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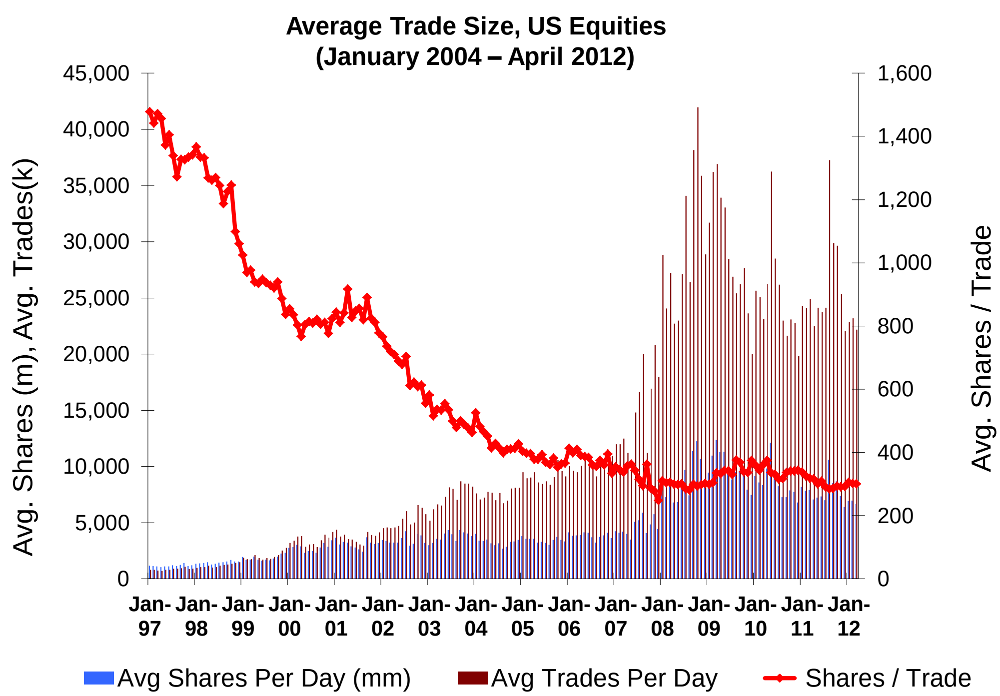
Darwin, Evolution and the Buy-Side Trader

By Laurie Berke, Principal

Evolution is a powerful phenomenon. Charles Darwin proposed that as species develop, their best physical and mental traits, such as strength, cleverness and camouflage, are passed on over time to the benefit of the ultimate survivors. These characteristics are the very ones that allow individuals to adapt effectively to a multitude of changes in the environment around them.

Evolution is taking place on the buy-side equity trading desk today. Today's breed of capital markets participant has been through the financial markets equivalent of an asteroid slamming into Earth – and has lived to tell about it. From the advent of DMA and algorithmic trading to the credit crisis and the fall of once-mighty Wall Street firms to Reg NMS and the rise of the regulators, buy-side traders responsible for the personal wealth and retirement assets of the American investor have had to grab a hold of change and hang on tight for the ride.

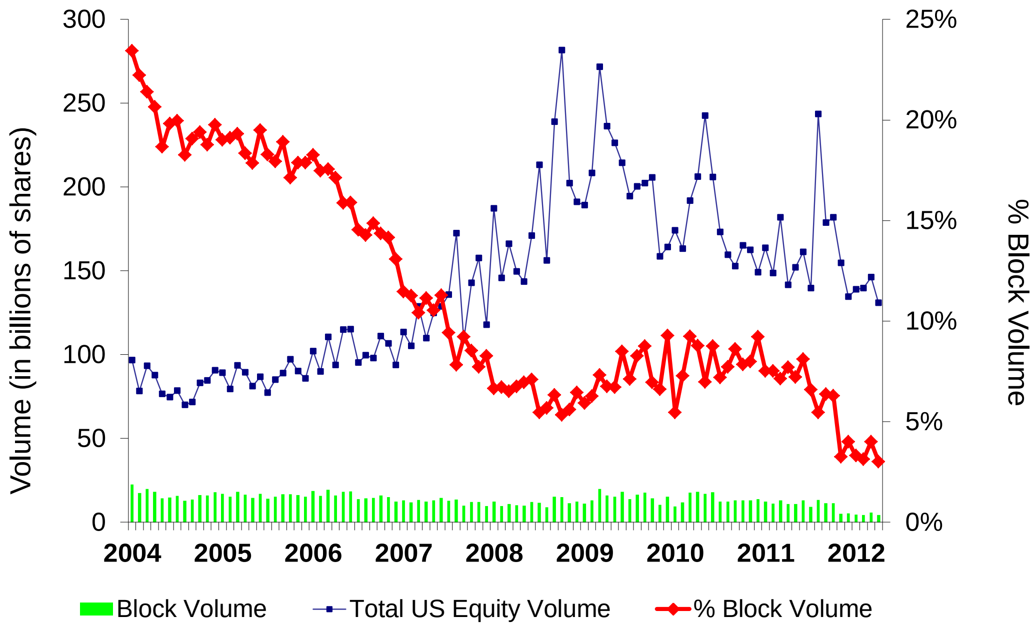


Source: TABB Group, US Exchanges

Trading Elephants

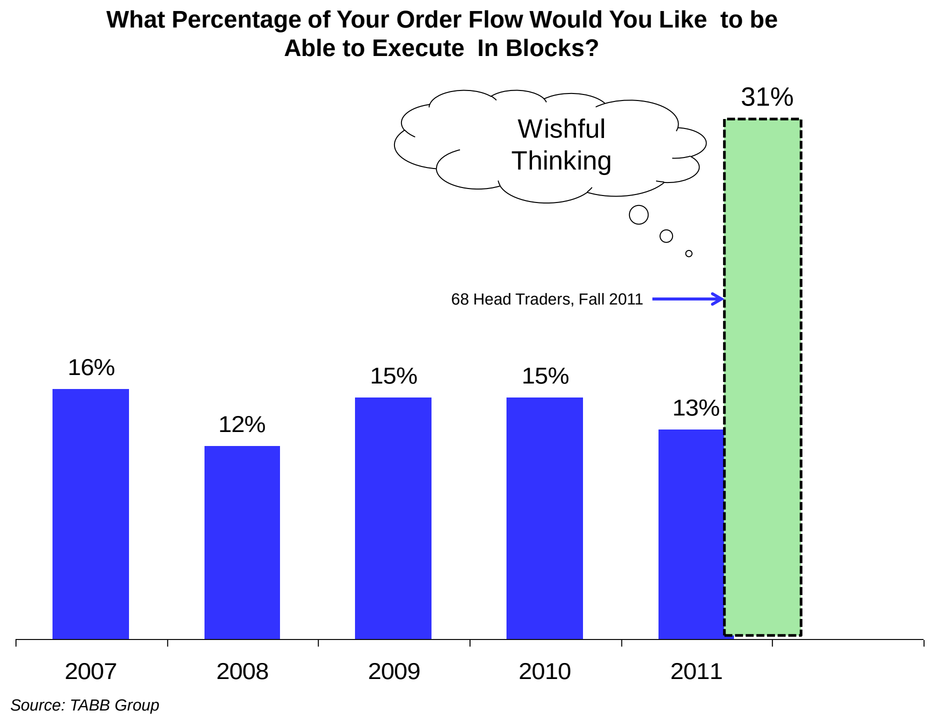
Today, as the U.S. equity markets struggle to return to normal growth, buy-side traders face an indomitable challenge: they are responsible for trading large institutional orders in a market where the average trade size on listed venues has been about 297 shares for the past year or more. Block trades of 10,000 shares or greater have averaged just over 3 percent of U.S. consolidated tape volume for the last six months. The percentage of equity trading volume executed in the dark continues to rise as buy-side traders struggle to aggregate bits and pieces of liquidity into blocks across a myriad of available liquidity sources. TABB Group estimates total off-exchange volume, in dark pools and ECNs and through internalization, at 33 percent of average daily volume these days. It's not easy to find where that liquidity lives when you need it in size.

Block Volume vs. US Consolidated Volume
(January 2004 –April 2012)



Source: TABB Group, US Exchanges

While traders bemoan a market structure that forces orders the size of an elephant through liquidity the size of a mousehole, they call for a renewed commitment from both their sell-side trading partners and their buy-side peers to step up and trade in size. In 2011, when TABB Group spoke with 68 head traders at traditional asset management firms, the average percentage of their daily trading activity executed in blocks was down to a mere 12 percent from just 15% in 2010. When we asked what percentage of their order flow these traders *would like* to be able to execute in blocks, however, the average answer was 31 percent, a level not seen since the last ice age.



Clearly the ability to find and participate in block liquidity is a value proposition that buy-side traders say they are eager to pursue. They have developed the knowledge and skills to trade algorithmically, to identify dark venues they wish to avoid and to opt in or out of interaction with electronic liquidity providers. They've become expert users of electronic trading tools and they have concluded that slicing and dicing is not the optimal solution 100 percent of the time.

Trading in block size is an experience, a decision process, an opportunity that requires a distinct set of skills from those required to trade using an algorithm. These block trading skills have carried forward even as the trading environment has been transformed. Fragmentation, lack of information, fear of market impact and information leakage may give a buy-side trader pause in the face of real block size. But a trader has to be far more skilled today, trading across lit and dark markets, trading instruments like ETFs and futures, even garnering equity market insight from trading activity across multiple regions and asset classes. Today's trader needs to know how to take advantage of a block opportunity when a block trade is the right implementation for any given order.

When to Walk and When to Run

So as the evolution of trading continues to play out, block trading remains a valuable complement to algorithmic trading. Consider when a PM sends a large sell order to the trading desk and that order must be completed efficiently in order to fund an aggressive buy order. The ability to find a willing buyer for size can mean the difference between capturing alpha on both sides of the trade or getting hit with a good dose of two-sided opportunity costs. In a situation like this, a trader has to know when bursting into a run from one venue to another may chase potential liquidity away, whereas a more measured pace will allow a willing partner to come and join the trade. This is the art of the trader as fiduciary. When transactions cost are incurred because a trader does not trade efficiently, it is the underlying beneficial owner of the assets who pays the price in basis points charged against his returns.

What block trading requires from both buy-side and sell-side traders is a set of relationship skills that have never lost value. These skills are fundamental to participation in a community that must overcome the fear of being gamed or being lied to in order to say 'yes' to a multi-party print. That relationship between the contra sides of a block transaction is built on trust and a mutual regard that will allow for the sharing of information, the give-and-take of truth and intent in the interest of achieving best execution. It's a high-quality experience, one that may, if implemented correctly, deliver reduced market impact while preserving investment alpha.

Honor in Survival

Block trading is an implementation choice only when there is a trading partnership founded on discretion and honesty. It is a practice that operates by a set of long-standing rules that allow for multiple parties with disparate roles and cultures to attend to their own interests without sacrificing the greater good of the community willing to participate in blocks. Completing a block trade requires tact and judgment between buy-side and sell-side traders. Sell-side sales traders must know which clients to call, which sales traders on the desk to give a nod to and, above all, who is dangerous and shouldn't be involved. Buy-side traders must recognize the economic value of the sales trader's ability to find a natural counterparty and to successfully conclude an artful negotiation. Those who act with the intent to mislead or misguide their trading partners will, sooner or later, lose their place in the block trading arena. They may find that the only willing counterparties are those who believe they too have succeeded at the counterparty's expense.

Evolution doesn't tire. Nor does change. In fact, the pace of change continues to increase in the equity trading world. The honing of skills never ends and the ability to adapt remains ever more critical. Traders who are able to draw upon a full complement of trading knowledge and resources will live to trade well another day. They'll know when it's time to run and when it's time to slow down and meet a 'natural' of the same species.

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