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## The Natural and The Machine

Why JonesTrading Is Promoting the  
Human Crossing Network

CEO Packy Jones

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**Buyside Snapshot: Mellon's Paula Peter**

**Figuring Out  
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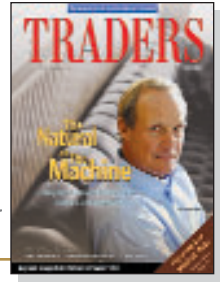
Photos: Mark Robert Halper

Muscle at JonesTrading: Packy Jones, chairman and Mike Hornbuckle, president

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by PETER CHAPMAN

## Cover Story



*Fighting  
back the  
electronic  
trading  
trend.*

# *The Natural* and **The Machine**

**I**t calls itself the human crossing network. JonesTrading Institutional Services, a firm once regarded on the Street as a low-profile third market broker, is counting on its human traders to expand its stock trade volume. And to that end, it is aggressively promoting its extraordinarily high crossing ratio.

Under significant pricing pressure, it is ending a nearly 30-year policy of working quietly in the shadows. The firm, until recently known as Jones & Associates, is boldly attempting to draw more attention to its specialized services. JonesTrading's new business strategy, say observers, may be a reaction to the changed economic pressures in the institutional equity trading markets. Money managers, also under cost pressures, are taking a hard look at alternative

execution methods.

“You have the traditional firms on one side and the computers on the other,” Packy Jones, son of the founder and the firm’s chairman and chief executive told *TRADERS MAGAZINE*. “We try to be right in the middle.” These computers are a reference to the growth in electronic-oriented trading services that typically charge bare-bones commission rates.

### Crossing Power

At the heart of Jones is crossing. Working out of head offices in an upscale suburban community of Los Angeles — as well as from several satellite locations — the agency broker claims it executes 45 percent of its volume as matches between money managers. Of the firm’s 124 employees, 62 are sales traders, who cover a network of 700 to 900 money managers.

The comparisons with its competition are striking: They typically may have hundreds more customers. Nonetheless, the percent of the order flow these bulge-bracket rivals typically cross is in the single digits.



Packy Jones

the \$9.50 level. A major institution needed to sell ten million shares. So it called Jones.

“We ended up crossing a little over 10

tap its network. The result? Considering the size of the order, Jones’ efforts produced minimal market impact. SVM traded within a 25-cent band during the three days Jones worked the order.

SVM, which has a market capitalization of \$3.5 billion, is at the high-end for Jones. The firm sees about two-thirds of its flow in small- and mid-cap names. Although it has a reputation in large deal stocks due to its relationships with arbitrageurs, Jones is better known for moving large blocks of less-liquid names.

“The majority of stocks are small- and mid-cap,” says Mike Hornbuckle, president of Jones Trading. “But that’s just because it is easier for the buy-side to pay off the rest of the Street with bigger-cap orders.”

‘AS RATES GOT MORE COMPETITIVE,  
WE’VE HAD TO DO MORE VOLUME.’

PACKY JONES

But to grasp Jones’ impact on the market, consider the ServiceMaster Company (SVM). The home maintenance company is listed on the New York Stock Exchange. The stock, not a stellar performer in recent years, trades about 600,000 shares per day. Last July, the stock was trending down towards

million shares,” Packy Jones says. “The trade was so large we had to print it in two parts on the consolidated tape.”

Rather than ask its traditional full-service firm to trade the name and risk a serious case of market impact, the institution (Jones would not disclose the name) asked Jones to

In the crossing game, JonesTrading largely competes with three others: Jefferies Group, Cantor Fitzgerald and Investment Technology Group (ITG). All three are larger than Jones. ITG crosses within its electronic POSIT system.

### Peer Group

Jones' prowess with outsized orders is documented in a recent report by the Plexus Group, a broker-ranking outfit. Where an order for a listed stock exceeded 20 percent of its average daily trading volume, Jones ranked fifth in a peer group of about 30 firms. Among the top four were two ECNs, which don't trade much listed stock. And where the trade is for more than 50,000 shares, Jones ranked first, according to Plexus. In this case, JonesTrading bested the ECNs.

The numbers are better when it comes to Nasdaq names. Where the order represents a high percentage of daily volume, Jones ranked second. Where the order exceeds 50,000 shares, Jones ranked third.

Despite the high marks, the past three years haven't been easy for Jones. Volume flattened out and commission rates dropped. The average commission at JonesTrading is now 3.8 cents, according to Plexus.

"We've had three flat years as far as our growth is concerned," Packy Jones says. "As rates got more competitive, we've had to do more volume to stay flat. But in the first quarter our gross is up 37 percent." As a private company, JonesTrading does not publicly-disclose its financials.

A firm such as JonesTrading is better able to weather a market downturn than many of its competitors. That's because traders are paid only out of commissions, allowing the

firm to keep overhead low. The firm has been making selective hires in the past year, according to Jones, taking advantage of the layoffs from larger shops.

Based on trades reported to AutEx/Block-DATA, the picture is brighter on the Nasdaq side. Listed volume has been stuck in a rut

AutEx figures don't always paint a complete picture, observers note. Jones' execs say the breakdown of listed/Nasdaq shares is closer to 60/40. They attribute the rise in Nasdaq share volume to decimalization, which has forced Nasdaq dealers to price on an agency basis. A Nasdaq market maker

'THE MAIN OBJECTIVE IS TO FIND THE OTHER SIDE.'

MIKE HORNBUCKLE

of about eight million shares per day for the last three years. Nasdaq volume, however,



Mike Hornbuckle

has grown substantially, surpassing four million shares per day last year. That's a doubling from the year 2000.

and an agency shop such as JonesTrading now have more in common.

JonesTrading execs seem unfazed by this significant shift in the business mix. To JonesTrading a stock is a stock, whether it is a Nasdaq or listed name.

### The 'Natural'

That gets back to crossing. The first step in the trading process is to work the network in search of a 'natural,' or institutional buyer or seller. A sales trader may also tap into a network of independent floor brokers at the New York Stock Exchange if the stock is listed there. Any overage is sent to an internal trading desk, which then works the order over DOT or in the Nasdaq market.

But to the JonesTrading sales trader, a stock is just a stock. "There is no difference between a listed and an OTC stock when executing on an agency basis," says Hornbuckle. "What's the difference? Someone has a seven-figure piece of stock for sale. It doesn't matter. The main objective of our business is to find the other side of the trade without using any of the marketplaces."

JonesTrading's decision to merge its Nasdaq and listed utility desks is a manifestation of that philosophy. Now there is just one agency desk. The traders working the overage don't specialize in either Nasdaq or listed markets. Each trader is responsible for both.

"It's a reflection of the way the business is going," says Packy Jones. "We don't care if it is listed or OTC."

### Agency Model

Nasdaq's move to an agency model isn't the only seismic change likely to benefit JonesTrading, say observers. As buy-side desks mull ways to reduce their transaction costs and rosters of brokers, they are considering the unbundling of commissions as they scrutinize their payments. Money managers are pressuring brokers either to price their research separately from their executions or, at the least, break out the cost of the research.

This movement could establish a freer market in executions. That's something Wall Street has never exactly experienced. Pure trading houses, such as JonesTrading, could profit as buy-side desks would no longer be tied to their research brokers for executions.

"They are actually cutting checks for research," says JonesTrading sales trader Steve Tullar. "Several customers are finding value in the agility to go wherever they want to get the best price. They don't have to go somewhere just to pay a bill." JonesTrading execs acknowledge, though, that this unbundling movement is still in its infant stages.

The firm has history on its side and knows market structure. In 1975, the year fixed commissions were finally abolished, Packy's father, the late George Jones, Jr.,

JonesTrading (Shares in '000s)				
Listed	Shares	Secs.	Cross %	Rank
2003	1,914,584	1,679	32.00	30
2002	1,779,944	1,562	33.76	30
2001	1,930,854	1,542	39.44	28
2000	1,409,482	1,729	41.83	34
1999	1,208,330	1,797	44.36	30
1998	1,065,318	1,971	41.34	28
1997	671,333	1,821	42.24	33
1996	521,245	1,526	49.99	32
Nasdaq	Shares	Secs.	Cross %	Rank
2003	1,109,853	1,377	40.00	44
2002	834,757	1,138	47.00	50
2001	499,329	1,000	37.71	57
2000	448,603	1,094	32.37	63
1999	360,498	1,064	32.43	63
1998	272,714	1,002	38.45	65
1997	280,177	1,020	41.35	64
1996	269,843	1,367	34.56	62

Source: AutEx/BlockDATA

founded the firm as Jones & Associates.

JonesTrading certainly has an all-in-the-family feeling. Jones' brother, Blake, has worked for the firm since 1991. Jones' uncle has been in the trading business for many years. And Hornbuckle's father, Ray Hornbuckle, also worked with Jones' father.

When Packy Jones agreed to run JonesTrading, he wanted to maintain the family feeling of the firm. He only agreed to come on board and run it if Hornbuckle —

known as 'Buck' — was brought in to co-direct Jones as president.

Both Jones and Hornbuckle are very intense men. They both play competitive sports. "One time I was coming into town to meet with them," recalls an associate. "From the two nights I offered, Packy said only one was possible because Thursday is always volleyball."

Both trading professionals feel at home in JonesTrading. 

In hockey, when the going gets rough and the skill players are being knocked senseless, the coach usually sends out the biggest, meanest guy on the bench. He has only one job: act as an enforcer. Do the dirty work that no one else on his team can or will do.

That's the kind of specialist image that JonesTrading wants to cultivate in the trading world.

It is an odd kind of agency firm. It is known for block trading in thinly-traded issues. It doesn't have a block desk. It certainly likes the tough guy image. Indeed, in an internal publication, it actually brags about the difficult trades that it can execute by roughly elbowing aside market problems that would stop others or lead to pricey executions.

"Our image is: hire an assassin. We do tough things," JonesTrading writes. Since the firm's founding in 1975, it has been dedicated to the creation of liquidity for institutional and corporate accounts through trading big stock orders.

JonesTrading, which is based in Westlake Village, California, has some 700 institutional clients in the United States and Europe. Clients include mutual funds, corporate treasuries, investment advisers, pension and risk arbitrage funds, among others.

Jones likes to depict itself as a kind of paladin of the trading world — almost anyone with an execution problem can hire it and benefit. It is a pure trading play. It has no investment banking or other interests such as a floor brokerage. It has no block desk that "we're shooting against," Jones crows. Those kinds of lines could sully the quality of its trading

operations, which the firm emphasizes crosses in the middle and can be flexible.

# Trading Tough Guys for Hire

"We can morph into anything the client wants," Jones says in the internal publication. "OTC, find the other side, access the floor — we're an extension of the desk. Everyone has a different way of using the Jones model." The firm compares itself to the Jefferies of the 1980s.

"Our big message," says Jones, "is we cross a majority of stock on Autex. We go from manager to manager without price fluctuation. We started with an old family business concept and no one has screwed it up."

Generally, this "we're not one of the Big Boys so we won't be tripped up by our own potential conflicts of interests" concept puts Jones in the third market, says an executive who is a Jones marketing consultant. She was pressed to compare JonesTrading with other firms.

"Cantor is somewhat like them," she says. Nevertheless, this executive, who didn't want to be quoted by name, also says she doesn't believe that Jones has a direct competitor.

"Direct access firms sell execution but just on listed securities while Jones provides execution

service for tight securities, the not easily tradable stuff, on all types of securities, on all types of exchanges. That's what makes them different," she says.

But the firm argues that the trademarks of its business are block trades and the quality of the execution. It claims that — even in difficult companies, with big numbers of shares — it will complete a trade and generate little market impact.



'We dig out the real buyers and sellers in ways you can't with machines.'

Jones' low-cost argument is based on the Elkins/McSherry market analysis data. It evaluated Jones for the quarter ending December 8, 2003. The evaluation was based on a total of 3.4 billion equity shares traded. This comprised 2.2 billion listed shares and 1.2 billion Nasdaq shares.

Generally, in executing difficult transactions, it was able to keep up with the Volume Weighted Average Price, or VWAP. It was one cent behind the VWAP on listed business, according to Elkins/McSherry.

On Nasdaq business, it was a cent better than the VWAP. Elkins/McSherry said these numbers put JonesTrading ahead of most other institutions. On Nasdaq trading, Jones was better than the average in the large-cap, mid-cap,



transparency. Our crossing rate is 45 percent, among the highest in the business.”

In 1975, George Jones, Jr. founded it as Jones & Associates. Previously, he had been working as an institutional equity broker for Mitchum, Jones & Templeton (MJT). It was a Los Angeles-based broker

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AN INTERNAL JONESTRADING PUBLICATION

according to Elkins/McSherry.

A more efficient execution model leads to a lower market impact and cheaper costs, Jones contends. Jones says this is because it is an agency firm with a difference — it has a strong upstairs crossing network. That leads to some other rather bold claims.

“We are the easiest way to move a difficult position,” the firm contends in the internal publication. “We dig out the real buyers and sellers in ways you can’t with machines.

We find natural buyers and sellers with a higher cross ratio than ECNs with the same level of

dealer founded by Jones’ father, George Jones, Sr., in the 1930s.

This family-run business, MJT, grew to become a powerhouse firm in the 1970s, with some 1,400 employees. Upon the death of his father in 1975, George Jones, Jr. founded his own firm, which three years ago established a subsidiary, Jones International, to conduct trading operations in Europe. Mike Hornbuckle is president of Jones Trading. He joined Jones in 1989. Before that, he had been in the industry for six years.

Jones officials like to describe their business as a mix of the big firms and the ECNs. “A crossing network that does size,” says one Jones official. Yet Jones is a self-described “enigma.” It is a trading powerhouse that generally has kept a low profile. It is a family business in a universe of big corporate entities. **TM**



A Family Affair: Packy Jones (left) and his father, George Jones, Jr., at an industry function in 1983 with Tony Landy (center) of Morgan Stanley

small-cap and micro-cap categories. In the giant-cap, it lagged by three cents,

ers and sellers with a higher cross ratio than ECNs with the same level of

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