Key considerations when choosing an outsourced trading partner

By James Williams

Outsourcing the trading function has become an important trend within the hedge fund industry as managers, both large and small, look to generate marginal gains by reducing the cost of operations.

Jeff LeVeen, Head of Outsourced Trading at JonesTrading

A report by Greenwich Associates in December 2018 found that 71% of respondents were "extremely satisfied" with their outsourced trading service providers. Some of the key reasons why managers decided to opt for outsourcing were found to be: the need for additional support for their own trading desks, cost savings and improved execution performance.

JonesTrading Institutional Services, one of the oldest and largest broker/dealer executing equity trading firms in the US, offers an outsourced trading solution for clients. "Our team at JonesTrading has been working on our own research white paper that will analyse the various costs and considerations associated with different internal trading set-ups," Jeff LeVeen, Head of Outsourced Trading, tells *Hedgeweek*.

"If I'm a USD100 million hedge fund manager or a USD10 billion manager, what do those set-ups need to look like and what will the costs and considerations be?"

For those who determine outsourcing the trading function is the best option, there are some key factors that need to be contemplated.

Agency-only

One of the first questions to ask is whether the outsourced trading solution is truly agency-only. In other words, is the trading firm engaged in principal trading (trading for its own account) in any meaningful capacity?

LeVeen suggests that while a lot of outsourced trading firms claim to have an agency-only model, some of them have principal trading capabilities via market making and other proprietary capacities. "If that is the case, I would want to know if I'm outsourcing my trading function to a non-agency-only firm, and if my orders are being exposed to potential principal trading," says LeVeen.

Dark pools

Another thing to consider is if the outsourced trading firm builds their own algorithms and hosts their own dark pool. If they do, they are most likely going to have their own high frequency trading market makers present in their dark pool.

Firms with alternative trading systems ("ATS") will likely stage every order for the firm in the ATS regardless of whether it comes from their outsourced trading business, existing sales/trading desk or their prime services business. Each order is routed to the dark pool before moving to other dark pools or the lit markets (exchanges). Consequently, every order, in the first instance, is exposed to the firm's high frequency market makers in their dark pool.

Active managers should be concerned about who sees their orders and how much they are exposed to principal trading. LeVeen remarks: "I would be concerned if I'm outsourcing my trading to a firm that has its own internal dark pool or its own principal market-makers. At JonesTrading, we have no principal market making at all, nor do we operate our own dark pool. We are a 'broker-neutral' platform. Significant thought goes

into where we execute client orders in an effort to achieve best execution and fulfil the manager's soft dollar and research budgets."

Natural liquidity

JonesTrading is a registered broker/dealer and a market leader in natural crossed liquidity. It was established in 1975, but has roots dating back to the early 1930's. It has a clearing relationship with Bank of America and is currently in the process of establishing a clearing relationship with Goldman Sachs. In addition, it has segregated its legacy institutional sales trading business from its outsourced trading business, including a physical separation of offices and personnel.

"If I was launching a new hedge fund, natural liquidity is of key importance. If I want to buy or sell a large block of stock, I want to do so without the market moving against me," explains LeVeen.

"Our institutional sales business trades north of 14 billion shares per year. Our outsourced trading team will canvas both the JonesTrading internal liquidity and the liquidity being shown to us by our broker network. If we can see there's an opportunity for a client to buy or sell a block of stock, we will let them know we have the opportunity to cross the stock for them. The liquidity we source helps our hedge fund clients achieve better execution."

A number of outsourced trading platforms are limited in their access to "natural" block liquidity and are forced to blindly direct all of their orders to algorithms or non-natural high touch firms. Sourcing block liquidity has led to better execution performance in many circumstances, especially in small and midcap securities. It also reduces the visibility and unnecessary exposure that routing every order to another firm creates.

"When we cross a block of stock internally with a natural buyer, we don't have to access the Street. We also have great access to the natural liquidity our covering brokers are showing us. Having access to both internal and external liquidity is a benefit to our managers. We believe the client is going to get a better fill because the order is not causing any kind of disruption by taking liquidity out of the lit or dark market. This is especially important in small and mid-cap equities where there is less liquidity and spreads are wider," says LeVeen.

Best execution requires deep expertise

As referenced at the beginning of this article, one of the key reasons for managers to utilise outsourced trading desks is to achieve best execution.

Best execution is something that JonesTrading prides itself on.

While the growth of outsourced trading has exploded over the past five years, many outsourced trading desks have recruited

junior traders to function as order handlers in an effort to keep costs down. However, this does not necessarily lead to best execution. Best execution requires expertise and years of experience navigating different market conditions. It also requires understanding the market structure, the various tools available, as well as each client's trading nuances and preferences.

This is not something that many junior traders will understand early in their career.

"Our experienced and tenured staff made it easy for us to launch this business five years ago. When you're running an outsourced trading desk, your emphasis has to be on execution performance and experienced high touch service," emphasises LeVeen.

"You need to respect why certain trades are done a certain way. We have 10 traders covering the US market, three traders covering APAC, and three traders covering Europe. Every single client on our outsourced trading desk has a dedicated relationship manager who is focused on managing the commission wallet, managing best execution and responsible for making sure they deliver high-touch coverage to the client.

"If someone wants to trade an order at three in the morning when Europe's markets open, they have a way to contact that experienced trader and execute on it."

JonesTrading will also advise clients on what amount of commission dollars should be allocated to research brokers in order to get the outcome they are looking to achieve. Typically, a member of the trading team will contact research brokers who cover JonesTrading (i.e. Goldman Sachs, BAML, JP Morgan, Deutsche Bank) to determine the expected amount of commission dollars required for a client to access their research portal. "We communicate this with our clients and come up with a thoughtful budget, in an effort to minimise performance drag," says LeVeen.

Limiting performance drag

MiFID II is proving to be advantageous in Europe as managers must now demonstrate best execution for their funds. As such, the cost of research has to be priced by each and every broker. It is a good standard and a practice that could end up extending to the US and other markets.

In many respects, this commitment to help managers run their commission wallets properly and to deliver the best "bang for the buck" to end investors, is something that JonesTrading has been doing for years.

"Outsourced trading is ultimately much more than just executing orders. We are doing a fair amount of consulting, in regard to service provider selection and trading technology, long before most funds even launch. And, once the manager has officially launched, we manage all aspects of trading, middle office, commission management, stock loan, etc. We get direct feedback from our portfolio managers regarding which research firms they are looking to pay and the resources they plan on using. This information helps us assist our managers with constructing a cost-effective research budget," LeVeen explains.

He concludes by saying: "Our goal is to help our managers run a well-organised and cost-effective business. We're hyper-focused on execution quality and performance drag and are constantly looking for ways to optimise both for our managers. If we do the best that we can do on those fronts, it should help our clients achieve better overall performance." ■