Why evaluated pricing is next

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Peter Jones, Director, Securities Evaluations, Standard & Poor's and Joseph Mariathasan, Consultant, StratCom outline the latest trends in bonds valuations.

Valuing a bond portfolio is often regarded as a straightforward exercise of obtaining the latest market prices from a group of market makers or an exchange, completely analogous to the equity marketplace.

The vast majority of bonds do not trade on a day-to-day basis and, traded over-the-counter, there is a fragmentation of information on prices and a consequent lack of transparency. In contrast to the US, Europe has not seen the same emphasis, so far, on ensuring that reported prices of securities fairly reflect their actual value.

As a result, pricing of illiquid bonds in a way that reflects their fair economic values is fraught with complexities that may be completely hidden by the inability to distinguish between the distribution mechanisms for prices such as Bloomberg, and the actual underlying sources of the information. This can give rise to the illusion that valuations have been obtained when there may have been no actual analysis by any party of the current circumstances relating to the creditworthiness of the bond.

Ultimately, there are three fundamental sources of price information. All prices that are disseminated in the marketplace have to be either based on actual trades, which could be out of date by periods varying from a few hours to many months, quotes from dealers that represent actual executable trading levels, quotes from dealers which may not necessarily reflect any real willingness or ability to deal, or on estimations of fair value that could incorporate traded price information and current broker quotes together with other publicly available information and analysis.

The most direct source of price information within electronic platforms are individual broker quotes and actual trade data, but in addition there are typically a number of other types of price data available. These additional sources can be clearly divided into two distinct classes.

Firstly, consolidated price data and secondly, estimations of fair value through the calculation of evaluated prices.

Consolidated prices are attempts to obtain the best price by either mathematically averaging price quotes from brokers after some quality checks or may as an alternative, have the latest quote from any contributor.

Sources of consolidated prices include exchanges such as MTS and the platforms themselves such as Bloomberg, Reuters, Mark-It and Telerate.

Evaluated prices can vary tremendously, based on their source, in quality and consistency and represent attempts to obtain a fair valuation of individual securities based on publicly available information combined with analytical approaches of varying degrees of sophistication.

There is an enormous amount of confusion in the marketplace between the distribution mechanisms for price information and the actual source of the prices. This confusion is exacerbated by the fact that distribution platforms such as
Bloomberg also produce their own consolidated prices and in some cases, their own attempts at fair value pricing as well as distributing third party consolidated prices and third party evaluated prices.

The ultimate user of a price therefore has to 'look through' the distribution platform to locate the underlying source of prices. This is a key requirement for any institution and one that perhaps, has not received the attention in the European marketplace that it has in the US.

Sources of price data can be organized in a hierarchy of attractiveness, leaving aside any questions of costs. At the top of the hierarchy are market quotes from a dealer actually willing to trade at the price at the time the quote is given. This is the ideal, but in general, will not be achieved except for the most liquid bonds and then only during actual trading hours.

Comparable in position in the hierarchy is the use of contemporaneous actual trade prices. As less than 16% of European and US corporate bonds trade every day, the universe of bonds for which such information is available is very limited.

Consolidated prices are conceptually very attractive because they can represent either average or best bid/ offer prices and represent the product offering of a successful exchange such as iBoxx. For them to reflect current value, however, they need to be based on quotations from market makers willing to deal at the stated price.

This is effective for the liquid bonds that are priced through iBoxx, but has very variable quality when applied to illiquid bonds. ISMA's pricing service for example, while based on an average of quotes from a large group of market makers, does not represent dealable prices.

In the absence of contemporaneous prices from actual trades or current prices from executable quotes, evaluated or 'fair value' prices can offer the most best representation of current fair values and in particular, are superior to the currently accepted practice of using indicative prices which is fraught with difficulties.

Use of indicative prices can compromise independence, as it does not necessarily represent any firm intention or ability to deal. Indeed, under extreme circumstances they could be manipulated to artificially enhance performance.
More generally indicative prices represent the fulfilment of a chore that gives rise to no immediate benefit to a market-maker and therefore it is often under-resourced, leading to only a cursory attempt being made to reflect current values.
Many market makers therefore do not change prices, or merely represent a change in yields with spreads above a reference bond kept constant for long periods of time, extending to weeks or months.

Despite these drawbacks, the idea of obtaining ideally a few indicative quotes from well known investment banks remains standard thinking in the European marketplace.

Evaluated prices have now come to play a prominent and crucial role in the pricing of debt securities in the US, and as European investors become more aware of their advantages, their importance in the European marketplace will surely grow.

What can be generally described as 'fair value pricing' encompasses a wide range of different approaches, ranging from a crude matrix pricing methodology which essentially takes no account of any information apart from movements in the yield curve, to the more sophisticated evaluated pricing approaches which attempt to take all publicly available information into account when arriving at a price.

Key features users need to look for in providers of evaluated services include: valuations that are obtained from independent sources; the ability to fully utilise all publicly available sources of information, including the current interest rate environment as well as sector specific and credit specific events and news; consistency within comparable securities with similar credit quality, structure and issuer; transparency in the pricing mechanism, enabling queries to be resolved through identifiable steps; reputation and credibility of the price provider to give comfort to the stakeholders; frequency of intra-day pricing enabling overseas securities to be valued at the same time as domestic.

The resources devoted to the European marketplace by providers such as S&P have risen significantly in the last couple of years, following increasing acceptance of evaluated prices by institutional players.

While fund managers in the retail marketplace may be slower to accept a concept that has only recently crossed the Atlantic, it may be only a matter of time before using evaluated prices to price securities in mutual funds in Europe becomes as common as it is in the US.

For further information on this please click here [1]

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