Discussion of "Clients' Connections: Measuring the Role of Private Information in Decentralised Markets"

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January 2020

How Information is Incorporated into Prices?

- Perhaps one of the most fundamental questions in finance (and economics) is: **"how information is incorporated into prices"**

- Different market micro-structures can have very different implications for this process.

- This in turn will affect the incentive of investors and the amount and the type of information they acquire.
  - Perhaps slightly more accurate question is how different types of information (e.g. information about others demand vs. information about assets fundamentals) on different types of assets (e.g. debt instruments vs. equity, small firms vs. large firms,...) is incorporated into prices.

- The information aggregation structure can affect, firms investment, security design, allocation of resources (including talents) in the economy.

Information, prices and OTC markets

- Why (government) bonds are traded in OTC?
- Bonds were actually traded in NYSE until mid-40s.
  - Migration from NYSE to OTC is associated with the rise of institutional investors in this market.
- Recently there has been many attempts (particularly in Europe) to move bond trades into electronic platforms.

Big bond trades are still difficult but smaller ones become easier with electronification

% of responses
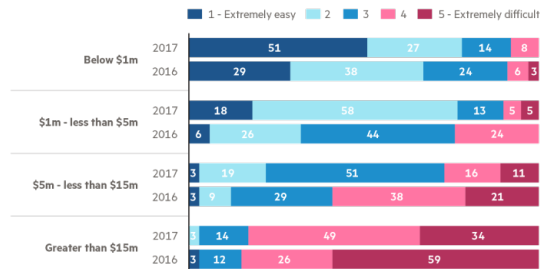
Based on 39 responses in 2017 and 34 in 2016

This Paper

- Proposes number of dealers with whom a client trades as a measure of informativeness of trades in OTC markets.

- Exploiting within client variation in number of dealers, the paper finds that:
    - number of dealers is correlated with better performance of trades.
    - This correlation is stronger on days with macro announcements.

- There are also suggestive evidence that dealers pass on the information to their subsidiaries.

This Paper

Connection Effects at Longer Horizons
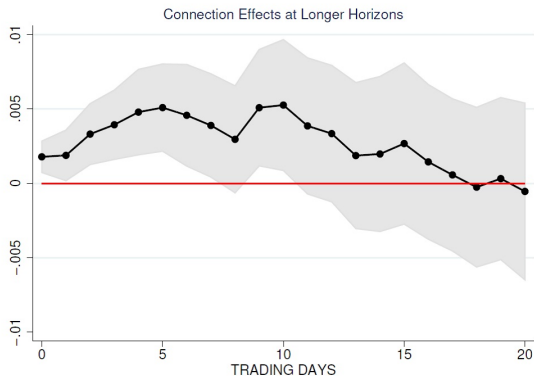
$$Performance_j^T = \left[ln(P^T) - ln(P_j^*) \right] \times \mathbf{1_{B,S}}$$

$$Performance_{i,t}^T = \beta \times ClientConnections_{i,t} + X_{i,t} + \alpha_i + \mu_t + \epsilon_{i,t}$$

Comment 1: Anonymous vs. Non-Anonymous Trading

- Most of the studies of the bond market found relatively large transaction costs (especially for smaller clients) associated with trading in OTC markets.

- They also found trading relations do matter a lot.
  - More favorable terms for more closely related dealers and clients.

- So are OTC markets just a way of extracting rent from clients?
  - Are we better off by moving OTC markets to CLOB?

- What if the main advantage of OTC markets is that traders are not anonymous and therefore repeated interaction can reduce information asymmetry problem?
  - Azarmsa and Li (2020): non-anonymous trading can enhance liquidity (and welfare) depending on the amount of adverse selection in the market.

Comment 1: Anonymous vs. Non-Anonymous Trading

- Important implication: Investors prefer to keep their closest dealers inventory risk relatively low.
  ⇒If an investor has an informed trade, the investor may want to divide it between the dealers so no one dealer is exposed to a large inventory risk.

- This mechanism also result in positive correlation between number of connections and trade performance (but for a completely different reason).

- Using the variation in the strength of the relation and trade performance can help to distinguish between the two stories.

- Is there any relation between the spread (transaction cost charged by dealers) and average trade performance?

Comment 2: Why not Using Client-Asset-Level Variation?

- Current analysis studies the relation between average monthly trade performance and the number of dealers used in that month.

- Theory suggest that the relation between trade performance and number of dealers should exist at the trade level.

- Using client-asset-level variation helps you to be able to control for anything else that varies at the fund level.

- It also helps to be able to investigate the source of information asymmetry.

Comment 3: What is the Source of Information Asymmetry?

- There is no default risk for UK government bonds.

- Information asymmetry should be either about macro news or liquidity events.

- The pattern of the estimated effect of connection on performance suggest the result is driven by the liquidity events.

- Why not performing the analysis for bonds that are subject to macro news and bonds that are subject to liquidity shocks separately?

Comment 4: Active Investors vs. Passive Investors

- To the extent that the result is driven by information advantage of the client, we should see no relation for passive investors and stronger relation for active investors.

- Why not testing the relation for different type of investors separately?

- Even within active investors, perhaps we can differentiate between liquidity providers and those who trade based on macro news.

Comment 5: What is the Right Level of Consolidation?

- Currently, the paper consolidate all accounts at the highest possible level of consolidation.

- Imagine a large investment bank with many different funds/trading desks with different strategies.

- Let assume that each fund within the investment bank works with only one dealer.

- An increase in number of dealers will be associated with more informed trading but not because anyone wants to hide the information from the dealers.

- Would be better to perform the analysis at different levels of consolidation.