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Continued Investment in Fixed Income, Despite Low Returns

What is the Impact on the Buy Side?

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The economic turmoil that began in 2008 has had a prolonged effect on the fixed income market. In the name of risk avoidance, investors have moved money from equity to bonds, particularly bonds that they perceive as safe, such as government issues. This increase in fixed income investments, along with increased regulations have caused buy side asset managers to think twice about the systems and processes in place to support this unique asset class.

Fixed Income Investments at a Peak

The level of investment in fixed income securities has grown significantly since 2008, primarily because risk-averse investors perceived these investments to be safer than equities. While that has not necessarily been the case, and risk-adjusted returns on bonds have not been particularly attractive, the money continues to flow in that direction. In July 2012, 94% of inflows to long-term funds worldwide went to fixed income products. In November 2012, fixed income overtook equity as the dominant asset class for UK pension investments.

The money continues to flow into fixed income investments. But with the low returns offered by highly-rated government debt, investors are looking to diversify into corporate and emerging market bonds. Responding to this demand, and with interest rates at new lows, corporate bond issuance has increased. However, uncertainty continues as western economies struggle – could this be a bubble?

Regulations Start to Catch Up

Since the 2008 crash, governments and regulators have pushed to establish a new environment that would reduce systemic risk. Regulators have not only revised existing rules but also are in the process of creating new ones, not all of which have been finalized. However, the impact is already apparent to investment managers. Tougher rules on capital adequacy have already caused sell-side firms to reduce their inventory of certain fixed income securities.

And all market players have been impacted by changes to the OTC derivatives markets that mandate electronic trading, central clearing, and additional collateral.

In this changing economic and regulatory environment, buy-side firms are reviewing their investments, as well as examining their processes and systems for effectiveness. The challenge is to satisfy regulatory requirements, generate returns, and keep clients happy. To begin the journey, portfolio managers and traders need high quality tools and information to steer safely through this stormy period.

Fixed Income is Unique

What is it about fixed income instruments, and the way they are managed and traded, that makes them different from other asset classes? The diversity of instruments means that it is impossible to generalize across fixed income, but a common theme is the large volume of securities in issue, plus benchmarks containing thousands of fixed income securities. The broad heading of fixed income covers bonds of all types, but can also include short-term debt, bank loans, and a variety of structured products, as well as derivatives for hedging risks and managing liabilities. A typical fixed income department within an investment management firm might be organized by asset type, with groups of portfolio managers and traders who specialize in a particular asset type working together, often with overlapping roles. And typically, they use systems that are also specialized to support that asset type.

Fixed Income is Unique

Fixed income covers a wide variety of asset types with different characteristics. Broadly, fixed income portfolio managers have to cope with:

Diversity - fixed income includes a variety of asset types, from simple bonds to credit derivatives and mortgage-backed securities

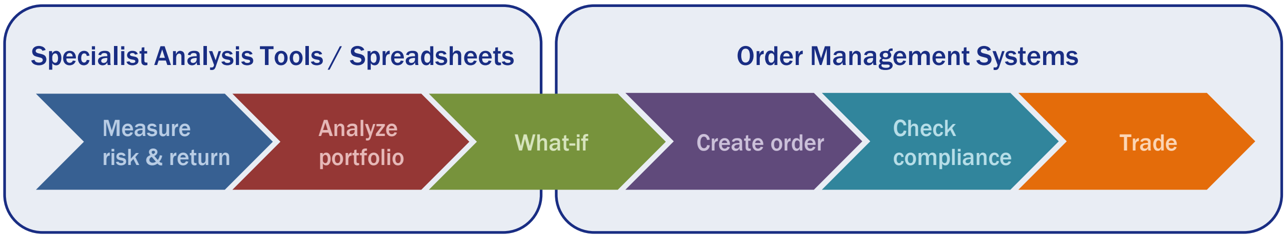
Volume - the huge numbers of issues, issuers, and associated data on each

The technology environment surrounding fixed income managers is typified by:

- Low level of automation, dominance of voice trading
- Multiple systems and data stores, not well integrated

Tools for the Front Office

Most asset management firms deploy several systems to support the full investment lifecycle from portfolio analysis to order generation, compliance checks, and trading. The majority of vendor products fall into one of two groups. Generally speaking, systems that are proficient in portfolio analysis rarely provide full pre-trade compliance checks and order generation, and systems that stand out for their compliance and order generation functionality rarely provide full fixed income portfolio analysis.



Typical Fixed Income Portfolio Management and Trading Workflow

Specialist Analysis Tools

These tools support the analysis and decision phase (and, yes, we include Microsoft Excel in this category). These products originated as fixed income analysis tools, some started as a service to clients of a broker dealer, while others are offered by market data or benchmark providers. These systems are often used just to support a particular asset type or because they provide specific benchmarks. These systems must be fed position data from enterprise applications, and link with other applications to perform enterprise-wide risk analysis and post-trade compliance.

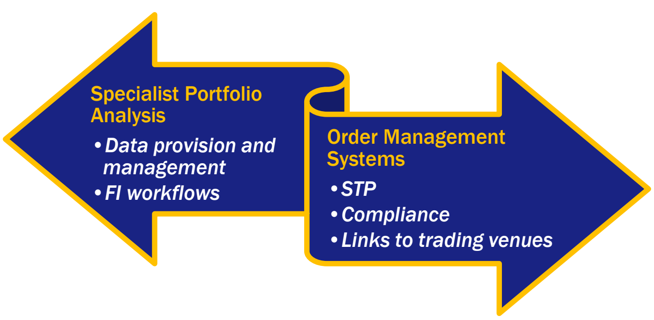
Common features include user interfaces that are designed for fixed income managers, with flexible analyses of portfolios and benchmarks and 'what-if' functions. Additionally, many products incorporate data management services, often bundling provision of market and benchmark data with the functionality. Some provide risk and performance attribution calculations, enabling portfolio managers to analyze all the analytical data about a portfolio in a single application. With tools that are purpose-built for fixed income managers they provide a complete environment for decision making, and as managed services, they take much of the burden of data provision and management.

Order Management Systems

These systems typically offer trade order management and compliance functionality. It is not unusual for an asset management firm to use different OMS products for different asset classes. Products that originated as tools for equity managers are not well-suited to managers of fixed income, and adapting them is a major task. While vendors of such systems have made progress toward true fixed income support, many still have work to do to match the decision support features of the specialist products. For example, few OMS products support historic position data maintenance and analysis, which the specialists provide. However, the OMS products continue to improve, and some may be able to supplant the specialists for certain asset types.

Fragmented Workflows

For years, the specialist tools and order management systems have worked together side-by-side, although they are rarely well-integrated. Often, each front office group is content to conduct analysis in their specialist system and then pass a file of trades to the order management system for further processing. Most IT professionals shudder at the notion of these siloed applications and fragmented workflows.



Specialist tools lack good facilities for integration with other applications. As a consequence the workflow is fragmented across different systems for analysis and order generation, compliance checking, order management and execution, and data is often manually entered from one application to another. Many firms recognize the operational risk involved and do their best to work around the problem with targeted automation at the interfaces that provide for import/export of data. Some firms are choosing integrated products that include analysis tools, order management, compliance, and trading.

Quality Data is Key

Good quality data is critical to any process, and fixed income is characterized by the volume and variety of data that must be highly accurate. The many data sources include external providers of market and index data, credit ratings, and fundamental research on issuers, as well as specialized data such as mortgage prepayment schedules, inflation figures, and issuer hierarchy information. Typically, internal systems provide risk, performance, and investment accounting data. Because of the complex mathematical analyses required of fixed income analytics and pricing models, the accuracy of the data inputs is essential.

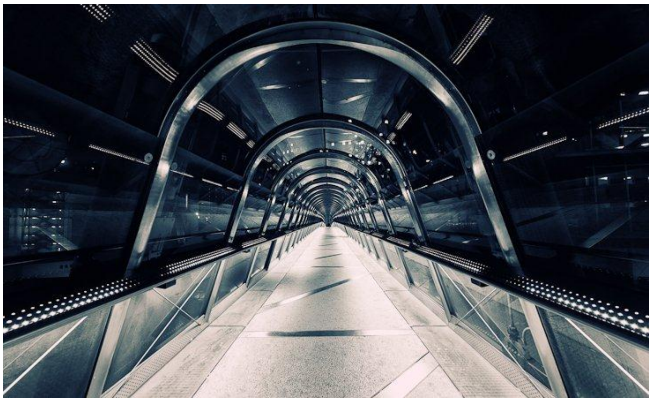
In Cutter Associates' survey of Research consortia member firms, 69% named quality of data and analytics as the most important criterion for a fixed income system. Obtaining and managing this data requires people with detailed knowledge of the fixed income business, whether they be in-house staff or vendor resources. Recent forays by vendors into offering data provision and management services are appealing to investment managers, providing the cost model is sensible.

Growth in Automated Trading

While fixed income decision support is dependent on complex systems, trading has traditionally been more of a manual process. Fixed income is still dominated by voice trading, but this is changing, partly driven by regulation and the drive to transparency, including pressure to demonstrate best execution. In a survey of CutterResearch consortia member firms, 58% said voice was currently the most important trading method. Looking to the next two years though, electronic trading platforms are expected to overtake voice, with 54% of firms expecting it to rank as the most important future trading method. This move to electronic trading, in some asset types at least, is confirmed by figures such as Tradeweb's quoted 15-fold increase in European credit trade volumes over three years. And new regulations on OTC instruments will soon force swaps trading on to SEFs or OTFs. OMS links to trading venues can provide the straight-through processing that specialists cannot.

Future Direction

The industry is immersed in a wave of regulatory change, and investment management firms are assessing the impact on their systems and organization. They continue to focus on integrating systems, managing data quality, and maximizing portfolio performance. Firms managing OTC derivatives have an additional effort to focus on automated trading, central clearing, and collateral management. The additional requirement for collateral increases cost and risk in the portfolio and requires careful modeling. The only certainty at the moment is that



conditions will change, both in the markets, and in terms of automation.

One theme that emerged from our conversations and our survey of CutterResearch consortia member firms is that they will continue to spend on systems. More than two-thirds of survey respondents expect to increase spending on fixed income systems, and 70% quote purchases or upgrades as a reason for this increase in spending. Firms will continue looking for opportunities to rationalize their fixed income applications, and some will move to integrated solutions and straight-through processing. But as a short term measure it is more likely that they will focus on data architecture and automating the integration of diverse systems.

Judy Blackwell and Kathy McDermott were the lead analysts on Cutter Associates' recent research title Fixed Income Portfolio Management and Trading. As part of their research, they interviewed numerous buy-side firms, attended system demonstrations, and conducted in-depth analysis. The results of their work are available to CutterResearch member firms.