



Asset Managers: e-FX helping to solve the jigsaw of complex operational challenges



Francis Maguire

As asset managers execute increasing volumes online they are starting to re-engineer their businesses models around growing their business through eFX, reports Frances Maguire.

Asset managers are rapidly increasing their volumes of electronic trading and, on balance, welcome lower costs and increased innovation resulting the proliferation of eFX platforms against the disadvantages of liquidity fragmentation. But more importantly, asset managers are demanding more from the providers of eFX, not just in terms of more sophisticated functionality but ease of connection and greater information sharing between the sell-side liquidity providers and the buy-side.

For Philip Simotas, president of currency risk management firm

FX Concepts, there is little doubt that the FX market will be wholly given over to electronic trading. He says that FX Concepts is rapidly increasing the amount of execution that is carried out electronically for its currency overlay strategies and absolute returns programmes. He says: "Electronic trading has now risen to just under 40% of our overall volume. The market is clearly moving in the direction of electronic trading and it is more a matter of how quickly it moves, as opposed to if. "Our own experience is that electronic trading has reduced transaction costs and has made our work

flow more efficient. This has allowed us to increase the capacity of assets that we can manage."

Increasing expectations from e-FX venues

If eFX continues to grow at this rate critical mass -- the point at which more than half of asset managers' volume is carried out electronically -- is not far away. While this means that eFX volumes are growing at a fast rate, it also means that asset managers will expect more from the eFX venues, and even that the speed of executions through electronic trading is starting to add to the market's volatility.

Rene Hartner, CEO and general partner, at Artos Capital Management believes that the proliferation of e-FX trading venues will help to create a liquid market for new market entrants such as hedge funds and individual investors. He says: "FX can be considered as an own asset class and has the advantage of producing uncorrelated returns to the stock and bond market which makes it interesting in particular for hedge funds who historically focused on equities or commodities." He adds that the availability of multi-bank platforms will also help to create a higher transparency of pricing, bid and ask spreads and will increase the speed of executions of orders.

According to Hartner the recent innovations in the eFX market have enabled a simpler integration of automated trading systems that are operating on sophisticated algorithms. He says: "I have not seen any operational challenges associated with this and I think that e-FX actually reduces operational challenges, in particular, the speed of executions, but it might have added to a higher short term

volatility in the market, as seen during the July events when carry trades started to unwind"

Russell Investment Group offers an agency FX solution to investment managers and pension funds interested in enhancing FX performance, managing costs, and reducing operational risk. Michael DuCharme, CFA, operations manager, at Russell, says that managers and pension funds recognise that improving FX prices and controlling transaction costs are important contributors to their performance. However, security selection and trading infrastructure, compliance, and other issues also have a significant impact upon performance. These requirements compete for the legal staff, management oversight, operations support, and information technology expertise needed to build or upgrade and maintain an FX infrastructure.

He says: "We've spent considerable resources to build an e-FX process to manage currency transactions for Russell funds, and we're offering that infrastructure to those clients who find it too costly, time consuming or risky to build or upgrade their own infrastructure."

Electronic trading has brought with it substantial improvements over traditional telephone trading as it is less prone to error, provides a record of trading activity, and enhances straight through processing. He says: "E-FX allows users to more easily connect to additional venues and access more liquidity."

Broader e-FX product offerings

While DuCharme welcomes the increased competition that the

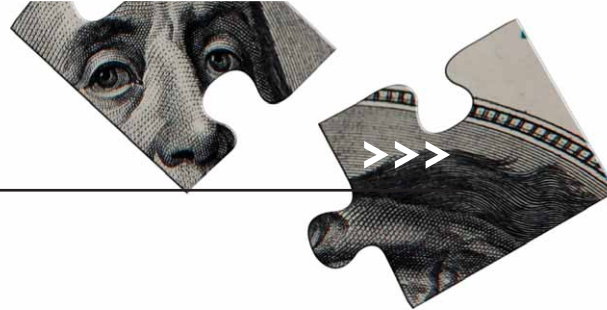


Philip Simotas

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proliferation of eFX trading venues is bringing, he believes there is still scope for a broader product offering from eFX providers. Russell is a global manager with investors throughout the world and for this reason it trades currency pairs that are not actively supported by many of the existing e-FX platforms (for example, currencies pairs involving AUD, CAD, and NZD). Says DuCharme: "We also frequently trade forwards and have difficulties obtaining forward points in an automated manner." However, he views the growing number of e-FX trading venues positively, as enhancing competition, but believes it is likely that the industry will consolidate.

According to DuCharme, conversations with investment managers and pension funds indicate that allocations to global investments are likely to grow. In particular, his firm is seeing an increased interest in passive hedging. However, global trading is impacting the firm's operations, more than its e-FX service. He says: "We've noted global trading impacting operations more than e-FX services. Trading around the clock, working with bank

**Rene Hartner**

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counterparty back office staff in different time zones, and managing increasing numbers of operational issues are the challenges we and other investment managers face.”

Although front-end trading systems often grab the spotlight in e-commerce, DuCharme says the firm’s attention is more focused on the back-office and where he would like to see more functionally rich e-commerce solutions being developed. “Russell has observed investment managers investing significant resources in post-trade processes. Thus, managers are interested in applications and systems that not only minimize transaction costs (like front-end e-commerce systems) but that can also decrease operational and settlement risk and reduce resource requirements,” he says. “For example, Russell’s participation in Continuous Linked Settlement (CLS) has helped us to manage settlement risk. Importantly, CLS provides a straight through view of the entire settlement process so that we can manage it proactively.”

As the eFX world grows it is broadening out to new types of users, such as long funds, which are seeking a more sophisticated ‘hedge fund type’ grade of online tools for managing FX exposure. DuCharme says: “When we meet equity managers who may have previously traded foreign exchange indirectly with their custodian bank (for example, attaching currency orders to their equity trade tickets), we hear plans and see steps they have taken to address issues with foreign exchange transaction costs.”

He believes there are two reasons why managers may be devoting more resources to foreign exchange trading: best execution requirements and competition. “Best execution requirements can motivate managers to assess alternative trading methods that increasingly are electronic,” he says.

“Competition encourages managers to seek ways to improve investment results. Because inferior currency trading can consume the alpha from a superior investment strategy, managers seek ways to lower costs and improve pricing. Consequently, managers are looking to e-FX, among other things, to help them with trading foreign exchange.”

He also believes that it is likely that trading currency options and other derivatives will increase the need for more complex electronic solutions in future. However, at the present time, the FX trading executed by many managers is still transacted to settle security deals and to passively hedge currency risk.

In terms of future development of services from e-FX providers Russell’s two largest issues are trade aggregation and connectivity.

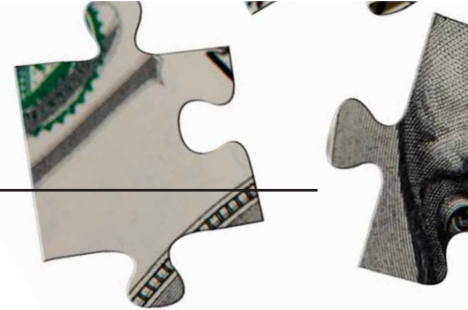
“Like most investment managers, we trade on behalf of many clients, each with one or more accounts. The most serious hurdle to frequent use of electronic trading systems is the inability to aggregate trades from multiple accounts into a block, trade the block, and allocate the resulting rates among the underlying accounts,” says DuCharme.

**Michael DuCharme**

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Connectivity concerns

Connectivity is another obstacle for asset managers and could be made easier by the eFX providers. Although ECNs provide a graphical user interface (GUI) to allow users to enter trades manually, manual trading can be risky, defeats straight through processing initiatives, and is not practical for large numbers of trades. Says DuCharme: “We use the Charles River Investment Management System, but it requires a significant upgrade to communicate with the ECNs via Financial Information eXchange (FIX) protocol.” Even though ECNs also publish their application



Josh Levy

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programming interfaces (APIs), DuCharme says this too is not a practical solution, as it requires IT resources that are limited because of other competing demands.

But Josh Levy, managing director of Tactical Asset Management, says that the ability to write directly to the APIs of the sell-side firms and the intermediary FX aggregation portals has brought incredible efficiencies as well as opportunities. He says: “The FX market moves fast. Now that FX trade success is measured in milliseconds - rather than in hours or days - the ability to accommodate automated, computer-directed e-trading has become invaluable.” While he believes the current levels of liquidity provision provided by the eFX market are adequate for Tactical’s operations, as large blocks of currency can be moved easily, the bid/offer spreads are not tight enough, especially in the more esoteric cross-currency pairs.

On balance, Levy is in favour of the growing number of new eFX

trading venues, which, he says, bring added competition and lower costs and fees. “Additionally, the new venues tend to bring innovation and added functionality, such as advanced order-handling or special analytics and reporting capabilities, to the market,” he says. However, the downside, he says, is that the segmentation of trade volume amongst the various FX venues means that trading in fast markets can become slightly more erratic and choppy due to the disparate ‘liquidity-pockets’ rather than one single concentrated liquidity-pool.

Greater transparency

But for Levy, the key most important development he would like to see in the eFX market is greater transparency. He says: “From our perspective, there needs to be more openness with respect to information sharing by the sell-side to the buy-side. Sell-Side providers offer many analytics and tools for market or price analysis, but share precious little information about customer trading trends, aggregate-behaviour, open-interest (to the extent applicable) live-orders, and open-positions.”

He says that useful aggregated information, given anonymously or in-aggregate to protect privacy), might include: at what prices orders are at, both limits and stops; the current, aggregated, open positions of the buy-side’s customers; and how these positions have changed over time. “Furthermore, information relating specifically to customers should be divulged, securely, by the service provider to their customers,” he adds.

Levy would also like to know what reports or analytical tools do dealers and prime-brokers have

that might be made available to the buy-side, how and why dealers are analysing his firm’s deal-flow and exactly how this information is being used.

The profound impact that electronic trading has had on the way the FX market does been business is already visible – especially in the interbank market, which has fully embraced electronic trading. When online FX trading was first introduced to the buy side in the late 1990s, initial client uptake was slow; perhaps this was because first generation bank platforms seemed to offer little improvement in price discovery and automated execution.

Conclusion

Electronic trading has already transformed FX trading on the buy-side by increasing the levels of automation, and with dealable streaming quotes not only improving efficiency but also enabling best execution. Furthermore, the delivery of transparent pricing and greater liquidity is now helping asset managers to improve fund performance and enhance alpha. The transparency of prices and ease of delivery by being able to add liquidity through posting bids and offers in the market 24/7 has made FX a viable asset class for electronic distribution. Returns have been further improved by coupling this with straight through processing.

Now it appears that there is more change to come from this pressure to finally level the playing field between the providers and the takers of FX liquidity. The winners will always be those providers that listen to their users and provide solutions tailored to their needs. This, it seems, will be the final challenge if they are to increase order flow from asset managers.