

The Secondary Bond Market

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A few weeks ago the Central Bank of Trinidad and Tobago in conjunction with the Trinidad and Tobago Stock Exchange officially launched secondary bond trading in the country. As stated in the Central Bank's press release, trading will be conducted via an electronic system identical to that which is used for the stock market.

This launch signified a very important step in the development of this country's financial markets. If one looks at the timing of the introduction of bond trading in other developing financial markets, it can be seen that this next step needed to be implemented for development to progress. Only Thailand, at the time bond trading was introduced, had very few government bonds already issued. Their fixed income market had only reached the stage of short-term government issues such as Treasury Bills and Notes. This was because there was no need in their economy for longer-term securities as the government was constantly running budget surpluses. Budget deficits after 1998 however required the issuance of longer-term bonds. The introduction of bond trading was done at the same time and was meant to spur the issue and investment in these longer-term securities.

Of course the issuance of long term debt is important to the financial market of Trinidad and Tobago and the introduction of a secondary market will help in providing a suitable environment for more numerous and frequent issuances. However we need to look at the other benefits of the secondary market a little closer.

In a market where there is no official pricing source for bonds issued, the price at which bonds are purchased or sold is partially subjective. This arises because the only way to determine prices used in these trades is through negotiations. As discussed in a previous article the party with the better negotiating skills usually comes out on top, forcing its price upon the counter-party. Bond prices will therefore be artificially skewed.

Prices determined through negotiations also cannot be compared to other trades in the same security even if they are done at the same time. This is so because of the imperfect information that exists in the market, as negotiations are only open to the parties who know about that particular pending trade (negotiations do not take into consideration the market demand and supply.) It is therefore possible to have multiple trades occurring at the same time in the market all at different prices.

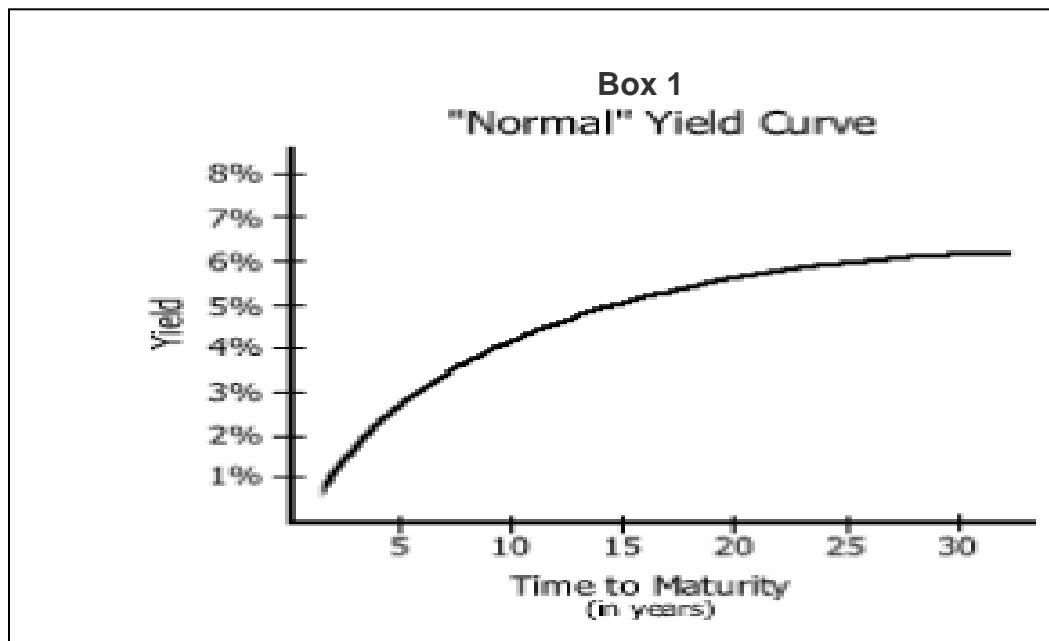
Accurate price determination is therefore necessary to enable trades to be conducted fairly as without it the price basis on which negotiations commence is questionable.

Accurate price determination is also necessary in order to assist in the valuation of securities for accounting purposes. Without a nationally recognized pricing source existing in the market, investors in the same security may carry different valuations of their holdings. This would severely reduce the ability to accurately analyze and compare the performance of companies in the same industry.

With the introduction of a secondary market these problems are alleviated, as there is now a central place where all demand and supply for a particular security can be displayed. Trading data will also be published in the media ensuring that the entire market has access to that information which they can then use to adjust the specifics of their demand or supply orders to suit changes in the market.

The market will also ensure that some sort of execution priority is given to orders placed in the system. Orders with better prices and earlier timestamps will have greater priority eliminating the existence of multiple trades occurring at drastically different prices. With the secondary bond market in place, the Central Bank will now have information at its disposal that it can incorporate into its policies. This will lead to a better assessment of the market prior to development of policies and accurate measurement of the effectiveness of the policies implemented.

A major benefit of the secondary bond market is that it provides information that can be used to construct a yield curve. This yield curve is a graphical representation of the country's bond maturities plotted against interest rates (See Box 1). This would allow a country to be able to determine the level of confidence that investors have in the economy as it shows at a glance expectations about future inflation and the perceived level of risk of the different tenor bonds by investors.



Presently, yield curves are constructed through mathematical calculations and while this is not incorrect it may be inaccurate as the calculations do not take into consideration the effects of demand and supply. Even if some form of adjustment is used to factor this component in, it still will not be accurate as prior to the advent of the secondary market there was no way to determine how many trades, what volumes and bid/ask levels were associated with particular securities. The secondary market seeks to provide this missing piece of the puzzle giving all the required information. Bond yields can therefore be determined and a change in the slope of the yield curve will be seen accordingly.

When the yield curve is constructed the Central Bank, and the market as a whole, can use it to determine the prices of securities that are not presently traded. Since the yield curve

plots tenors against rates, if there is a new issue coming into the market for a tenor not previously issued, investors can determine in advance the approximate yield and price, this is especially important when placing bids for new issues in the auction system run by the Central Bank. One merely has to locate the time to maturity on the x-axis of the curve and read off the associated yield from the y-axis where the tenor and curve intersect. Bids received by the Central Bank should therefore now be clustered around the associated point on the yield curve allowing for a more competitive bidding process and a more intelligent bid.

The determination of prices using the yield curve does not stop at Government bonds only; it can be manipulated to determine prices for corporate securities also. The investor only has to adjust the yields of the government issues by the perceived level of risk associated with the corporate entity. Subjectivity does come into play here again but it now rests on an objective platform making it a little more stable.

In conclusion, the advent of a secondary bond market in Trinidad and Tobago is welcomed as it can assist in furthering the development of the financial market of this country. It must however be supported wholeheartedly by all associated parties. The government, regulatory boards and brokers can only provide an environment conducive to the carrying out of trades. It is up to the investors to explore the great possibilities of this new development.

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