Hedge funds drive development of customised solutions

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The last year has seen frenetic activity among technology and solutions providers as the hedge fund industry adapts to the post-financial crisis/sovereign debt crisis environment. Tools for compliance, reporting and risk are most obviously in demand, but tools and the markets they address are becoming interchangeable and vendors have to respond to trends in a more targeted way than ever before.

Take trading venues: the fragmentation of liquidity away from the largest exchanges has increased the demand for sophisticated trading systems that track liquidity as it moves from venue to venue and that analyse in real-time where to send orders.

However, the picture is changing much more rapidly than anyone could have imagined. The number of venues is still proliferating just as overall volumes have shrunk and this will inevitably lead to structural changes with which technology must keep pace. Rob Boardman, head of algorithmic trading sales at ITG, says: “In the long-term, there are too many players and there will undoubtedly be more consolidation, particularly if volumes don’t pick up.” But he does not believe, however tough markets become, that liquidity will once again become concentrated in one venue per jurisdiction. “The genie is out of the bottle now,” he says. “There will be at least three or four venues in the longer-term if the US experience is anything to go by.”

So despite the upheaval, there is still likely to be more choice and better execution for funds. This choice could be augmented by the creation of more dark pools, a process which ITG believes will accelerate this year even as lit pools decline in number. “They have lower overheads so large banks and institutions will run them as standalone activities,” says Boardman. He believes hedge funds will exploit this opportunity creatively. “One of the largest hedge funds in London set up a system to send a large part of its business to a few dark pools before starting to trade.”

On the other hand, using smart order routers (SORs) to actually place orders risks alerting other investors to the strategy. “Some funds avoid using SORs and dark pools because the signals sent give the game away. Because of the size of their trades they may prefer to trade in the main market,” adds Boardman.

So is the continuing development of dark pools still considered a game-changer? “If you are prepared to wait to trade they are useful,” says Boardman. “But for more urgent trades – and many hedge fund trades are considered urgent – funds may need to be prepared to pay a little extra on the main exchanges to get the deal done.”

There is also some suspicion that banks use SORs to attract orders to their internal crossing engines, or dark pool platforms that they use to drive down their own costs of trading. Boardman does not comment directly on this but points out: “It is easier for us to explain what we do to clients. There is no suggestion that we are keeping back the best version for ourselves.”

Particular demand has been witnessed for customised routers which essentially provide protection against gaming. “If you are paranoid about the way you trade, you can get maximum protection – but you have to give up some opportunities too,” Boardman says.

Latency has certainly become a game-changer. One of the main issues affecting traders is the risk that market prices will move before the order is executed. This risk has been amplified over the last two years as market volatility has scaled unprecedented peaks, and as new trading venues and liquidity pools have fragmented the market. The huge industry-wide efforts to reduce latency have cut the time of a round-trip from a broker-dealer on the London Stock Exchange from 100 milliseconds ten years ago, to 5 milliseconds today.

Gerry Buggy, Global Head of Hedge Fund Solutions at Thomson Reuters, says: "It's an arms race and prime brokers are racing into it just as Apple did in the mobile phone space. Funds want the least number of hops. Milliseconds mean a lot – they want the fastest box, the closest location to the exchange and updates in real-time."

In fact, the rapidity of technology development has allowed the biggest and best equipped funds to attempt arbitrage opportunities between trading venues. However, ITG says the strategy is not necessarily high-yielding. "Arbitrage takes place, but the cost of trading and clearing European equities is still high compared to the US so it is a fairly unattractive strategy," says Boardman. "In any case, arbitrage opportunities often exist for minutes rather than milliseconds in Europe so speed is not necessarily the key."

If speed is not always critical, convenience always is. The largest vendors and data providers now aim to provide "plug and play systems" to service as many different needs as possible in one place. Thomson Reuters, for example, launched its Elektron service in April to access all trading venues, provide historical data on assets, and provide access to the big machines that are needed to cope with the complex algorithms that ensure the fastest trading. The fibre-optic network is an attempt to create a data network "community" to replace the more costly and cumbersome individual technology links between financial firms and multiple exchanges, trading platforms and vendors of trading services. It also provides access to markets such as China, for which trading infrastructure is difficult to built at an individual hedge firm. Says Buggy: "For the hedge fund it is cheaper, easier, faster and aids communication with counterparties and service providers."

While technology solutions for most hedge requirements exist, accessibility is an issue, particularly for smaller funds. Jeremy Rowlands, chief executive of Caliburn Capital, a fund of hedge funds firm, says: "Five years ago, we set up and went shopping for a mid-office software platform and discovered there was nothing available, so we decided to build our own. There has been progress in the market in the last few years, but we are still convinced there is nothing better out there than what we have built – unless you are Goldman Sachs or Brevan Howard with enormous resource and running a prop desk."

The problem is that hedge funds need both the financial muscle to buy the complex suite of systems that investors demand, yet also be small enough to remain nimble. As Rowlands says: "There are relatively few people who are big enough and sophisticated enough to have systems that stand up to due diligence and – from an AUM perspective – are small enough to be a boutique operation and stand a realistic chance of outperforming in the long-term."

Because this is essentially a cottage industry that has started to mature, only a minority of firms are able to cope with the demands placed on them by institutionalisation. "Many businesses grew large in terms of AUM and then threw bodies into solving problems, but woke up to find themselves in a mess," adds Rowlands.

Some areas of hedge fund activity seem to have been more or less overlooked in terms of technology and process. Research, for instance, is key to any investment firm's success and yet the approach to investment decision-making has barely advanced in recent years. Mark Rice, general manager of Tamale, a research specialist, says the ability to instantly review research and the sources thereof is vital in volatile markets. He points to funds run by some Tiger Cubs, who encourage analysts to be responsible for the quality of each other's work. "Each week they go through each other's ideas but they need to be fully informed to do this, including having access to systems that allow full transparency, including the sources for the analysts' work," says Rice.

Static data is also often overlooked despite the fact that errors can cost funds millions. Says Buggy: "Corporate actions such as stock splits were not thought interesting and not a big seller for Thomson before the crisis. But the institutionalisation of funds – which means less reliance on the prime broker – means they are taking on greater ownership responsibilities themselves and sourcing data directly from data providers."

Other areas are so new that vendors are only starting to address them. The move by some hedge firms into Ucits funds, for instance, poses a variety of challenges. Regis Veillet, head of sales and client relationship for Societe Generale Securities Services in Luxemburg says: “The challenge for us was to adapt our system to managers that are used to working in a prime broker set-up. We had to develop different services such as tri-partite reconciliation and accelerate our capacity to interface with managers.”

Partly as a result of this move into the traditional fund space and partly as a means of sustaining profitability in a tough environment, some hedge funds have started to pay trailer fees and this too has resulted in a demand for upgraded processing. “This sounds pretty straightforward but it is actually complicated because there is no standardisation,” says Veillet. “The methods of calculating fees are more or less infinite and then there is the challenge of automating processes to chase fees and ensure the client is paid the right amount on the right date.”

In other words, while the industry is – perfectly understandably – fixated on all-singing, all-dancing risk and trading systems, focus on processing and administration is making a comeback. Getting it right and keeping costs low are maxims that could dominate the industry for some time to come.

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