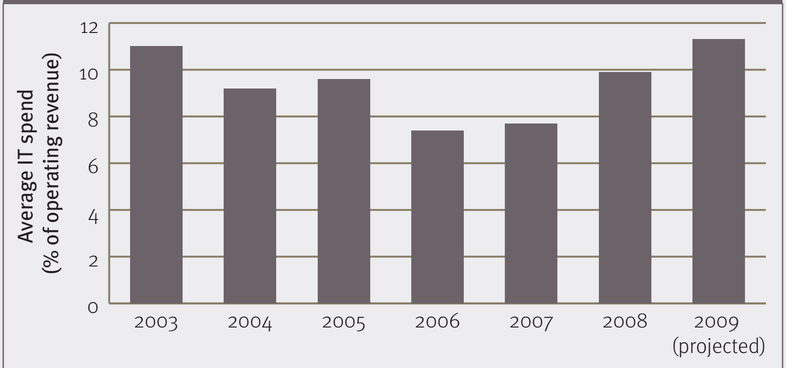
Trading on a budget

FIGURE 1: OPERATING REVENUE ALLOCATED TO I.T. SPEND BY GLOBAL ASSET MANAGERS



Source: Investit IT Value Service survey

In an environment of reduced asset values and limited scope for business growth, many asset management firms are looking to keep costs to a minimum without sacrificing performance. Like other departments, trading desks have had to make some painful adjustments.

While outlay to brokers remains a significant line item on the buy-side budget, technology costs have become more significant in recent years, particularly when one considers the growing complexity of trade automation and the investment required to source liquidity effectively across multiple channels in fragmented markets.

Sacrificing technology capabilities in an industry where performance relies increasingly on the trading desk's mastery of algorithms, smart order routers and trading venue connectivity may not be an option for many buy-side firms.

"In the last five years, firms have been investing in new types of systems like execution management systems (EMSs) and risk management tools, so the base costs of IT have been pushed up as the systems' complexity has risen for many traditional asset managers," said Simon Stratford, head of systems practice at consultancy firm Investit and author of the firm's IT Value Service survey. "The majority of IT spend – around 70-80% – relates to the upkeep of IT infrastructure and these systems."

Figures from Investit's IT Value Service survey show that the IT budgets of investment firms are projected to increase by 3% on average in 2009, although this ranges from an expected decline of 10%, to an anticipated rise of 20% among the firms surveyed. The average IT spend as a percentage of revenue was 11.3%, compared to 7.7% in 2007.

Value for money?

Budgetary considerations have led buy-side firms to explore a range of strategies for optimising the efficiency of their trading operations, including the outsourcing of some execution tasks, centralising dealing operations and leveraging broker relationships to make the most out of sell-side-supplied technology.

Betsy Anderson

head of centralised dealing, Ignis Asset Management

Brad Hunt

European head of electronic trading, Goldman Sachs

Neil Joseph

VP, trading technology, J.P. Morgan Asset Management

Raymond McCabe

partner, Williams Trading Europe

Frederic Ponzo

managing director, NET2S

Some investment managers are looking more closely at the most cost-effective means of obtaining vital trading technology, such as an execution management system. Pricing models vary considerably. A broker-supplied system, for example, may not have an up-front cost, but is generally supplied on the understanding that a certain volume of flow will be directed to the supplying broker. Added to this is the opportunity cost of being tied to a single broker for trading, regardless of execution quality. A vendor-supplied system, on the other hand, is generally charged on a flat monthly rate, with market data costs typically also passed down. Of course, a vendor-supplied system will rarely put minimum limits on required flow and will, assuming multi-broker functionality, provide the ability to choose from a wider variety of broker tools. For the moment, there seems little likelihood of the two models converging.

Whilst independent, unregulated, technology vendors are unable to charge commission-based fees for EMS platforms, which is typically the way broker-owned platforms are priced, there is the option for message-based charging structures. However, introducing this style of charging would, potentially, result in a backlash from the sell-side, said Russell Thornton, global head of EMS product marketing at buy-side trading technology provider Fidessa LatentZero. "If the broker has invested heavily in promoting its execution services to the buy-side and as a result sees increased volumes, it could consider increases in its independent EMS technology fees as unjustified."

For firms that have to operate within tighter budgets, there is also the option of hosted solutions, which may particularly appeal to smaller or mid-sized managers as a means of securing trading technology with the richness of functionality traditionally available only to their larger buy-side counterparts.

However, this can work out to be a more expensive solution if costs relating to trading decision tools, risk, and asset class and market data integration are borne by the buy-side firm. Some vendors have addressed the needs of smaller firms by releasing scaled-down versions of their products, while others offer a higher-end hosting service, which removes some of the administrative and implementation burdens without sacrificing any of the functionality. ■

BETSY ANDERSON

head of centralised dealing, Ignis Asset Management

"Trading FX and managing cash as well as equities within the centralised dealing desk allows us to form cross-asset views."

"Before we established the centralised dealing desk at Ignis, our fund managers handled their own executions. First and foremost, setting up a dedicated dealing desk allows them to concentrate on their core competencies of stock selection and analysis, while allowing the traders to concentrate on execution. To maximise the benefits of a central desk, good communications lines between our portfolio managers and traders are essential to ensure investment decisions are implemented as efficiently as possible, to achieve the best outcome for our funds and our clients.

At Ignis, we manage a range of fund types including, amongst others, absolute return, 130/30 and long-only. Two fund managers might decide to buy the same stock, but have very different rationales for holding it, different price sensitivities and a very different timeline, both for implementation and for holding it depending on the type of fund. So we need to be aware of as many of the factors driving an investment decision as possible. Initial communication becomes even more important in fast markets as market circumstances change and strategies need to be dynamically and quickly updated or changed. Knowing the driver for a trade helps us to make those decisions quickly and efficiently.

All equity and equity-related trading, including derivatives, FX and cash management is managed, without exception, through the centralised dealing desk. This ensures a consistency and robustness of processes and procedures and a consistency of standards.

The technology investment required to set up a centralised dealing desk is relatively low with choice of order management system (OMS) being key. We use a different best-of-breed OMS for our equity, FX and cash trading, as we require distinct functionality for each asset class. We have a common accounting system and compliance functionality that underpins our different OMSs, so the core data being fed through these is consistent, but the medium for viewing data and executing remains asset specific.

Trading FX and managing cash as well as equities within the centralised dealing desk allows us to form cross-asset

BETSY ANDERSON

continued

views, which enhance our overall execution quality. For example, we often seek a currency view when trading equities to establish if there is a potential currency impact on the stock, or we might gain an advantage from getting an FX view on a stock that trades in multiple currencies.

Conversely, if you know what's driving equity orders and you know the style of a particular fund, being aware of the timeline around a stock trade for example, you can gain an edge when managing the FX and cash and hedging currency positions.

Compared to trading asset classes separately, centralising dealing operations allow us to look at our counterparties on a more holistic level to determine the quality of the relationship across a wider range of services and technology provision. It also allows our brokers to have a better understanding of our wider business and knowledge of our overall stock base.

Having a dealing team that has a common ethos also helps to establish and solidify long-standing counterparty relationships. Although individual traders interact with different sell-side counterparts, we do this in a common way so our counterparty expectations are standardised and their understanding of our expectations is standardised. This makes it easier to determine who is meeting our expectations and who we want to do business with, based on our collective interaction with counterparties." ■

BRAD HUNT

European head of electronic trading, Goldman Sachs

"A growing theme among larger buy-side clients is their efforts to increase efficiency through trading automation. At its core, this entails adopting a systematic approach to trade optimisation, order flow segmentation and algorithm selection. The end-goal is both to increase desk efficiency and yield lower, more predictable trading costs.

The first iteration of this approach involves segmenting low-difficulty orders and executing these using a selection of broker algorithms or trading tactics. Previously, these orders typically would have been executed either manually or using offerings such as broker direct-to-capital services.

> "It is the broker's task to improve execution performance relative to client-defined benchmarks."

However, automating low-difficulty orders is only the first step: this isn't simply about using broker algorithms for a higher proportion of flow; rather it is about adopting a quantitative and systematic approach to trading, and linking that more closely to the investment management process. Buy-side firms are finding that a more quantitative and disciplined approach yields better results.

For the client, there is also a single point of accountability at the broker for ongoing execution quality monitoring and optimisation. We have found this leads to better alignment of purpose and a richer, more objective dialogue with clients.

The low-difficulty trades generally produce the most predictable results, so a broker would work with the buy-side client to define a set of execution strategies that will automate a significant percentage of their order tickets using the most optimal combination of the broker's algorithms. In some cases, this can amount to 50% of a client's order tickets and up to 30% by values, which are typically outsourced to two or three brokers.

Rather than selecting algorithms for trades individually as before, the buy-side desk defines a common rule set based on pre-defined and agreed criteria. Adopting this approach allows asset managers to extract maximum value from brokers' offerings – leveraging their investments in trading infrastructure, trading intelligence and liquidity footprint – within a structure that is objective and transparent, and most importantly which incentivises and empowers brokers to utilise all of the tools in their arsenal to obtain the best possible execution results.

It is then the broker's task to improve execution performance relative to client-defined benchmarks. Some ask brokers to compete versus a benchmark, with better performers earning a greater allocation of flow. Others choose tactics based on their experience.

Automating simpler trades also allows experienced traders more time to work on more complex, larger, trades where their skills can have maximum impact on performance – a particularly significant advantage during a time when resources are constrained.

This approach also forces a degree of rigour and objectivity from investment management firms in the way order flow is segmented and classified. Flow is typically split up in terms of volatility, spreads, order size, market cap, investment benchmark and urgency.

By working with brokers to create customised trading strategies for specific types of flow, buy-side firms can develop a consistent way of handling different orders. This makes it easier to compare broker performance and create the competitive tension between providers which an asset manager requires to ensure they get the best possible output." ■

NEIL JOSEPH

VP, trading technology, J.P. Morgan Asset Management

> "We have been encouraging brokers to adopt FIX's Algorithmic Trading Definition Language."

"The importance of trading technology in today's market environment has meant that it is not an area where major cutbacks can be made easily.

However, there is a need to be more cognisant of the methodologies used to develop technology and use a more iterative approach, which can help buy-side firms change their priorities in line with technology trends.

It is now crucial to be able to show a projected return on investment and a sound business case for each potential project to ensure the trading desk receives the maximum potential value from the tools they use and that the initial capital outlay is justified.

An important step, especially when looking at the functionality of execution and order management systems, is to compare the benefits of a vendor-supplied system with those of building proprietary solutions. In recent times, building as much non-generic technology in-house as possible has helped us to work better with the trading desk to determine exactly what kind of functionality and tools they need to increase trading efficiency.

We have done this recently by extending core vendor platforms in-house, such as our EMS, and building a trading system on top of a vendor-supplied complex event processing engine.

The customisable, best-of-breed EMS system has proved to be more cost-effective than if we had tried to create something similar internally.

While the supplier is responsible for maintaining the connections to trading venues and our brokers' program desks, sales traders, internalisation engines and algorithms, we have the ability to make changes and enhancements to the system when we see fit, without having to involve the vendor. This has been particularly useful when adding our own proprietary algorithms to the EMS, tweaking business processes and consolidating data in a way that suits the traders on the desk.

An asset management firm looking to build a customised, best-of-breed application suite for its trading desk needs to ensure that these systems are fully FIX-compliant, as this is where the majority of the cost savings can be realised. Having FIX also ensures new tools can be added quickly and easily; it has been particularly useful in helping us to integrate internal and vendor supplied pre- and post-trade analytical tools into our EMS.

Broker relationships are important in making sure we stay up-to-date with the latest technological developments. It is also crucial to look at developing certain areas in conjunction with them as they supply a large portion of the functionality required on the buy-side desk.

We have been encouraging brokers to adopt FIX's Algorithmic Trading Definition Language (ATDL), which simplifies the rollout of new algorithms by enabling brokers to send a standardised, ready-to-use file to all its algorithm distributors.

Implementing ATDL will reduce the costs of writing algorithmic language and drastically reduce the time it takes for algorithms to reach the market. If the buy-side continues to push these kinds of developments with their brokers, the whole of the industry stands to benefit." ■

RAYMOND McCABE

partner, Williams Trading Europe

"Many buy-side firms look to outsource trade execution to turn the fixed cost of hiring traders into a variable cost, but this is not the only advantage.

Our approach is to be an extension of the client's trading desk by using our execution expertise and access to liquidity and information flow from 450+ counterparties globally.

In our experience, there are broadly three types of buy-side firm for which outsourcing holds attractions.

First, a small but growing manager – with up to $200 million AUM – may look to outsource all their trade execution requirements. Outsourcing enables smaller buy-side firms to access a larger number of sell-side relationships, which gives them the chance to participate in illiquid lines of stock they might not usually have access to. In some instances, outsourcing agencies will help firms to build sell-side links when they become large enough to manage their own trading.

Second, mid-sized managers that have $200 million-$2 billion AUM may outsource so they can use cost savings to hire in other areas, such as analysts.

Finally, clients that trade more than $2 billion usually have a fully-staffed trading desk, but they value the anonymity that using an outsourced desk provides. This is particularly useful when trading large positions and trying to limit market impact.

Our own clients range from long/short equity hedge funds to long-only asset managers, private equity firms, activist investors and endowment funds.

RAYMOND McCABE

continued

"Funds that have downsized are now looking to use outsourcing providers to fill some of the gaps."

Because desired levels of execution and service depend on the portfolio manager or head trader's wishes, ongoing dialogue with clients is crucial to ensure their intentions and aspirations are interpreted correctly by the outsourcing provider.

An outsourcing provider's traders must have the experience to work with clients to devise appropriate strategies that take account of factors like where a stock was last traded, who is holding the stock and any market inefficiencies in stock demand and supply. We have 20 traders across three different offices with many years of experience between them.

A constant dialogue is also crucial in ensuring portfolio managers are not worried about losing control over the execution function, which is one of the main considerations for buy-side firms before deciding whether to employ an outsourcing provider.

To alleviate this worry, we use IM Trader, a customised technology platform that allows clients to send orders and instructions directly to traders. This goes straight into our order management system and all executions are sent directly to the client's blotter in real-time.

Some clients express concerns about a perceived conflict of interest, but we have no proprietary trading account and operate as an agency broker, so our interests are fully aligned with clients'.

Since the financial crisis hit, we have seen more enquiries from US trading desks looking to use our European arm to reduce the cost and potential risk of error associated with using overnight traders. In the US, some funds have downsized and are now looking to use outsourcing providers to fill some of the gaps left by staff departures." ■

FREDERIC PONZO

managing director, NET2S

"The explosion of technological investment that has been required since MiFID makes IT a natural place to look for places to streamline and create cost efficiencies in the current market environment.

Since the financial crisis, many buy-side firms have retrenched any plans they may have had to expand and increase trading flow, meaning investment plans to upgrade order management systems (OMSs) or implement smart order routers (SORs) have either been reduced significantly or put on hold.

There are however, more practical ways to cut technology

"Many firms are looking at ways to cut market data costs from vendors and exchange feeds."

spend. Many firms are looking at ways to cut market data costs from vendors and exchange feeds, sometimes by arbitraging from one terminal provider to another. When the dollar was weak, a lot of business moved from Thomson Reuters to Bloomberg, and vice versa as the dollar started to pick up. In order to do this, buy-side firms are running on short-term contracts with data vendors rather than being tied in for 12 months.

In addition, buy-side firms are also looking at the way they administer and consume market data. It used to be common for a trader or fund manager to have both a Bloomberg and a Thomson Reuters terminal, as well as direct feeds through their OMS system, and were therefore potentially paying three times for the same feed as there was no system in place for reconciliation. One firm we worked with had a market data bill of £1 million per year, which reduced by half following rationalisation.

Buy-side firms can also save money by training up their traders to work across asset classes. This is common among the larger asset managers, who are consolidating dealing activities to a central dealing desk. It shouldn't diminish trader efficiency and it also allows the firms to streamline their broker management.

However, trying to migrate to a single technology platform might not be as successful in cutting costs, as there is no 'silver bullet' multi-asset class execution management system (EMS). Most firms have either selected asset-specific EMS systems or had EMS functionality bolted on to an OMS.

Buy-side firms that put a large amount of flow through their brokers also have the option of looking for alternative ways of paying for technology when trying to save money.

There will be limited investment in EMSs in the short-term because of the initial spend that is required. Showing a saving over 36 months is great, but the problem is most firms need to save money within a much shorter time scale.

While the more trading-intensive, quantitative firms will be suffering the most from technology cut backs, they also have the most leverage on the sell-side as they will be the ones paying more commission and putting the most flow through broker tools.

One buy-side client bought an SOR engine that will cost them £2 million over five years. They managed to convince their brokers to split the cost of the SOR between them based on the amount of flow they pass through. These types of firms can look to the sell-side to subsidise their technology investment in exchange for guaranteed trading flow." ■