

CFA LEARNING OUTCOMES DECODED

In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. Nicki DeGroot, CFA, author of this article works as a finance consultant and tutor for Tutor.com.

FIXED INCOME: FIXED-INCOME MARKETS: ISSUANCE, TRADING, AND FUNDING

LOS: Describe secondary markets for bonds

This key LOS sets the foundation for bond trading and active investment management. Understanding how bonds trade in the secondary market is key to building knowledge of bond valuation and credit analysis for fixed-income portfolio management.

The secondary bond market exists as a way for parties to trade existing securities. Investment strategy has evolved as many fixed-income investors actively trade bond holdings instead of buying and holding bonds until maturity. This has led to an increase in secondary market activity where those securities are traded. There are three primary avenues for trading in the secondary markets:

- The over-the-counter (OTC) market accounts for the vast majority of volume in the secondary market. Here an electronic system matches buy and sell orders from various participants.
- An organized exchange is a central place where buyers and sellers can meet to trade.
- A bond tender occurs when a bond issuer offers to repurchase its outstanding bonds to reduce debt or refinance at a lower rate. Bondholders can choose to resell their bonds or not, though the bond tender price is often above the current market price.

Investors participating in the secondary markets include institutional and retail investors, with retail investors often participating via mutual funds or exchange-traded funds (ETFs). Investment banks often participate as brokers or dealers. Bond issuers primarily enter the market to execute bond tenders.

Bid-offer or bid-ask spread

In the secondary market, bonds are traded at a spread. The dealer will purchase a bond from an investor at the “bid” while offering to sell it to an investor at the “offer” or “ask.” The difference between the bid and offer results in a trading profit to the dealer to compensate them for holding the inventory and facilitating the trade.

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Bond liquidity

Bond liquidity is important as it measures how quickly an investor can convert their bond to cash at a price close to the fair market value. The larger the bid-offer spread, the more illiquid the bond. A tighter bid-offer spread indicates a more liquid bond. The average spread is around ten basis points, but it can vary from 5 to 50 basis points, depending on the liquidity of the bond.

Trade settlement

Settlement is the process through which a trade is executed, and the investor receives or pays cash for their bond. This is not instantaneous, and the days until settlement vary depending on the bond. Liquid government bonds may settle on the same day (cash settlement) or one day later, known as “T+1”. Most corporate bonds settle in two or three days (“T+2” or “T+3”). Settlement, in certain jurisdictions, may take up to seven days. Two central clearing systems, Euroclear and Clearstream, are used by investors to settle trades in the secondary market.

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PRACTICE QUESTION

A fixed-income portfolio manager purchased a corporate bond in the secondary market. Which of the following is *most likely* the counterparty in the trade and the days until settlement?

- A. The bond's issuer and T+1
- B. An institutional investor and T+3
- C. A retail investor and cash settlement

B is correct. In the secondary market, bonds are most likely purchased from another investor, including institutional or retail investors. The bond issuer would be selling bonds in the primary market. Corporate bonds typically settle in two or three days, known as T+2 or T+3.