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Tailor-made trading desks: How the buy side is embracing an outsourcing model

The Realization Group

COWEN

Tailor-made trading desks: How the buy side is embracing an outsourcing model

A rising number of asset managers across the globe are exploring the idea of outsourcing some or all of their trading desk to a third-party provider. Already popular in North America, this practice is gaining traction in Europe and Asia as firms discover the increasingly compelling arguments in favour of outsourced trading solutions.

Numerous institutional investors of all sizes, as well as hedge funds, family offices and specialist trading firms, have taken advantage of the expertise and depth of experience that an outsourced trading desk provider can offer. Wider coverage, better execution, new sources of liquidity, trading anonymity and increased operational flexibility – these are some of the benefits they have reported.

In this report, The Realization Group speaks to experts at some of the firms helping asset managers to understand and unlock those benefits. We hear from ***Daemon Bear****, chief executive officer at Anderson Bern Capital Management,* ***Chris Elliott****, prime brokerage and outsourced trading sales at Cowen,* ***Michel Finzi****, global head of product management at financial technology group Enfusion, and* ***David Berney*** *and* ***Michael Broadbent****, both of whom are principal consultants at Ergo Consultancy. Together, they explain the growing appeal of outsourcing from a business perspective as well as the different factors that asset management firms should consider.*

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Introduction

For some people, the term outsourcing creates an automatic response. They think of it in terms of giving up control, or of the loss of in-house resources. If you don't do something yourself, the thinking goes, you are only building dependencies and leaving your firm at the mercy of external forces. That of course has not stopped numerous industries from successfully outsourcing business activities that at one time or another were considered core functions. After all, the practice of outsourcing has been around for decades and is predicated on economic principles that go right back to Adam Smith.

In the financial markets, the question then comes down to what a core function really is. What makes an investment firm tick? Is it the analysis and the insight that leads to trade ideas? Is it about relationships and networks? Every firm will define its edge or USP in its own way. But what is clear is that the business of executing trades has evolved and is no longer automatically seen as a core function. In that sense, it has become an activity that is increasingly seen as suitable for outsourcing. This can be seen from the latest study by Greenwich Associates, which showed that one-third of the institutions they surveyed saw outsourcing as a good solution to manage flow and achieve best execution.

But what about the other two-thirds? In fact, while the Greenwich study highlighted the increased interest in outsourcing, it also revealed that only one in 10 of respondents were actually using a third party for their execution needs. What is holding so many firms back? Experts in trading desk outsourcing say much of the hesitancy comes down to one word: education. Or rather, the lack of education. What many people don't yet realise, they say, is that outsourcing the trading desk is all about addition, not subtraction. It is about adding to a firm's strengths rather than reducing staff numbers.

Matching capabilities with strategy

The practice of hiring a third party to conduct some, or all, of a firm's trading has been most popular in the United States. But other parts of the world are starting to catch on as word spreads among asset managers and executives at trading firms of the benefits of outsourcing.

For a number of firms, either the value proposition from relying exclusively on in-house trading has fundamentally changed, or the fund has found that it cannot pursue ambitious growth targets without partnering with third parties. Working with a trading desk provider means the opportunity to "right-size" a firm's trading capabilities to match current conditions and future strategy.

A key driver of this trend has been the surge in multiple asset class funds, which nowadays account for some $11 trillion in AUM and 14% of the global asset management sector, according to benchmark provider FTSE Russell. That total is more than five times the $2 trillion seen in 2003, when the share was just 6%. But even with such strong fundamentals, fund executives historically have been cautious about the practice.

"In Europe, in particular, there's a lot of education involved," says **Chris Elliott of Cowen**. "There are a lot of conversations to be had about how this can complement rather than replace a trading function. When you get past that idea, that there is a benefit and you identify what that benefit may be, then people are quite comfortable with the idea of supplementing the trading function."

For a small firm, like a start-up hedge fund, the idea of outsourcing has immediate appeal because of mundane matters like back-up support. If a firm has one trader, what happens when they are on holiday? No one can work around the clock throughout the year.

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Michael Broadbent of Ergo Consultancy divides the world of candidates into three groups based on the amount of funds under management.

Start-up funds or those with $1 billion to $2 billion in AUM are ideal candidates for outsourcing; it provides 24-hour coverage and back-up, two features that are costly to achieve for smaller operations. Funds ranging from $2 billion to $25 billion are potential candidates; outsourcing offers efficient ways of trading a new region or asset class and can also strengthen a fund's business continuity plan. Above $25 billion, the decision may be a little more complicated as some of these firms will have large trading teams. There are still arguments in favour of an outsourcing solution, such as BCP planning or better execution, but they also may see value in retaining more in-house control.

"That's why there's a grey area, although there are very big funds, bigger than that, that are outsourcing entirely," Broadbent says.

Whatever the size of the firm, there are substantial external forces that are pushing funds to entertain the idea of outsourcing. **Michel Finzi of Enfusion**, noted the general trend towards fee compression, which is making fund managers think about new ways to boost bottom-line performance. He also said Covid has forced the financial industry to reconsider the value of having traders and portfolio managers sitting in the same office.

"As fee pressure continues, people allocate their resources to really focus on generating performance and operational alpha. You can't ignore that," Finzi says. "There's a revenue line and a cost line, and so, how do you think about that? Do I need to take this on myself? Or is there a trusted partner that I can outsource these types of functions to? Whether it's Covid or just a trend of fee compression, the outsourced trading business has very solid underpinnings."

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The Covid pandemic ultimately may be seen as a pivotal moment. It has pushed people to rethink some of their assumptions about their business. **Daemon Bear at Anderson Bern Capital Management**, who has spent the majority of his career in the asset management sector running trading desks, said Covid has changed people's perspectives.

"What the pandemic has done is allowed people to take stock, take a deep breath, and actually look at what the outsourced trading offering actually is – what it actually offers versus what you're trying to achieve," he says.

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Correcting the myths

One of the main obstacles to firms embracing outsourcing has been the notion that it is essentially a cost exercise designed to enable funds to reduce headcount. While proponents of trading desk outsourcing will tell you that it can definitely be cost-effective, the main drivers are adding benefits, not subtracting costs. Chief among these benefits is the ability to add new trading capabilities.

"It all ties to extending into new markets, regions or asset classes," says Finzi. "If it's regions, then there are compliance frameworks and risk-compliant market access components that you've just got to be aware of. There's experience navigating those markets. There's staying abreast of new developments."

In other words, firms should not necessarily seek to outsource their trading desk because they don't value the function of a capable trader. Rather, it is because they do value that function and need more of it. The idea is that outsourcing allows a fund to gain more skills and knowledge – in the aggregate – than it could build for a reasonable cost in a reasonable timeframe.

Bear of Anderson Bern thinks about the function of a trader in terms of one of his earliest lessons in the markets. "When I first started in the trading world and asset management, I was told by someone that the buy side trader's job is to avoid destroying the alpha that the manager is trying to generate," he says.

"If you're going to replicate a service, you want to replicate the service at the top end of capability and beyond. You don't want to start cutting corners. I don't see this as a monetary thing. I see this as an increase in capability, an increase in reach and an increase in efficiency. And I think it has to achieve that for it to be a worthwhile model."

While outsourcing in some industries might feel depersonalised, in the case of a function such as trade execution, it is in fact the opposite. An outsourced trading desk provider needs to understand its clients well in order to do the job. Significant effort needs to be invested in learning the style, capabilities and interests of the asset manager, and a relationship needs to be firmly established.

"We spend a lot of time looking at the client's interest list or even their portfolio, and the trading desk can provide information and colour about pricing movements back to that portfolio manager," says Elliott of Cowen.

Providing colour plays a big role in cementing trust and understanding what the portfolio manager needs. It allows the portfolio manager to see that everyone is on the same page. Or, the third-party can act like an early warning system, keeping the client up-to-date when there has been an important price development.

As Finzi describes it, an outsourced trading desk solves a problem that any growth-oriented fund is likely to face. "If an asset management firm wants to expand its business, it's only got a couple of choices. Go to a different region or expand the product types that you invest in and the asset classes. If I decide that I want to do that, to offer more products, what do I have to do? I have to go and bring in that expertise," he says.

A range of benefits

Those additional trading capabilities result in benefits for the fund in a variety of ways.

Liquidity is a key factor. An established trading desk provider will have a large number of traders and an even larger number of relationships. Those all translate into sources of liquidity that an individual fund could not hope to have on its own.

Another critical way concerns regulation. If, for instance, a U.S. or European-based fund has exposure in Asia-Pacific, or wants to gain exposure, there may be regulatory regimes that an individual fund would not necessarily know much about.

Broadbent of Ergo Consultancy notes that MiFID II has made best execution a centrepiece of the regulatory landscape and has strengthened requirements that were originally part of MiFID I. "Under MIFID II, you should be driving for best execution on everything your firm does with anything that's remotely called client money," he says.

"Most funds trade their primary asset class pretty well. If they're equity trading, they'll be able to prove best execution," Broadbent adds. "The problem is the second and third asset classes. If they trade some fixed income, as either hedging or for money positioning, or if they do FX, the question is, how are they doing those trades? If they've just given them to their prime broker or custodian as a matter of bookkeeping, are they getting best execution?"

There is also the question of compliance and reporting. Depending on the location of a fund or its trading footprint, there may be differing reporting requirements. An outsourced trading desk has the scope to bolt on services. "You need to think of them as a partner in your fund, as an actual part of your trading desk, and then you can get the best out of them. Don't think of them as just some broker you flip an order to and forget about," says Broadbent.

Finzi highlighted the value of being able to interact in markets anonymously. In addition to benefits in terms of best execution, new sources of liquidity or help meeting regulatory requirements, an outsourced trading desk can essentially act as a fund's beard.

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Meanwhile, Elliott drew attention to the idea that outsourcing helped funds focus on what really matters: idea generation. For those funds that believe the portfolio manager should be focused on generating ideas, not executing trades or haggling over prices, it thus becomes a lot easier to show why outsourced trading makes sense.

Making the journey

Once a fund has weighed the pros and cons of an outsourced trading desk as a concept, there is the question of how to choose a solution, and eventually the issue of implementation. Experts say the review process needs to focus on ensuring the provider's and client's business models are well aligned.

"I'd want to be certain that the person is acting in my best interest at all times and is aligned with me, because they are an extension," says Finzi.

For instance, some providers may see their role purely as a service on demand. For the RTO model of outsourcing (reception and transmission of orders), there may be less of a dialogue between the provider and the client. At the other end of the spectrum, the trading desk provider will work to essentially feel like a part of the client fund.

"There's a lot of effort that goes into researching and evaluating a company, and then deciding to buy Coke and sell Pepsi," adds Finzi. "A poor hand-off to the person who implements that idea can quickly destroy whatever value you are going to get. So there has to be this really good understanding of intention."

Ergo, which specialises in helping funds identify outsourcing solutions, says a critical component of the process is due diligence. "Due diligence for us is to follow the process of order creation, order execution, post-trade reporting, and how you settle and go through your custodian process, then figure out what is easy, and what people have challenges with in each part. Our aim is to fix some of the difficult stuff along the way," says **David Berney of Ergo Consultancy**.

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The provider-client relationship can vary significantly depending on a fund's objectives and personnel. Bear of Anderson Bern Capital Management said he had worked for one buy-side firm that had seven different investment strategies covering about 170 funds. "You had some guys who were looking to hold stocks for a minimum two years. You've got other guys with holding periods of a much shorter timeframe, where execution weighs significantly on their investment performance. One of the biggest challenges for a service provider is aligning yourself," he says. "Even working with different asset managers within the same group, it varies dramatically."

Bear said his due diligence would involve scrutinising a provider's policies regarding execution, and in particular how it deals with aggregation and allocation. "If I were a start-up fund of, say, $100 million under management, I'd be a little bit concerned if I knew that one of the additional outsourced trading clients was a fund of $10 billion under management. If the aggregation allocation policy was clear that orders would be potentially worked together, I'd have concerns about that."

Those concerns would be about both the impact on the market and also the allocations the fund in question would be getting.

Once a fund is ready to move forward, the actual technical work is relatively straight-forward. Elliott of Cowen says some people believe that setting up an outsourcing arrangement is more complex than it actually is. They think of it like establishing a prime brokerage relationship, which can take months. But Elliott says that is because a brokerage relationship involves a raft of issues from legal agreements to pricing negotiations. By contrast, the journey from handshake to implementation for an outsourcing agreement may be as short as a few weeks depending on the solution sought.

Another difference: outsourcing is not an all-or-nothing proposition. "You don't have to jump into all the different services that we offer. You can start off with just an execution relationship," Elliott says. "You can start quite small."

10 Reasons Why Funds are Exploring Outsourced Trading Solutions

The arguments in favour of outsourcing the trading desk are numerous, although funds need to perform due diligence to make sure they work with the right provider. Here are 10 of the top reasons for exploring outsourcing.

1. **Geographical reach** – The ability to trade in new far-flung markets without a significant investment in staff or infrastructure.
2. **Asset class coverage** – The ability to handle additional asset classes where there might be less or no in-house expertise.
3. **Best execution** – Performance monitoring through TCA reports.
4. **Focus on strategy** – Freeing up portfolio managers to focus on idea generation rather than execution.
5. **Sourcing liquidity** – Being able to take advantage of the strength of an outsourced trading desk provider's relationships to tap into new sources of liquidity.
6. **Anonymity** – Reducing market impact from trades by maintaining anonymity.
7. **Operational flexibility** – Some providers may allow clients to start small and increase their usage over time; providers also can help funds with back-up and BCPs.
8. **Aligned interests** – Depending on what third party is chosen, a client can ensure the provider's interests are aligned with those of the fund.
9. **Regulatory requirements** – Being able to rely on an established international provider with experience dealing with different regulatory regimes.
10. **Bolt-on services** – The opportunity to integrate other services, such as risk reporting, as part of an outsourced solution.

What's next?

Trading desk providers are now starting to expand the universe of what kind of trades can be handled by a third party. Cowen, for instance, is pioneering outsourced fixed income trading and has recently been building a large FX service.

The logical trajectory, according to Finzi, has been for the adoption of outsourced trading to move in tandem with market efficiency. As market quality and market structure reforms occur in different asset classes, they become more suitable for outsourced trading solutions. Equity markets, where there has been intense competition and extensive innovation, have thus been fertile ground for outsourcing already. The same goes for listed options and futures.

"But then you step into swaps and swaptions and the whole IRS complex. And you have the proliferation of SEFs to serve as a clearing function, or even just the electronification of voice transactions, with essentially the concept of a tape," Finzi says. "Those are all things that just lead to market quality improvements that ultimately will increase liquidity." He said all of that sets the scene for outsourced credit trading to gain in popularity.

Bear meanwhile says he believes the industry should form a working group to tackle questions around best practice for firms that are going down the outsourced trading route. "I'll align it to what's going on in the digital asset space. It's at a crossroads, where we've stopped debating whether it's a good or bad thing. We have to accept that it's a good thing for some people," he says.

Elliott of Cowen says that appeal holds true for an extremely wide range of market participants.

“At its core, the execution function is the same,” he says. “Portfolio managers generate ideas, and traders execute those ideas. But the people we speak to could range from a small hedge fund start-up to a large asset manager. It could be a family office. It could be individuals. There are a lot of people in the asset management business, and they all start from different points.”

And regardless of where they start from, the growing expectation is that more and more of them will end up in a similar place: looking at outsourcing their trading desk as a way to strengthen their business. The reasons are too numerous, and too compelling, for asset managers to ignore.

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