Why bonds fit awkwardly in the separate account space

By Editorial Staff *Thu, Apr 8, 2021*

'The bond market is structured around the trading habits of large institutions,' said a Cerulli director. 'With rare exceptions, fixed-income separately managed accounts are likely to continue to be manager-traded.'

Despite its importance as an asset class in the separate account space, fixed income represents less than 5% of model-delivered accounts, according to the latest Cerulli Edge—U.S. Managed Accounts Edition. Given how bonds are traded, asset managers struggle to deliver a bond portfolio to a broker/dealer (B/D) in a model format.

"Low-grade corporate, emerging market, and municipal issues trade infrequently, whereas the average daily trading volume of many stocks numbers in the tens of millions of dollars," says Tom O'Shea, a Cerulli director.

When asset managers send sets of equity tickers to an overlay portfolio manager (OPM) at a large B/D, the B/D can usually send the trade straight to the market because there's enough liquidity in equity trading, O'Shea said.

But if the asset manager were to send CUSIPs for a municipal bond to the B/D, the OPM would have to enter the bond market and post bid or ask prices for the bond and wait for a buyer or seller to emerge.

Additionally, fixed-income trading still depends on human networks. Stocks are usually traded through electronic networks that execute trades in seconds. Bonds are traded through buyers and sellers with long-established relationships that facilitate negotiation.

"Fixed-income asset managers typically have deep sell-side relationships, developed over years, that allow them to buy and sell bonds at institutional-level pricing that is unavailable to an investor buying through a retail overlay portfolio manager," he added.

The few asset managers that offer model-delivered bond portfolios do so through only the largest B/Ds, whose trading desks typically have the same deep relationships with counterparties that large fixed-income asset managers do. These model portfolios are also limited to high-grade, highly liquid fixed-income securities.

Fixed-income models will remain difficult to deliver in a model format, Cerulli believes. "The bond market is structured around the trading habits of large institutions," said O'Shea.

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