

# Outsourced Trading in Focus

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The concept of outsourced trading is not new to hedge funds, but its relevance has arguably come to the fore in recent years as managers of all shapes and sizes seek out ways to run their businesses as cost-effectively as possible, in response to ongoing fee pressure.

Lying at the heart of the proposition is the ability to leverage a team of outsourced trading professionals located in multiple jurisdictions, who act as a genuine extension of the front-office.

Not only does this give hedge fund managers the chance to run their portfolios using a 'follow the sun' trading model (if they have a global mandate that is), it avoids them having to build their own expensive trading infrastructure, as well as the associated costs of hiring top talent.

With cloud technology helping new funds to re-imagine what it actually means to run

a hedge fund business, the concept of outsourcing a trading team is now woven into the fabric of the industry, helped by the fact that investors view outsourcing – in its various guises – with a positive air, more often than not.

This realisation is now dawning on larger established hedge funds as they re-appraise their internal infrastructure and look for ways to bake in greater operational efficiency.

One firm benefiting from this wider rate of adoption is Cowen, whose Global Outsourced Trading Group ("Cowen") provides a full-service, global, multi-asset class execution and support solution to the buy-side community. According to Jack Seibald, Managing Director and Global Co-Head of Prime Brokerage & Outsourced Trading, the firm has achieved a good number of notable wins over the past 12 months, including many of the high-profile fund launches whose teams have spun out of well-known and highly regarded large hedge fund platforms.



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Jack Seibald

“The increased notoriety of our offering, the addition of more than a dozen traders as well as several support staff around the globe, and the launch of our FX trading solution, combined to propel the business for us over the last year,” says Seibald.

“Right now we have some 175 clients, which compares to about 130 a year ago. Our revenues from our OT clients YTD are almost double what they were a year earlier thanks to increased market volatility and the resulting trading activity earlier in the year, the addition of the new clients we onboarded, and perhaps most notably, the much larger starting AUM size of managers using our solution. In spite of the disruption caused by Covid-19, the pipeline in place in early 2020 materialised, and as importantly, has continued to build in a meaningful way as many well-pedigreed and experienced managers have continued to launch new funds. This continued pace of launches has been one of the biggest surprises for us over the last year.”

As Cowen’s Outsourced Trading solution is widely connected to brokers across the globe, its trading team was able to assist clients without issue during the height of the volatility in March and April 2020. “We implemented our business continuity plan early, and quickly pivoted to the work-from-home solution by moving equipment located at offices to traders’ homes and installing enhanced connectivity protocols,” outlines Seibald.

In many ways, Covid-19 has proven to be an important stress test for the Outsourced Trading solution and so far, it seems Cowen’s trading team has emerged unscathed, yet battle-hardened.

Part of the reason for why managers have explored the notion of outsourced trading is because of the difficulties some of them had to deal with in the early stages of the outbreak. Any concerns they might have had have receded as firms have adjusted to remote working and realised their infrastructure might not have been quite what they thought it was.

As a result, a larger number of managers have found themselves at least evaluating the option of outsourced trading, and in some cases have adopted it as a back-stop solution, or a support function during the pandemic. Undoubtedly, some might look to implement it on a more permanent basis, even when they get everyone back to the office.

Specifically, Cowen’s Global Outsourced Trading Group consists of several trading teams located across the US with offices in New York, Stamford, San Francisco, and Atlanta, as well as internationally in London and Hong Kong. In total, it boasts 35 traders, of whom at least two thirds have at some point in their past worked for buy-side firms.

Throughout the trading day, thanks to the extensive technology architecture built within Cowen, the outsourced trading team provides full transparency during the entire trade lifecycle, from the time the portfolio manager sends an order to the time the trade is executed.

The trade lifecycle is then completed with the transmission of the end-of-day files to prime brokers and custodians (and other service providers as required by the client), and finally the uploading of beginning of day positions to all of the requisite trading systems.

#### **A bedrock of trust**

One of the hallmarks of Cowen’s Outsourced Trading solution is the deep level of trust between its traders and the end clients. To achieve this, Cowen spends a lot of time with prospects to understand their specific business needs. This includes understanding the investment strategy in detail and working with the manager to tailor the solution to the specific client’s investment and trading style.

Cowen takes time to understand, in detail, how a manager thinks about the investment process and what relationship he’s used to having with traders. What kind of



portfolio reporting he's used to. How he prefers to monitor the portfolio during market hours, and so on.

The technologies employed allow Cowen to tailor the solution to pretty much any of their clients' trading needs.

"Once we have a good understanding of the client's needs and preferences, we can suggest how best to set up the manager, which OMS/EMS solution might work best for his or her needs, which one of our trading groups might suit them best (sector specialty, geography, etc), and which lead trader is likely to be a good fit, personality-wise," explains Seibald.

As a result of the full service and full transparency of its service offering, Cowen's clients gain an implicit degree of trust that in many instances allows its traders complete live views of their portfolios. The benefit to this is that Cowen's traders can more effectively manage the client's position sizing, as well as facilitate the manner in which they can accept client orders on specific trades (number of shares, percent of portfolio, etc).

Rather than merely acting in the capacity as a trader, taking an order, executing it or sending it out to the intended executing broker, Cowen's traders really are functioning as the eyes and ears of the fund manager, and highlight relevant newsworthy headlines and events.

Moreover, when Cowen enters into a new outsourced trading relationship, the portfolio manager could have up to 20, 30 or 40 brokerage relationships that they wish to maintain. Cowen will review these relationships with the client and go through a budgeting process to determine what each broker could expect to receive in commissions and then, over the course of a quarter and year, ensure that the budget is accurately monitored and adhered to.

### Key components to consider

For any hedge fund or long-only manager considering an Outsourced Trading solution there are several

components to assess what makes a great solution different from a good one.

One of the most important features of Cowen's buy-side desk solution is that it operates a pure agency-only model, thereby avoiding potential conflicts that could arise with executing brokers operating broker/dealer desks where they are making markets and trading on their own accounts.

To guard against this, Cowen's Global Outsourced Trading Group is completely independent and legally separated from Cowen Inc's other institutional trading businesses. This ensures that each client's information is properly guarded.

Another important aspect is the flexibility of its pricing model. Cowen offers two models: a Direct Fee and a Service Fee model.

#### 1) Direct Fee

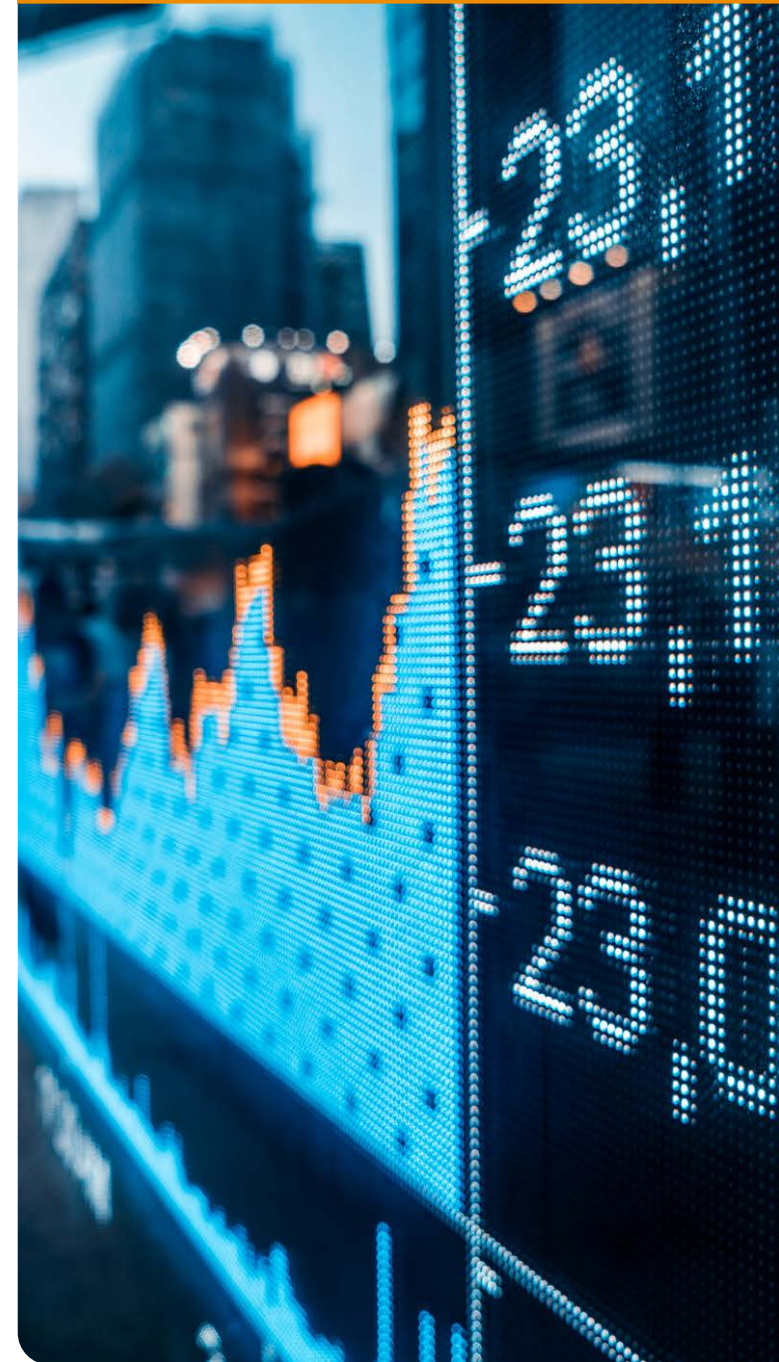
This model works by negotiating a percentage of the client's trading volume that Cowen would then execute over the course of the year at a fully transparent execution rate, which Seibald says is "typically lower than an institutional rate". Cowen earns its fee based on that execution rate.

Also, under this model, Cowen manages all of the remaining order flow that the client designates to other brokers, at no charge.

#### 2) Service Fee

Under this model, Cowen agrees to manage all of the client's order flow to its preferred executing brokers and charges a modest service fee, in addition to the commission rate negotiated by the client and paid to the away broker.

The Direct Fee model is most beneficial to managers who turn over their book on a frequent basis, as it results in lower overall commissions paid, while the Service Fee model makes more sense for lower turnover strategies that still require access to multiple brokers.





Regardless of which fee model a manager uses, they receive full transparency on each order, including which broker is working it and how and when every fill occurs. In addition, the brokers themselves gain full transparency on who the client is, which can be important from a KYC best practice perspective as all of the trading connections are set up in the client's name. This reinforces the client's brand, as Cowen is not interposing itself between the client and the designated broker.

"Unless the client doesn't want us to, we always provide the executing broker the client name on the order they are receiving and which they will execute. And clients are always informed of which executing brokers are handling each specific trade. This benefits both the client and the executing brokers as each has full transparency at all times.

"In contrast, others in the outsourced trading business often don't do this, but rather execute the orders themselves and then flip commissions to the designated brokers. In addition, our team also assists the client in developing commission budgets and continuously monitors the progress to optimise the services the client needs to manage his/her portfolio, such as research and corporate access, just as it would if they worked directly for the client," explains Seibald.

### **Comprehensive multi-asset class coverage**

Over the years, Cowen has expanded its multi-asset class coverage, such that it is now able to cover global equities, futures and options, global FX and fixed income. Having

that comprehensive coverage is vital for any outsourced trading platform wishing to build its client book, as many of the fund managers spinning out of multi-strategy shops will expect to receive the same level of institutional calibre support.

One of the most meaningful developments for 2020 was the introduction of an FX trading solution, which now has a team of eight covering FX markets during US, Asia and Europe trading hours.

As with all other members of the outsourced trading organisation, Cowen's FX traders have a mix of buy-side and sell-side experience, the former being particularly important when developing a 'like-minded' relationship with hedge fund and more traditional investment firms.

"Adding FX to our repertoire brings complimentary services to our already developed client base, and importantly, extends the reach of our offering to a more diversified and larger potential audience of more seasoned funds that tend to invest and trade across asset classes," says Seibald.

On the fixed income side, Seibald says that while they've always had people in the organisation able to execute fixed income securities it has tended to be largely limited to IG and high yield, as well as some emerging market securities.

"As a result of heightened interest received from potential clients, the firm has begun to build out a dedicated fixed income Outsourced Trading solution to more comprehensively cover the asset class on a global basis. We have now hired Joram Siegel to





lead the team, and are working to further develop the offering and roll it out shortly,” confirms Seibald.

Offering a truly institutional-quality Outsourced Trading solution takes substantial human and financial commitment; much as it does for firms running prime brokerage businesses. At the end of the day, fund managers want it to look and feel as though an outsourced trading desk is a natural extension of their business. It sounds obvious, but it is far from simple to achieve. Cowen feel as though they are on the right track, given the depth of investment they’ve made and the experience they’ve gained over the years, and how this is translating into market growth.

“Our goal is to replicate that large fund platform experience for managers, as they adjust to running their own hedge fund business,” states Seibald. “The alternative is that they’d have to make a serious investment in infrastructure on their own.

“We treat our outsourced trading clients no differently than how we would if our traders and support team worked directly for the manager. We make our portfolio management systems and our real-time portfolio monitoring and reporting solutions available to managers, and perform a full reconciliation and shadow portfolio reporting function for those clients who feel they would benefit from it.

“Our clients give us permission to reconcile their trading accounts with their respective

prime brokers and custodians, and our portfolio reporting team does all of the daily reconciliation work and reporting work,” says Seibald.

### Trade aggregation, reconciliation & reporting

Another key differentiator is the multi-custodian portal, which Cowen offers as part of the base service agreement, in addition to real-time portfolio monitoring tools, shadow portfolio reporting and capital introduction services.

Portfolio aggregation is not something typically offered by outsourced trading desks. The reason Cowen is able to offer this goes back to the earlier point in this report about building a bedrock of trust; without this trust, portfolio managers would not be comfortable agreeing to grant Cowen’s team access to their prime brokerage accounts, which is crucial to performing the aggregation function.

For example, if the PM has 100,000 shares of Tesla split across three or four prime brokers, they want to see their total exposure during trading hours. Post-trade, Cowen makes sure everything goes to the right PB account and the right custodian.

“That’s a service that PMs spinning out of high-quality organisations, where they are used to having everything done for them, really appreciate,” says Seibald, who explains the aggregation service in more detail:

“We are electronically connected to probably two dozen global prime brokers and custodians so for us to download trade files from the likes of Morgan Stanley, Goldman Sachs, JP Morgan, or BNY Mellon, is no problem. Equally, if the client decides to add another executing broker or custodian to the fund’s operations, that’s fine too.

“We are in possession of all executed trades, so in addition to managing the end-of-day file transmission process, we also have the ability to provide end-of-day “flash” profit and loss and position appraisal reports. We then do a “true” reconciliation overnight so that when the manager walks into the office the next morning, all of the trading systems have already been populated with the trade data that our team has reconciled back to the various PB accounts.

“The managers give us a limited trading and operational authorisation to do this on their behalf and trust us to work with their client service representative at each prime broker. Over time, our clients’ prime brokers have learned to appreciate that there is one centralised desk handling things correctly.”

The above illustrates the breadth of operational support Cowen gives each and every one of its Outsourced Trading clients, taking care to interact with the fund’s prime brokers and other third party service providers. It is a collective mindset that seeks to ensure no stone is left unturned, such that the fund portfolio is always in synch with the front-office team.



### Global growth prospects

For any hedge fund manager looking to trade global markets in this current period of heightened volatility, there are clear benefits to leveraging an outsourced trading desk with offices located across the globe. A New-York based manager trading global equities might have one or two in-house traders covering US equities, but lack the infrastructure to effectively trade the overnight markets in Europe and Asia. By using a solution like Cowen's, the PM can leverage the skills of Cowen's Hong Kong or London-based trading desk teams, and build a rapport with them as if they were a part of their own firm.

Once the US markets have closed, managers can stage their trade orders and leave specific instructions for trading Asia and European markets overnight, i.e. if there is a news development on the manager's top holdings, traders contact the PM for additional instructions. And the reverse is equally true; European and Asia Pacific managers can avail themselves of Cowen's US-based trading teams to help them trade as optimally as possible during US market hours.

"As we started marketing our services in Asia, local fund managers were interested in using US-based traders working on their behalf when they were asleep. We've onboarded a good number of new clients over the last year in the region through our Hong Kong office, who are engaged with our US trading team. We are seeing growth in all directions - with managers across the globe using our trading desks based in the US, Europe and Asia, as appropriate," confirms Seibald.

It's not only hedge fund managers who have embraced the outsourced trading model. Large, traditional long-only investment managers are also exploring the merits of this route, but it has unsurprisingly been a much slower process, given their size and long established ways of doing business. For newly launching managers it is a relatively straightforward, binary decision: Do I build or do I outsource? It is a much more mechanical decision making process.

For a multi-billion dollar fund manager, however, the decision is more complex and typically involves evaluating existing trading infrastructure and personnel. The process used to introduce an emotional consideration, the question was one of maintaining the existing infrastructure and team or reevaluate and begin to outsource. However, we are increasingly seeing a rise in client requests to supplement their teams with additional resources, whether that is to support the existing desk, add a new geography or asset-class capability.

Nevertheless, since the beginning of 2019, Seibald confirms, "we've onboarded a few long-only managers and we anticipate further growth with that cohort of clients over the next few years as more of them explore both the cost benefits of outsourced trading and the access to the experienced global trading teams available to them."

### A longer-term Post-Covid trend?

Many investment firms will have used the impact of Covid-19 to accelerate their decision making and adopt outsourced trading as a permanent part of the operating business

model. This is unlikely to change in a post-Covid marketplace as fund managers across the globe appreciate the myriad benefits that such a solution affords them.

A recent survey conducted by KPMG and AIMA on 144 global hedge fund managers sought to discover how the alternatives sector had performed and adapted to the new environment, and how investment funds were expected to change going forward.

The survey, found that 71 per cent of respondents cited the success of operating in the current remote working environment as a catalyst to increase outsourcing operational and technological solutions to improve efficiency, generate cost savings and manage margins more effectively.

Against a backdrop of wider adoption it is little wonder there are more OT providers entering the competitive fray. Firms including BTIG, Jones Trading, Peregrine & Black, CF Global, Tourmaline Partners and TORA are just a few of those competing with Cowen to win market share.

Seibald views this as a positive. In his mind, the more OT providers there are for managers to consider, the more credibility it gives the solution.

“Our greatest competitor is not someone else providing this solution, it is a manager deciding to build it internally,” opines Seibald.

“We need to do everything possible to convince managers that there is nothing they can build internally that

they couldn't get from us. As prospective clients compare and contrast our offering with that of one of the other players in the market, we're in a good position to win mandates so long as the needs of the manager are reasonably comprehensive (i.e. they aren't just looking for execution services).

“A number of brokerage firms with a sell-side execution business have tried to extend it into an outsourced trading desk, but it's a difficult hurdle to overcome, using sell-side trading systems and traders to manage to function as a buy-side desk. For the most part they are limited to only providing execution services, and don't have the ability to offer the more comprehensive level of transparency or the reconciliation service that we do.

“But more competition is good because we think it helps raise awareness. We take it as a positive.”

### Conclusion

Outsourced trading has long been a familiar concept to US fund managers, but in the wake of the global pandemic, managers across the globe are now becoming increasingly cognisant that it is a viable long-term solution to either replace or support their front-office trading capabilities.

The level of competition is likely to heat up over the coming years, which will require fund managers to pay close attention to the scope of service offerings: how

much operational support will there be? What is the pricing model? What level of transparency, trade aggregation and reconciliation does the OT solution provide? How many traders do they have, and what level of buy-side experience do they possess? What is the breadth of broker network and asset class coverage?

There are other factors, of course, but the above will certainly need to be carefully considered as part of a manager's due diligence. After all, getting the relationship right can go a long way to securing a mutually beneficial arrangement.

“With a larger number of credible OT providers in the marketplace, the concept of outsourced trading in Europe and Asia is gaining traction and receiving broader recognition. It's an ongoing maturation cycle.

“We anticipate that over the next two years we will see a material increase in European clients, specifically, which will likely outpace the growth of our client base in the US,” Seibald concludes.

For now, it would seem the magnetic pull exerted by Outsourced Trading solutions is likely to remain significant. Covid-19 has accelerated the way hedge funds think about their business operations, and shown that they can remain resilient even when the entire team is working remotely. As managers evolve, Outsourced Trading solutions are likely to become a more permanent consideration. ■

#### Jack Seibald

Managing Director, Global Co-Head of Prime Brokerage & Outsourced Trading



Jack Seibald is Global Co-Head of Prime Brokerage and Outsourced Trading, Cowen Inc. He was a co-founder and managing member of Concept Capital Markets, LLC until its acquisition by Cowen Group, Inc. in September 2015. He has been affiliated with the firm and its predecessors since 1995, and has extensive experience in prime brokerage, outsourced trading, investment management, and research dating back to 1983.

## COWEN

Cowen Outsourced Trading provides investment managers with a first-rate, cost efficient solution for their trading needs. Our offering is full service, multi-asset class, global, and is differentiated by its transparency and level of operational support. Cowen Inc (“Cowen” or the “Company”) is a diversified financial services firm that operates through two business segments: a broker dealer and an investment management division. The Company's broker dealer division offers investment banking services, equity and credit research, sales and trading, prime brokerage, global clearing and commission management services. Cowen's investment management segment offers actively managed alternative investment products. Cowen Inc focuses on delivering value-added capabilities to our clients in order to help them outperform. Founded in 1918, the firm is headquartered in New York and has offices worldwide.

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# The Manager's Perspective

Chris Zellner, Co-Founder, COO and CCO, Asymmetry Capital Management

Asymmetry Capital Management is a diversified equity long/short healthcare fund located in San Francisco. We launched the fund in January 2013. We launched the Fund in an infrastructure partnership with a boutique asset manager, which enabled us to use their trading desk. In September 2015, as they were being sold to another firm, we took the decision to spin out on our own. Doing so meant we needed to replicate the infrastructure partnership we had enjoyed.

At that time, outsourced trading had grown to the point where major institutional allocators were comfortable with it. We knew the Cowen team because when we first launched we had a relationship with Jack Seibald and Mike Rosen at Concept Capital, before they were acquired by Cowen.

Cowen came to us and presented us with a very attractive offer for their Outsourced Trading solution, which we felt would get us close the previous infrastructure partnership we had been using. We do have some direct relationships on the Street that we use but probably 98 per cent of our trading activities go through Cowen.

The business philosophy at Asymmetry is to keep the team as small as possible, operationally, and outsource as much as possible.

More recently, we've increased our trading activity in Japan and it has helped us using Cowen's trading team in Hong Kong. The bottom line is we don't want a bunch of different relationships; regardless of whom we had chosen to do outsourced trading with, they needed to have a fully functioning global footprint.

Being a healthcare fund we are research-intensive and we direct Cowen's Outsourced Trading team to pay the Street. We use approximately 40 different executing brokers and every quarter we do a commission review. We have a very close relationship with their traders, especially the San Francisco team; we treat them as if they were in-house.

The Cowen team acts as an extension of Asymmetry and saves us from hiring and managing our own trader, in addition to not having to build and maintain the necessary infrastructure. For us, that is a home run.

At present, we aren't using Cowen's multi-custodian portal because we use a single prime broker. That said, we still have a fair amount of complexity. We are

running a number of separately managed accounts in addition to the flagship fund. Each one of the SMAs has its own PB; we must direct trades on behalf of the client.

Once we go multi-prime for our flagship fund, which we anticipate will happen in 2021, we absolutely will take advantage of the multi-custodian portal. The fact that Cowen does this for its OT clients is very helpful.

My advice to those thinking about choosing an outsourced trading partner is to go into the selection process knowing what you need from the relationship. Your trade flow and commissions are currency. You also must be comfortable that the firm provides you with sufficient documentation to fulfil your best execution obligations (for SEC regulated firms).

You have to do detailed due diligence to pick the firm that is going to fit with you, which isn't always the easiest thing to tease out.

I would also say that one needs to look at the overall firm relationship holistically. Cowen has a large healthcare research and investment banking footprint, which is one of the things that is helpful to us when we think about our overall Cowen relationship. Our experience is that the smaller institutions tend to do a better job of looking after you on a more holistic basis.

Ultimately, make sure that what you need is aligned with what the OT provider is offering to do for you. That's the bottom line.

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