

F Optimized Trading Empowering the trader in an automated world



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Today's equity markets continue to show great strength and resilience, but that strength masks a new and challenging dynamic facing all market participants, regardless of size. Whilst turnover in the global equity markets continues to rise, there is little doubt that money managers have become far more discerning about their choice of sell-side counterparties. Those brokers that are able to clearly demonstrate their value and expertise will be the overachievers in this new, highly competitive marketplace. Those that can't will become increasingly marginalized. Here, Fidessa's Anthony Martinez explores the challenges ahead and looks at some of the essential measures brokers can take to ensure they stay ahead.

This view of the new world order is endorsed by two leading industry analysts, Tabb Group¹ and Woodbine Associates². In their respective reports on the US equity markets, both seek to highlight the increasing importance that the buy-side is placing on a deep understanding of market structure and trading prowess, and the fact that this is now becoming the key benchmark for broker selection.

The cost and margin pressures that the industry continues to face mean that every sell-side firm needs to find ways to be more productive with less resource. One of the best ways to achieve this is to embrace technology that enables them to automate processes, improve client service and add real value, which ultimately will generate more client commissions whilst minimizing costs.

The trader's principal role is to provide a 'gold standard' in execution, but this has become increasingly challenging in this new, highly-automated world where orders and executions flash through the trading platform in the blink of an eye. The mix of client order flow that brokers are receiving has changed beyond all recognition, with seemingly endless permutations of order handling logic needed as they continue to optimize trading strategies in their quest for the holy grail of best execution.

¹US Institutional Equity Trading 2015 - TABB Group, May 2015.

²Broker Opportunity Among Institutional Investors in the U.S. Equity Market - Woodbine Associates, February 2015.

It is incumbent on technology providers to keep pace with this change and support this new dynamic. With a higher percentage of electronic orders and fills, traders are increasingly required to focus on those orders that are behaving abnormally and which require a greater degree of focus. Often clients expect a collaborative approach to managing these outliers. The real key is to identify them early and, crucially, before the client does. It is this collaboration and partnership that is more highly valued than ever before.

Today at least 60% of all client order flow is routed through low touch execution channels, typically using algorithms and execution logic designed to achieve best execution and minimize market impact. The vast majority of these orders achieve their aim, but the real value a sell-side trader brings is to quickly identify and then act on those that look set to underperform. Those brokers who can proactively demonstrate that they are in complete control of their order flow will continue to be favored over those that cannot.

Regulatory drive for execution quality

The MiFID II proposals in Europe, which look set to force a clear separation of payment for trading and for research, will have widespread implications for the sell-side. They will also, inevitably, create a clearer picture in terms of those that have successfully embraced the new trading dynamics and those that have not. Those brokers unable to clearly demonstrate their execution capabilities will find themselves excluded from the execution process altogether and paid only for those services for which they can qualify and quantify the value they bring. Whilst there are no current plans to pursue a similar unbundling process outside Europe it seems inevitable that 'best

practice' will dictate a permeation of this clear delineation to other parts of the world.

As execution becomes unbundled from research, its value and quality will come under increased scrutiny. The execution services on offer will have to withstand comparison with the highest quality providers charging a similar or lower price. Under the MiFID II proposals fund managers will have to inform their clients how they select the venues on which to trade, which execution strategies they use, what procedures they have in place to analyze execution quality and how they are monitoring and verifying best execution on an ongoing basis.

Order routing disclosure enhancements are also on the US SEC's directives list. According to Tabb³ research, "execution quality is the top initiative for 53% of buy-side firms in 2015." They also report that: "leading buy-side firms that have acquired new technology, built quantitative analytics and added internal market microstructure expertise will invest further in surveillance and compliance tools in order to combat any perceptions of inaction or impropriety."⁴

Real-time monitoring vs TCA

There is a proliferation of post-trade TCA tools designed to assist in the quest for best execution. These typically provide both the buy-side and sell-side with a next day review of the previous trading day, and most use this in some part to adapt and improve their execution and order routing decision making. Endless amounts of quantitative information is filtered and dissected to show how orders

³US Institutional Equity Trading 2015, Part 3: Crossroads of Best Execution - TABB Group, May 2015.

⁴US Institutional Equity Trading 2015, Part 1: A Vision Forward - TABB Group, May 2015.

performed against various industry-standard benchmarks, and market data vendors are offering tools that include eye-catching heat maps and charts showing trends and directional flow. Whilst valuable, these reports do not address the key issue: the need to flag an outlying order with an early warning system that alerts users to problems instantly so that they can change course and adapt execution strategies to take account of real-time microstructure anomalies. Post-trade TCA reports highlight today's issues tomorrow, by which time it's too late; the outcome is already determined and the poorly performing order serves as a constant reminder of what might have been.

Increasingly these post-trade reports are being expanded in an attempt to address pre- and at-trade predictive analytics. However, this presents significant technological integration and market data challenges. It is expected that by 2017 most buy-sides will be using some form of statistical analysis to formulate their pre-trade strategies. It seems inevitable, then, that in the coming years statistical order and execution analysis will continue to be front and center of order routing decision making and execution management. Meanwhile, the traditional best execution definition has morphed from the US-specific Reg NMS/NBBO standard to a global initiative where algorithmic strategy and venue selection decisions are monitored and must be defended, often in real or nearly real time. HFT and dark pool interaction is scrutinized as buy-side traders become increasingly concerned over information leakage and gaming, thereby increasing total trading costs. Price slippage, fill quantity and liquidity are taking on increasing levels of importance.

Analytics and TCA are not 'one size fits all' solutions; market participants need something far more nuanced. What is

considered good for one metric might fail for another, with many intertwined variables ultimately determining an order's final outcome - for example:

- How is the overall market performing and how is the particular sector that you are trading performing against it?
- What is the liquidity of the stock and how difficult is it to trade?
- What algorithm did you use and is the expected outcome as anticipated?
- Has the price moved disproportionately since the order was received?
- Is the venue that you sent the order to sending back timely executions?
- What is the spread capture of the individual slices?

The issues associated with providing various best execution standards are prevalent across multiple sell-side desks - retail, institutional high/low touch and program trading. The problem, therefore, is having such a large universe of orders with multiple and disparate metrics, some of which may diverge from the intended outcomes and need to be proactively managed in a timely fashion. Against this backdrop, the concept of an early warning system becomes essential in the provision of an exceptional execution service to clients, regardless of their chosen execution channel.

One thing is clear; analytics will continue to be an important part of the trading process. Both the buy-side and the sell-side will come under constant pressure from their clients to provide data that proves they really are providing best execution and minimizing transaction costs. They will need to filter through the mass of information and

provide clear data that is valuable, relevant and impactful to their clients' decision making processes.

Whilst pre- and post-trade analytics might pre-determine the initial trading plan, real-time analysis will become more prevalent as the requirement grows to fine-tune execution strategies 'in-flight'. It is this capability that will improve overall performance and make the real difference to the quality of the execution service.

Optimized trading

The evolution of the equities trading desk continues and, inevitably, new tools and workflows will be essential in order to demonstrate differentiation in a fiercely competitive operating environment. The bar

for execution quality is already set high and will continue to be raised as the unbundling of research and trading becomes a reality and brokers' execution capabilities will have a real and tangible value in their own right.

Regulatory pressures and burdens, coupled with specific client requirements, will necessitate state-of-the-art, optimized trading systems and services that combine higher performance throughput with cutting-edge analytics that provide a clear understanding of the increasingly complex and nuanced marketplace. Traders will need to be nimble. They will need to deploy the right tools to enhance their order execution capabilities if they are to compete effectively in a world where execution prowess will be fiercely competitive, highly differentiating and discreetly measured.