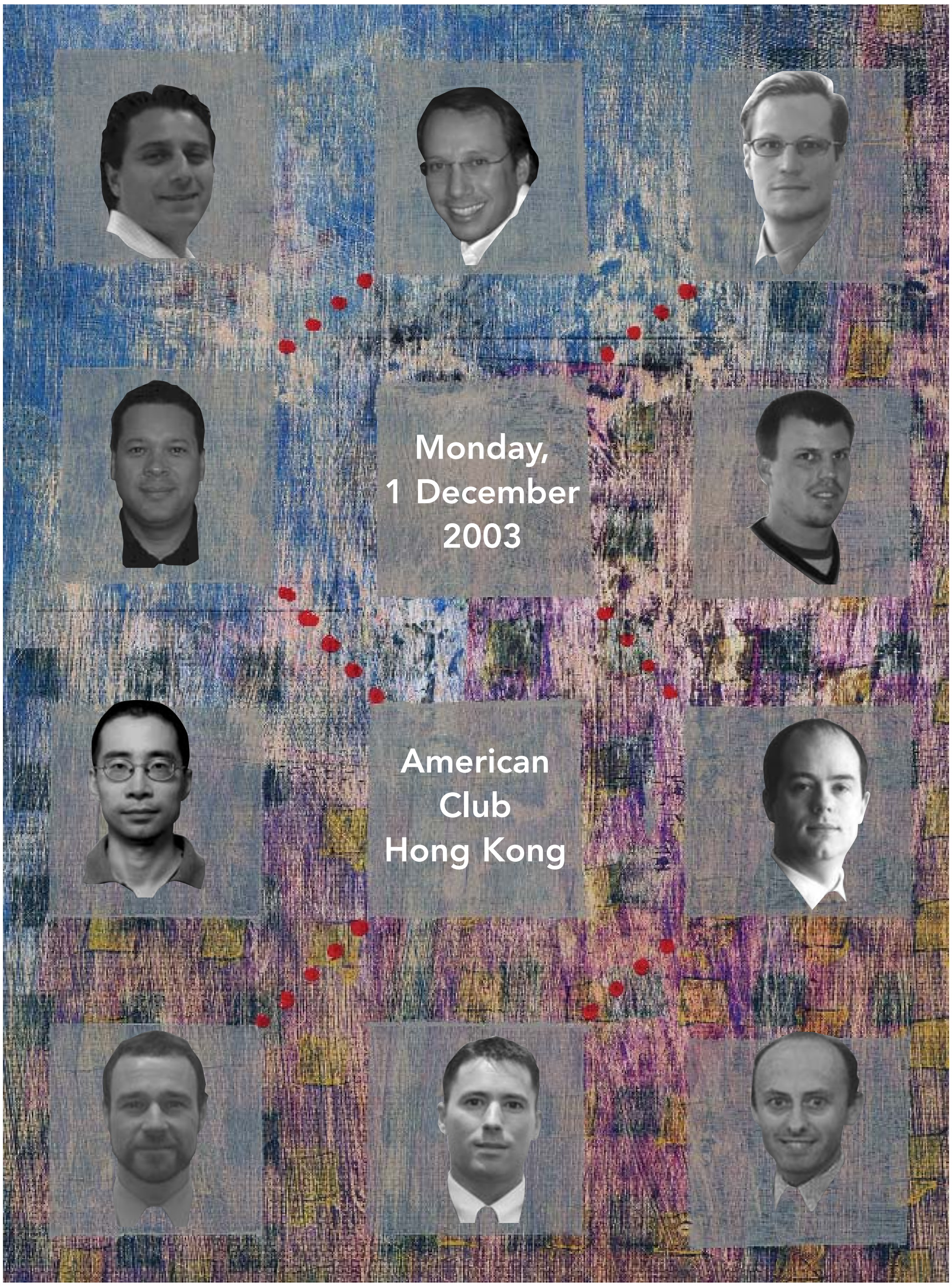
FIXAsian buy-side roundtable

Where have we been, where are we going?



PARTICIPANTS:

Peter Stutsman
Capital Group

Mark Northwood
Fidelity Invesment
Management

Dean Chisholm
Invesco

Michael Brady
JF Asset Management

George Molina
Templeton Asset
Management

Chris Biscoe
Credit Suisse First Boston

Brook Teeter
E*TRADE FINANCIAL

Mark Howarth
Instinet

Hector Ortiz
Reuters

Zheng Yin
Reuters

As we did almost two years ago, we invited the dealing directors from several of Asia's largest buy-side institutions to give us an updated view on the status of electronic trading in Asia. As you will see from the comments below, the discussion raised some clear differences across what could be described as analogous or similar organisations.

Implementation around the table

Chris B – To get things rolling, tell us what electronic trading means for your businesses now, and how does it differ from what it meant a year or two ago?

Mike B – I think a pretty common response to this question for people who go from a state of lacking connectivity to having or embracing connectivity is that it is hard to imagine life before, or living without connectivity in the future. The evidence for this, anecdotally, is when FIX does go down – whether it's at the broker's end or at our end – all of a sudden life, as we know it, ceases to exist and it's like going back in time.

Dean C – We're trying to get going. In aiming to be at the leading edge and implement FIX allocations at the same time as blocks, we're finding it a lot of hard work to reach where we want to be. You've got to have a vendor with support in the region and we're not fully there yet. Also, it's a real challenge to ensure that all the brokers have the range of messages and test environments with the infrastructure to do some heavyweight testing up front. We're trying to do ten brokers in Hong Kong and ten in Japan at the same stage. It's not easy.

Mike B – This is one of the issues that FPL is trying to address. More needs to be done in terms of certification and implementation. Why is it just as hard for Invesco today as it was for us at JFAM a year ago and Fidelity much earlier than that? Why is it still such a painful process and why isn't it getting any simpler?

Chris B – My belief is that it has gotten a lot easier and we see that alternatives have emerged to facilitate that, particularly in the hedge fund community. Smaller organisations, which don't have to have these all-encompassing solutions for their electronic trading, can be up and running in a week, whereas, two years ago, it would have taken them six months.

Mark H – Yes, I agree that it has got a lot easier. The front-end, the trading side, is relatively straightforward in terms of testing and implementation. It is post-trade that really takes the time and effort to achieve true STP. But all the focus of vendors and much of the industry is on order entry and front-end implementation, while everything else seems to be a second priority.

Brook T – Have you seen more demand for FIX from hedge funds?

Mark H – I don't think hedge funds start with FIX; I think they start with the objective that 'we want to go electronic, can you tell us the best approach to achieve it?'

Chris B – What difference has FIX made to your trading desks? Does it change the way you do your business? Do you look at the markets differently?

George M – At Templeton, a few years ago, we probably did about 10-15% of our order flow through FIX, now it's close to 95%. We've taken the extra step now of being able to send global programs out from our side with execution straight back to our FIX system. In places like Korea, sending out an excel spreadsheet used to take 40 minutes and now takes five minutes.

Mike B – Most importantly, the buy-side dealer and the broker do not need to spend the majority of their time and focus on the numbers, as that is now automated. Their top priority is improving the quality of the execution.

Peter S – A few months ago, our volume exploded and I can't imagine being able to manage the workflow effectively without the intra-day FIX execution monitor and being able to see all the orders on the book. We would have spent all day answering the phones trying to get order updates with a 20% failure rate. Now, we can be proactive and achieve what we need to without requiring 15 different phone calls.

Electronic trading shaping the role of a broker

Chris B – So are we looking at a shrinking industry then?

Peter S – Not necessarily. We're still relying on people to add value by managing the execution. While there's someone doing that work, it gives me the opportunity to concentrate on different things.

Mark H – Are you doing more direct market access trading?

Peter S – We've just started trading via direct market access. If we were going to use it for more than 5% of our business, we'd have to staff differently. There's a finite amount of tickets that I deal, because most of those tickets are not market orders; you're talking about something that is going to be worked over the course of the day. Maybe it makes sense if I slash commission rates in half, I can probably hire ten more people, but it would literarily take staffing something like that to use that much more DMA.

Mark H – Although a fundamental change, why wouldn't buy-side firms slash rates in half, take on five extra people and take more control?

Mark N – It may be that there will be more pressure from the regulators to do that.

Mike B – Clearly, any business that becomes more efficient needs fewer people. That is partially offset because if the business is more efficient, more business gets done. But what it also means is better quality people. In Korea and Taiwan, all you previously needed was someone that could copy down IDs and figure out the cash calculations correctly, whereas now you can communicate that information electronically. Now you need someone that can add value to that execution. This trend is still in process and will continue to grow.

Chris B – So what are the key focal points for brokers to add value in 21st century trading?

Mark N – VWAP engines answer that question. Just working the orders through the day is something that a computer can learn to do better than any trader can. Value-add comes from the ability to assimilate and weigh up information in the way that only humans can. For example, a key to trading in Korea is judging developments in Japan and Taiwan and being able to communicate while thinking outside of that pre-programmed box.

Peter S – The role of the broker is also going to continue to provide liquidity. We are still going to rely on someone's discretion to be able to tactfully make the calls and create a way to put up one, two or possibly ten days' volume.

George M – The traders are being asked to become part of the investment process. Instead of just dealing, they need to put your orders out, take care of them through the day, monitor the orders and also be part of the investment process by generating trade concepts, arbitrage ideas and liquidity analysis.

Volumes, liquidity and FIX

Dean C – I saw a recent statistic highlighting that the actual volume of trades is now higher than it was before the tech boom, showing that there are huge volumes out there. There's a continual problem of working the orders when the average size is going down substantially.

Mark H – For the US market, on an average trading day, Instinet will write over a million tickets. While volumes are going up, ticket numbers are exploding. Very different trends.

Mark N – It is interesting that the US and UK are moving away from the block trade mentality, with one of the causes being the rise of benchmarking. You are impacting the behaviour of traders by requiring benchmarking against VWAP.

Mike B – I think that the pendulum is going to swing back. There'll be a lot of automated trading done using algorithmic engines for small or low impact stocks. Less-liquid stocks or very large orders will necessitate finding blocks.

The brokers' products and services

Chris B – Do you think the product suite is going to change? If you just trade vanilla equities now are you going to start looking at trading alternative products such as warrants and options?

Mike B – Asian brokers will have to provide suites of products that complement their clients' investment objectives. The broker will need to offer choices, which could mean trading equities, futures, warrants or OTC options and then provide the client's choice electronically, whether it's tapping liquidity or best price.

Chris B – In the future, is the use of algorithmic trading, whether developed by the buy or sell-side, going to play an important role in your trading?

George M – It's about strategy. We expect to hit VWAP at least 70% of the time. With algorithmic trading, we're looking for a range of options and them being customisable by the client. Volatile stocks benefit from DMA and it is much quicker for us to do it ourselves. We need control of some algorithms and DMA to achieve speed with these volatile stocks.

Mark N – If I wanted to use an engine offered to me by a broker, I want him to drive it, not me. The responsibility for execution is still on the sell-side.

Mike B – Although if I develop and own a better algorithm then I have a competitive advantage and want to keep that as proprietary.

Peter S – I don't see that big an advantage, as you can figure out what someone else has used if you have a broker activity sheet. For the large part of our business, I don't see that we'll move towards use of algorithms. We would concentrate on big blocks rather than packaging it up even more than we do currently.

Chris B – Does that mean that in the future you'll rely less on broker technology and own most of it yourself?

George M – No, because we still need to pay for research, but how much we'll pay for research I don't know, particularly in the context of us wanting to do more trading ourselves and keep the larger orders for ourselves.

Mike B – Although I think that is still some time away, the whole area is changing very rapidly. The investment in this arena is going to come down quite quickly, because it's not too far away that the buy-side will get access brokers' current algorithms. That's a pretty good start point for us.

Dean C – We already do some algorithmic trades in the US, but here in Asia our focus is VWAP. That remains the basic commodity that any broker should provide. Then there's liquidity that comes into play when you start looking at anything fancier, as these markets are often horribly illiquid. Even in a market such as Australia, you are left with off-market secondary placements at the end of the day, just to move significant blocks. Both sides are often left with blocks they want to get rid of. Algorithms aren't going to get rid of this problem.

Matching and following

Chris B – So why haven't we seen the anonymous matching engines take off as much as we would have expected?

Mark H – Liquidnet seems to me to be a great design and I'm surprised that it isn't stronger in the markets.

Mike B – One issue is that there aren't enough participants around in this part of the world.

Peter S – Also, the participants all tend to be the same, with similar styles and views. By comparison, the large Japanese brokers can provide access to the corporate client base, which often takes an opposite view to us. There's no one playing that role here.

Dean C – It's a bit like playing poker with your friends – you don't want to reveal your hand up front.

Peter S – The other difficulty for these anonymous matching services is to juggle the marketing of anonymity while at the same time, marketing their service 'opportunity' in order to bring people to the table.

Mike B – Fair comment. In its infancy when there's no critical mass, there's a slight mistrust of the operators of the technology, not of the technology itself.

George M – I also think the education of the local trading market place is important. For example, our local desk in Korea focuses on getting the orders out, targeting VWAP and then onto something else. Our traders here are analysts. Unless you can get local dealers to participate, you're not going to have too much success.

Brook T – Is that an opportunity for local players in Korea? Right now there are maybe five or six securities firms that have embraced technology for crossing or bringing in electronic business.

Peter S – I think it depends. One problem that some of the local firms will have is the issue of counter-party risk.

Mike B – Also there's a problem in Korea with retail players simply watching which big foreign buyers are in what stocks. Very often, if you use a foreign broker in a small or mid cap stock, once you're identified as the largest buyer, the stock goes vertical, because people follow right after you. There's a major advantage to using local brokers because you can hide for a day until they reveal the foreign net buying.

Smaller players getting involved in electronic trading

Chris B – Hector, from Reuters' perspective, has it been easier to get smaller participants to embrace electronic trading from what it was a few years ago?

Hector O - We have recently launched products aimed specifically at the mid/smaller participants in Asia and we find it is really a process of education.

Zheng Y – A lot of it is driven by the big buy-side firms in Asia. If you want to send orders electronically to the smaller sell-side players, they will certainly embrace it. But this is weighed against the investment needed. From a Reuters perspective, we collaborate with the smaller FIX vendors to offer simpler FIX session terminals for the client. While it is driven by the big buy-side firms, in Taiwan brokers are getting ready to receive orders electronically from Hong Kong and Singapore because they know that QFII is imminent. They will still rely on the phone, but are also waiting to be told by clients that they need to be capable of taking electronic FIX orders.

Chris B – What about the smaller buy-side firms? How do they fit into this?

Zheng Y – Again, in Taiwan they will aggregate all the retail orders and send electronically to US, Hong Kong, Singapore or Japan for trading, but the size is much smaller. The bigger funds that trade the US want to do it electronically but again it comes down to a cost issue, but it is coming.

Brook T – In the context of the myriad of networks, Order Management Systems and FIX engines, how do you get them involved in electronic trading generally?

Zheng Y – The sell-side need to place orders, so come to us and ask us to provide a cheaper FIX vendor with all the functionality and that is ready to go. FIX in a box basically. They aren't going to integrate directly to the market just yet, so they don't need everything now. Of course they would like to have a Reuters terminal but we say no, as they need to be set up with FIX. What we do is work with different vendors across Asia and educate them to go out to the brokers with a ready solution.

Dean C – For the smaller brokers we can look at Australia as a case study. Iress first entered the market as an information terminal and basic order flow system and penetrated the market hugely. Now it is difficult to get the smaller brokers off Iriss and onto an international system, so they need intermediate web-based technology that is easy to install and use.

Mark H – Also, who from the international buy-side is going to send significant flow to a local broker? You've got counter party risk issues when you do so…

Mike B – There's basically two choices to achieve wider adoption of electronic trading. The first is client pressure on one firm at a time. For example, having told some Indian brokers with very small operations that they need to send confirmations electronically, they took it on, even though we're not quite there yet,. The other choice is for it to be mandated by the Regulator and then adoption will happen very quickly.

Commoditising Trading

Chris B - Has trading become more of a commodity? Will we find that at some point in the future that 70% of our order flow is done by systems and the remaining 30% dealt by people who are market specialists?

Peter S – While we should reward brokers for service on the trading side, if you build an engine and you're simply plugging in trades, it would be hard to justify paying large commissions. for that service. Alternatively, if a broker delivers a block trade at a 2% discount to market, I'd pay fifty basis points. If we aren't prepared to pay for the good service that a broker provides, someone else will, such as a Hedge Fund, who may offer a broker fifty basis points for the first look at their best ideas. I think it's going to be tougher for the program and VWAP engine sides to continue to be compensated.

Dean C – You can guarantee that margins are only going to go down as they have been for the last five years.

Mark H – It comes down to what is a good rate for services. While a certain amount is paid out in market fees, the core issue is what clients will pay for having a broker.

Five year forecast

Chris B – To wrap up, let's ask you all to predict what the next five years will bring us in terms of electronic trading.

Mark H – Post trade is what we're all going to have to work on in the next five years, as that's where everything breaks down in STP.

Mike B – As a long shot, I predict the equity market and trading will look more like the bond market with more OTC trades, in the context of brokers making record profits in the bond market and providing services and liquidity with no commission at all.

Dean C – We'll see maturity in technology. Allocations are an issue and will become a much more mature process. We'll continue to struggle with lack of liquidity in certain markets, particularly in Asia with the small and mid caps, as foreign firms tend to take a big position in these. However the major changes will come from regulation. We haven't yet seen the full cycle of changes that will result from the current drive in the US. It is going to force the industry to operate differently in the future, for example everyone has been saying for years that softing is going to go.

Mark N – As we now know it, it's gone! Looking into the future, I think the trend of the empowering of the buy-side desk will continue. The regulators will dictate that we have a duty to our shareholders to fund best execution, which includes the issue of commission. I think there will be movements of personnel from sell-side to buy-side in the execution space, with buy-side increasingly becoming a competitor to the sell-side. Although that is probably a long way off it seems to be the way we are heading.

Peter S – Technology will allow us to handle a larger volume of business more efficiently, but the crux of what we do and the fundamental process will survive. I can't imagine the buy-side replacing a broker helping us to find liquidity. I look for my broker to help us tap liquidity that is not necessarily being tapped by everyone else at the same time.

Chris B – Is it different in Asia than the rest of the world because of how difficult it is to deal out here compared to other markets?

Peter S – In Asia specifically, the question is rarely 'why are you offering this price?' it is 'why aren't we getting this done quicker?' I think that we'll still be going to domestic brokers who have access to domestic business, for example in markets like Japan. While we might make opportunities ourselves, there's a huge web through all the different brokers in all the different markets. As Capital, it's unrealistic for us to build and maintain all those relationships.

George M – Although block trading will always be around, we don't want to miss any pool of liquidity, so in the future we'll see a lot of electronic tools helping us to achieve our goals. We're going to need to send out the easy orders / VWAP orders electronically to enable us to get on with dealing block orders through DMA, algorithms or by tapping brokers to go and find the other side of the trade. Brokers will need to continue to reinvent themselves to ensure they offer products to the buy-side using electronic trading, block trading, corporate connections and so on. I think that we'll see a lot more value add as a result of electronic tools in the next five years.

Brook T – Are the brokers in Asia, as we know them, all going to be around in five years time?

Peter S – Seriously, I think that in the same way that we see boutique research houses, there'll be execution boutique houses out here. They will need to offer more value purely on the execution side.

Dean C – That will become clearer as the Regulators impose their views. They will move the brokerage away from research and that will change the landscape very quickly.

George M – We're already seeing many brokers offering pricing schedules, with DMA, arbitrage trades, block trades and sourcing of liquidity priced separately. I think that from a buy-side perspective, it makes sense.

Chris B – Also, making commissions more transparent is ultimately good for investors. From a Reuters perspective, what is the overriding impression you get listening to the comments around the table,?

Hector O – I have found it interesting and heartening that from both the buy and sell-side perspectives that while industry changes and advances are inevitable and should be encouraged, it is also likely that some more-traditional aspects to trading will still be around in the future.

Chris B – Thanks everyone for your participation. FIX

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