Discussion of

Corporate Bond Trading on a Limit Order Book Exchange

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Research Topic

Broadly, the question of

*Why is there so little (organized) bond trading?*
– so I decided to go East and learn the bond business. Everybody I knew was in the bond business, so I supposed it could support one more single man. All my aunts and uncles talked it over as if they were choosing a prep school for me, and finally said, “Why–ye–es,” with very grave, hesitant faces.

From The Great Gatsby, by F. Scott Fitzgerald
Bonds belong on electronic limit order markets

is the view of many academics ···

Corporate Bond Pricing 101:

▶ Estimate a (common) term structure of interest rates
▶ Add a (firm specific) default risk premium

Hence

▶ There is much less room for disagreement about corporate bond prices than stock prices.
  ▶ → Lower volatility of bond prices.
  ▶ → Giving away less options when posting limit prices.
▶ The common underlying term structure
  ▶ Stronger cross-sectional arbitrage relations among bonds
  ▶ → Scope for algo type trading in the cross-section of bonds
Why don’t bonds trade on limit order markets?

A mystery …

Most bond markets trading OTC.
US Corporate Bonds: Phone or electronic posting of prices.
What are some of the explanations advanced?

▶ Buy and hold institutional investors – bonds disappear (supply problem)
▶ Search cost (sort of similar)
▶ Historical accident (Lack of room at the NYSE) (Biais and Green, 2007)
▶ Oligopolistic issues (lack of competition)

Consequences:

▶ Trading costs in US corporate bond markets way too high. (Harris, 2015), (O’Hara, Wang, and Zhou, 2016)
An example of a market where limit order trading of corporate bonds just works.

The first analysis of the paper is essentially confirming that corporate bond trading at the Tel Aviv Stock Exchange works:

- Liquidity of a corporation’s bonds comparable to the same corporation’s stocks.
- Off-exchange trading of corporate bonds even lower than equities.
My main issue with the paper - framing

I would like more “big picture” thinking/writing. The international impact of the paper will be driven by what it can tell us about

- Why is the Israeli market different?
- What does it tell us about e.g.
  - Feasibility of regulatory initiatives in other bond markets?
  - Success factors for somebody wanting to build a corporate bond market from scratch (Fintech)?

Start with possible explanations of the OTC outcome.

- Bonds stuck in institutional portfolios
- etc ....

Then go to what is different about the Israeli case, and try to help the reader to see how it links back to big questions.
Retail Investor Participation

An example, take the second analysis of the paper: One distinguishing feature of the Israeli Market: Higher retail trader participation. Their analysis show that retail traders actually participate in corporate bond trading, unlike almost any other market place, and some characteristics of retail trading. But uncertain what to make of it. Mechanisms? One potential mechanism: The presence of retail traders wanting to trade small amounts makes it potentially more lucrative to post limit orders by market making type of intermediaries. Leads to broader question: Is it enough to have some limit order posting to get action going?
More minor comments

Another example of a broad question you can answer:

- The issue of bonds being stuck in institutional portfolios. You could test this by looking at bond age/maturity. Is the trading concentrated in the “on-the-run” type bonds?
- Don’t use specific characteristics of bonds at all.
- Bonds are different from equities. You could use that better.
  - e.g.
    - The finite maturity gives a predictable component to bond prices you don’t have in equities.
    - The crossectional arbitrage relations brought by the joint term structure: Can look for arbitrage type trading of relatively mispriced securities. Is liquidity different there?
    - Should liquidity be calculated the same way for bonds as for equities? (Schestag, Schuster, and Uhrig-Homburg, 2016)
Interesting example showing that limit order trading of corporate bonds can work.

The more you can inform about why it works the better.

