $107.89M) a family owned and run investment advisor focused on fixed income, finds value for clients by creating carefully curated bond portfolios. It's not easy. To fulfill some customized investment strategies, Jeff noted it can take two to three months to get the bonds he needs at the price he wants to completely build out a client portfolio.

Where do the smaller AUM firms with lower trading volumes such as Watkinson's go? Jeff finds it more economical to use aggregation platforms like BondNAV. With a keen understanding of their client's needs as well as the nuances and complexities of the municipal bond market, BondNAV has the goal to make it simple for advisors to find the right bonds quickly and efficiently. Gone is the laborious task of sifting through hundreds of bond offering messages from bond dealers. Sure, BondNAV has frequently traded bonds on their platform, but there are also bonds you'll never see on a brokerage firm listing.

A New Bloom of ATS Entrants

However, it isn't just regulators and established ATS platforms noting the rise in municipal bond trading volumes. Jonathan Birnbaum founded OpenYield, an automated bond marketplace designed for algorithmic processes. Established in corporates and govies, the firm is expanding into the municipal bond market. Not a muni veteran, Jon combines his fintech experience at several start-ups with his U.S. credit and emerging markets trading experience at Morgan Stanley for a welcome fresh take. Uniting retail brokerages, investment advisors, asset managers, and market makers, OpenYield strives to create for each a readily accessible, navigable, and dynamic liquidity environment.

Jon summarizes OpenYield's perspective in one word: connection. Designing and applying protocols through a flexible API connection, he sees the opportunity for execution management systems that can aggregate and route orders in the municipal bond market. With a technology enabled process, programmatic rules can be created for portfolio allocation and best execution. What advisor or fund manager wouldn’t want that?

In his big picture view, it’s technology enabling low cost scalability as the key to greater market adoption. Making the municipal bond market more efficient and less costly in turn increases accessibility. That potentially brings new investors to the market—investors who may have previously eschewed it because of the market’s historically cumbersome and archaic structure. With more entrants comes more capital and with that, more data, more liquidity, and better pricing. It’s a grand positive feedback loop.

Primary Market

But where do all those secondary traded bonds come from originally? The primary market. No bond trades in the secondary until it was offered first in the primary.

As 2024 comes to a close, new issuance is shaping up to be a blockbuster year. With over 10,000 new bond issues having come to market through November 2024, issuance is on track to top $500 billion in 2024, potentially besting the $510 billion mark set in 2020. It could be the highest in a decade.

But when it comes to technology, the primary market has been largely overlooked. Maybe it’s the process. Almost the opposite of the blinding speed of tech-enabled trading, bond underwritings—competitive or negotiated—are time consuming and cumbersome. Filled with issuers, advisors, underwriters, and attorneys, a bond issue can sometimes take months to years to get to market. Perhaps because of all that, to date there hasn’t been much technology to aid and abet that process.

Until now. Enter Munichain.

Offering deal management and analytics providing clear and smooth communications between and among the deal team’s many members, Munichain also serves as a record keeper of the transaction. As anyone who has worked on a bond issue has experienced, as soon as the financing closes, deal amnesia sets in almost before the electronic signature ink is dry. Having the transaction memorialized is a sure-fire antidote to that memory loss. Additionally, there is a lot of bond reference data (i.e., price, coupon, maturity) being collected along the way as well. Where there is data, there is opportunity for AI, efficiency, and process automation.

The firm is cautious to coy about its future plans. The firm may be the leader in the field simply because, as one wag put it, there isn’t anyone else doing it. Yes, the room is empty—for now. But with 500 billion reasons for others to pay attention, the firm’s close-to-the-vest approach on its plans is well warranted.

The Muni Channel: 24/7 Streaming

While the municipal bond market is still over the counter, a sometimes overlooked outcome of all this ATS electronification and digitization is the creation of a 24-hour marketplace. As ATS platforms continue to grow and merge (for example, note the acquisition of MuniBrokers by MarketAxess in 2021), it is not hard to imagine these platforms coming together to resemble a quasi-municipal bond exchange in the not-so-distant future.

UFO Documentary

Now, that all said, can I please get back to watching this carefully researched documentary explaining the important correlations between crop circles, Stonehenge, alien abductions, and the Easter Island heads?

Oh, and Big Foot. Can't leave out Big Foot.

Forbes.com

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