

Some Investors Know: Evidence from Corporate Bonds

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USA: Amount Outstanding

- end of 2019: 21T
- end of March 2020: 22T (GDP 19T)
- Corporate bonds: 10T
- S&P500 Market Cap 25T

Canada: Amount Outstanding

- end of 2019: 2.2T
- end of March 2020: 2T (GDP 1.7T)
- Corporate bonds: 1.1T
- S&P TSX Composite Cap 1.3T

Annual Bond Returns

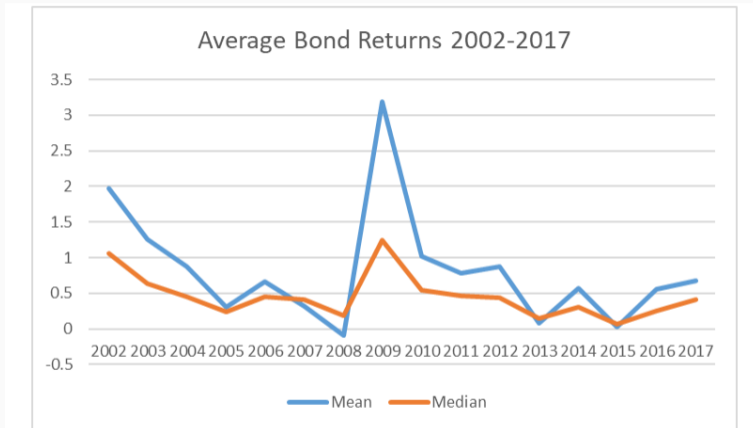


Figure 1: Sample monthly mean 0.82%, median 0.46%, stdev 1.3 [For Equities: mean 0.88%, median 1.3, stdev 4.1]

US Corporate Bond Market: Structure

- Over the Counter (decentralized) market
- Electronic trading: Volume about 10%, n. of transactions. Minimal for NIG.
- Most trading via phone calls.
- Strong price dispersion (same bond, different prices)

Market Share of Top 10 Dealers

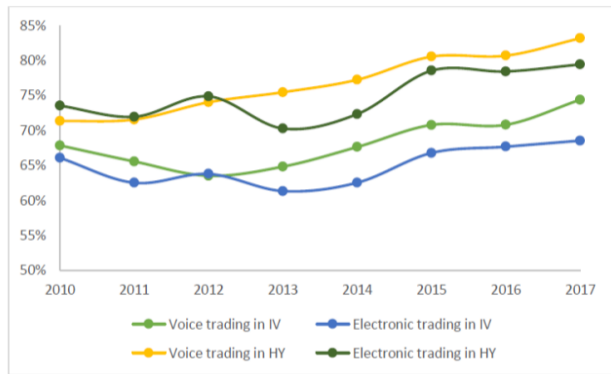


Figure 2: From O'Hara and Zhou (Journal of Financial Economics, 2020)

Trade Reporting and Compliance Engine (TRACE)

- All transactions for US Corporate Bonds
- Started in 2002 (not updated after 2017, we are waiting)
- Merged with bond and issuer Characteristics (FISD)
- Institutional trades: above \$500,000
- Block trades 5MM+.
- Retail trades (micro): below \$100,000

Transaction Costs

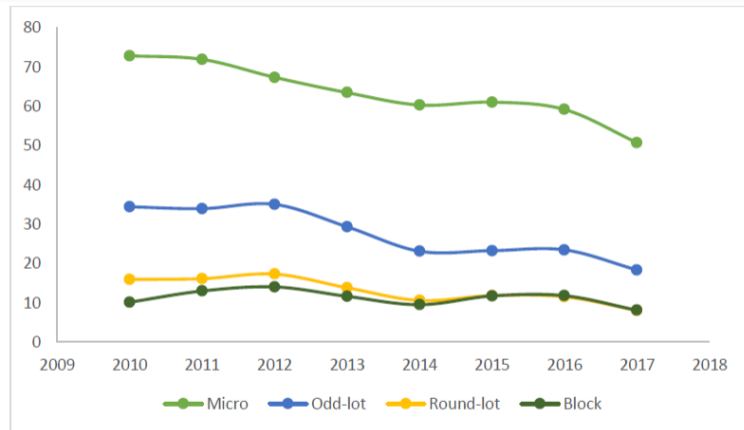


Figure 3: From O'Hara and Zhou (Journal of Financial Economics, 2020)

Transaction Costs

- Denomination \$100, return 0.82% per month
- Micro transaction costs (round-trip) \$1
- Block transaction costs (round-trip) \$0.16
- Return 12 month: about \$10.3
- Micro: net of t. cost about \$9.3
- Bloch (5MM+): net of t. cost about \$10.14

Transaction Costs Covid IG

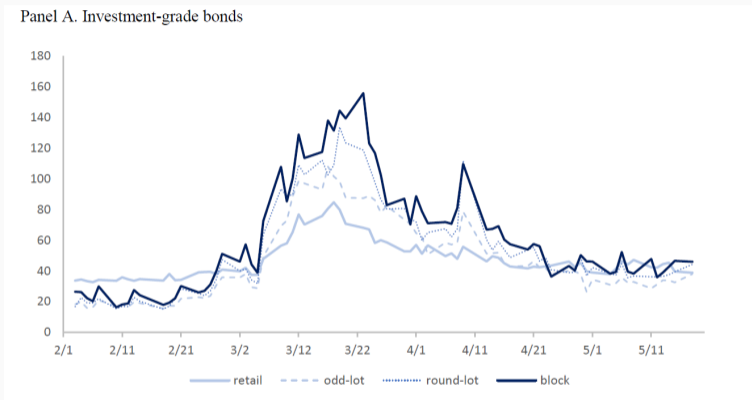


Figure 4: From O'Hara and Zhou SSRN (2020)

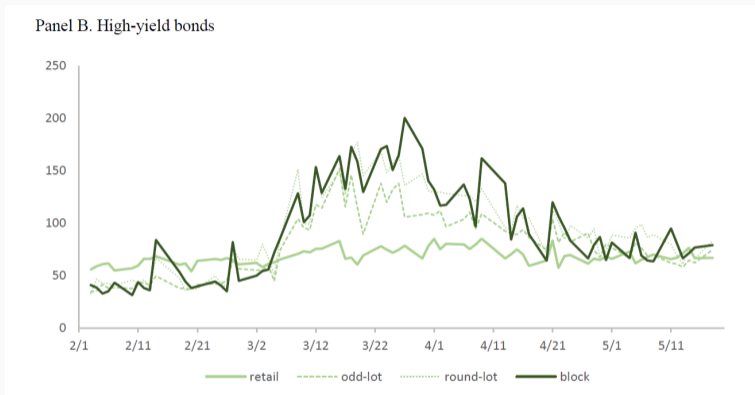


Figure 5: From O'Hara and Zhou SSRN (2020)

- March 6-early May 2020.
- Early March Facing redemptions bond funds sold very liquid bonds
- Very liquid bonds come under pressure
- Several dealers reached capacity (absorbing sales)
- Dealers themselves stopped providing liquidity to unload bonds
- Primary Dealer Credit Facility (PDCF). Announcement (March 17) calmed primary dealers
- Secondary Market Corporate Credit Facility (SMCCF). Announcement (March 23). Purchase of bond ETFs and bonds calmed secondary dealers

Who is informed? Hypotheses

- We do not know which investor knows what
- Retail investors might be as well informed as institutions, but:
 - Institutions pay more attention (retail underreact to news)
 - Institutions may have access to privilege information (cannot be the full story)
- In equity market cannot distinguish retail and institutions
 - Stealth trading, trade pulverization
 - Anecdotal evidence from practitioners is inconclusive
- TRACE allows to examine the trades of retail and institutions

Decomposition of Bid-ask spread (Glosten&Milgrom)

- Level of information positively related to trade size
- Large trades have firm-level information
- Small trades have little firm-level information
- Difference particularly visible for NIG and private-issuers

Predictability

- If prices diffuse information, then same-issuer bond and equity prices should be related.
- Information goes faster for equities (most of literature)
- Bond indexes predict stock returns ahead of monetary policy announcements

Predictability (cont'd)

- Bonds attracting highest levels of trades of institutional investors (top bonds) predict:
 - Remaining same-issuer bonds (non-top bonds)
 - Same-issuer equity return
- Non-top bonds and bond attracting mostly retail trades
 - Do NOT predict same-issuer top bonds and equity
 - Do NOT predict equity returns
 - Tend to reverse over a month (sentiment trading)

Evidence from TRACE III (Momentum)

Momentum: investors extrapolate from past returns and place bets of return continuation.

- The bet is: past winners continue to do well, past losers continue to do badly
- Typically profitable in all asset classes
- Great returns, but subject to peaks and crashes (not for the faint of heart)
- Profitability conditional on UP and DOWN market
- Driven by exceptional returns
- More prevalent in NIG bonds
- Note: iShares MSCI USA Momentum Factor ETF not real mom (only winner side).

Seminal paper Hong and Stein (1999) “momentum cycle”

- Information arrives (say positive news), but it is **gradual**
- Fundamental traders adjust price upward as they process it
- Trend seekers (momentum traders) see the trend and buy
- Overreaction phase: price increase above fundamentals
- Later on price stabilize at a lower level

Momentum: Theory

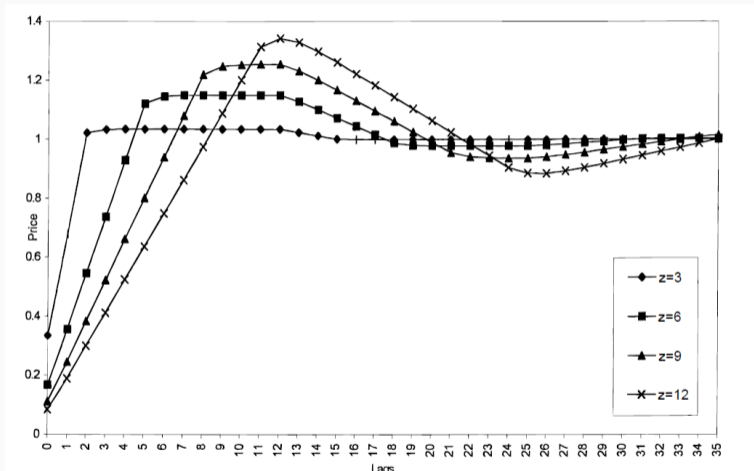


Figure 6: HS 1999 Momentum, higher z slower information speed

Momentum Series

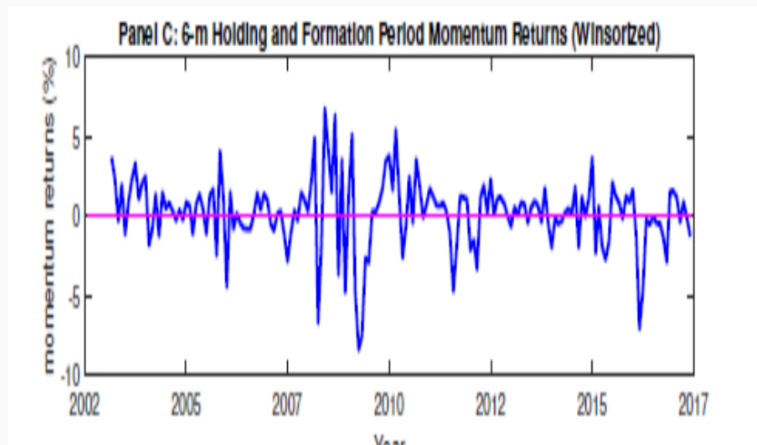


Figure 7: Mom six month

Evidence from Equity Markets (from Quarterly Reports)

- Investment advisors and mutual funds invest in the first part of the cycle
- Pension Funds act as contrarian at the end of the cycle

Implications

- Fast info. spreading: momentum cycle is short
- Slow info. spreading: momentum cycle is long

How do we use momentum to discuss investors' information?

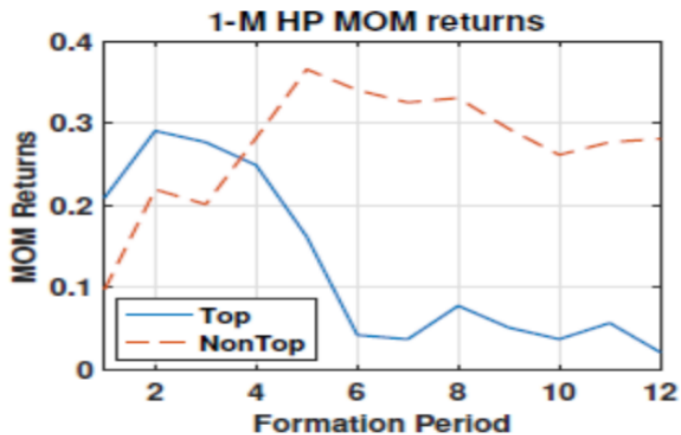
If institutional investors are more informed than other investors:

- Bonds attracting large volumes of institution's trades should show short mom
- For the remaining other bonds, slower information diffusion, so longer (and stronger) mom

If retail investors are not informed:

- bonds on which retail concentrate should show no momentum

Momentum and Information Diffusion Speed



Conclusions

- The trades of institutional investors reveal that they have an informational advantage on smaller investors.
- The larger the trades, the more information (different from equities)
- The trades of retail investors reveal sentiment trading, no information in trades
- Note: retail substantially higher transaction costs than institutions

Transaction Costs Covid IG

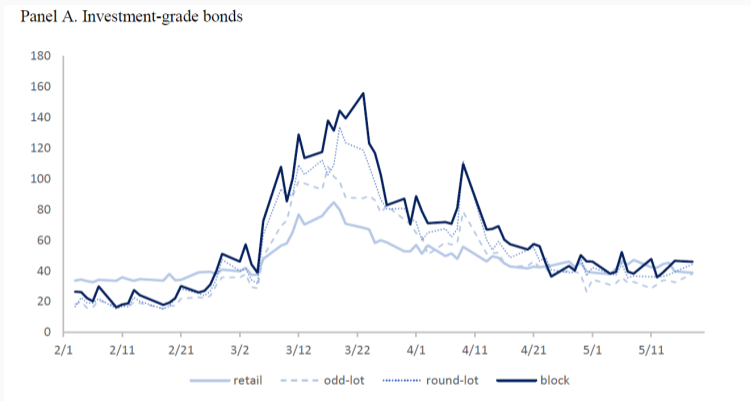


Figure 8: From O'Hara and Zhou SSRN (2020)

Transaction Costs Covid NIG

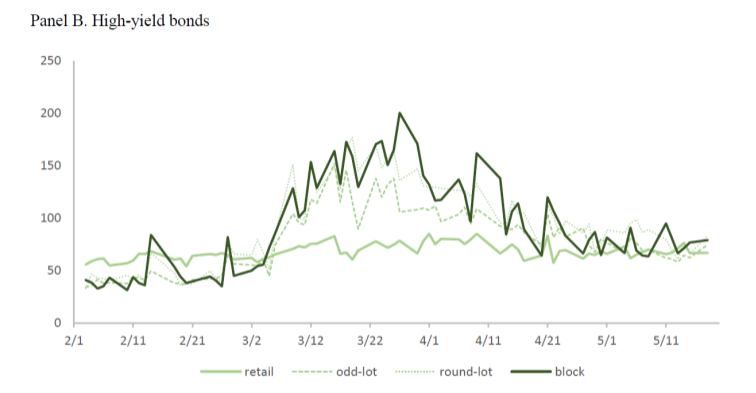


Figure 9: From O'Hara and Zhou SSRN (2020)

- March

6_earlyMay2020.EarlyMarchFacingredemptionsbondfundssoldveryliquidbonds

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