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Today's Junk-Bond Trader Just a Shell of Old Swashbuckling Self

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By Katie Linsell and Claire Boston

(Bloomberg) -- They used to be some of the savviest people on Wall Street. Maybe they still are, but these days pretty much all junk-bond traders need to do their jobs is a decent list of contacts.

They don't have to deploy deep analytical skills nearly as often to figure out whether to buy millions of dollars of high-yield bonds and hang onto them for a while, or flip some fast. In 2015, about 70 percent of the time a major bank traded a high-yield bond, it was doing no more than linking up a buyer and a seller, according to a recent estimate from the consulting firm Tabb Group LLC. A decade ago, the figure was 20 percent. That was back in the high-flying days when dealers bought big blocks of bonds from fund managers, broke them up into chunks and sold them to clients over time. Now asset managers essentially have to do the work themselves, and it can take a lot longer, with the client's money, not a bank's, exposed all the while.

What's changed? The rules. Under global regulations known as Basel III, banks have to use more capital to fund risky assets, while the Dodd-Frank financial reform law in the U.S. has imposed strict limits on how much of their own money they can deploy. And U.S. banks and brokers have to report every trade they execute within minutes of doing so, under a rule that came into force more than a decade ago but is still influencing markets.

"If you're a high-yield risk taker at a bank, you're thinking, 'My hands are tied, I can't take risk and it's so transparent, no one lets me make money.' It's very frustrating," said Thomas Thees, a former head of North American credit trading at Morgan Stanley who now heads fixed income trading at CastleOak Securities LP in New York.

As the Federal Reserve starts to hike rates in the U.S., many market participants are warning that dealers' reluctance to take risk could spell trouble. If bond prices fall and fixed- income fund investors start to cash out of their holdings, money managers could find they have trouble liquidating assets to meet redemptions.

By some measures, trading in corporate bond markets is about as active as it always was, but the Tabb Group's figures underscore why so many investors are concerned. "It's harder than it used to be to transact without disturbing the price of the market," said Steven Logan, the London-based head of European high yield at Aberdeen Asset Management, which manages 293 billion pounds ($422 billion). "Ifit's not an urgent trade, you could take weeks to completely sell a position." Dealers are cutting back while the junk bond market swells.

There are $2.2 trillion of high yield bonds outstanding, up from $741 billion 10 years ago, the Bank of America Merrill Lynch Global High Yield Index shows. With revenue from bond trading having plunged, banks are shrinking trading staffs, with job cuts recently at Morgan Stanley, Credit Suisse Group AG and Nomura Holdings Inc., among others.

"Dealers are making fundamental operational changes, and things aren't going back to how they were," said Anthony

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Perrotta, global head of research and consulting at Tabb Group in New York. He said it's up to asset managers to figure out how they will trade in a market where dealers have a diminished role.

The technology industry is looking to step into the breach; there are at least 99 companies that hope to electronically link up buyers and sellers of bonds. It may be that fewer than 10 of the electronic bond trading firms survive, Bloomberg News reported last month. Bloomberg LP, the parent of Bloomberg News, has a bond trading platform of its own.

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Not everyone is convinced corporate bond markets are less liquid than they used to be. The percentage of U.S. corporate bonds that are bought or sold every day compared with outstanding company debt is in line with historical averages, according to data from the Securities Industry and Financial Markets Association, a trade group.

The difference between the prices at which dealers buy and sell securities, a measure of liquidity known as the "bid-ask spread," has been narrowing for more than a decade, excluding the financial crisis, Federal Reserve Bank of New York President William Dudley said in a speech earlier this month. Dudley said evidence of declining liquidity is mixed.
But even if overall corporate bond market liquidity is little changed, many asset managers fret about how they'll navigate coming waves of redemptions from their investors. "Asset managers are getting bigger and bigger but they are also asking for a market that trades more reliably," said Chris White, who created the GSessions trading platform at Goldman Sachs and is the founder of ViableMkts LLC, a market structure consulting firm. "These two forces are in conflict."

--With assistance from Alastair Marsh.

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