Engaging the market with more intelligent FX orders

Order management has become an important area of focus for buy-side firms and, consequently, an area that any bank offering an FX trading platform is keen to develop. Nicholas Pratt examines the many ways that the buy-side can work their orders to improve the way they engage with the FX marketplace and how their needs may differ between different client segments – from the more casually trading corporates simply looking to hedge an exposure to the high frequency and high intensity FX traders looking to generate alpha.

The availability of order management algorithms has been hugely beneficial to buy-side firms in enabling them to minimise market impact and to achieve better execution results. And banks have been investing significantly to ensure that their e-commerce platforms can meet the new demands of the buy-side for more sophisticated order management and to keep pace with the accelerated evolution of the electronic FX marketplace.

Engaging the marketplace

There are essentially two ways for buy-side firms to electronically engage the marketplace, says Yaacov Heidingsfeld, founder and chief executive of US-based TraderTools which provides trading services to sell-side banks in the FX market. They could decide that they want to show a complete order to a particular vendor or they could decide that they would prefer to work that order within their own technology and only send it for execution once specific execution conditions have been met. "If you have a sophisticated order management system, which many more buy-side firms have now either created or purchased, you do not have to show your entire order to a particular market participant," says Heidingsfeld. "You can instead work the order internally by taking streaming executable prices into your system and only send an execution request to specific market participants when pre-determined market conditions are reached."

The order management requirements will vary between different market participants. "At one end, the average corporate trading FX will be more business-sensitive rather than specifically execution-sensitive. Of course everyone wants the best price but a corporate may have a different approach to price discovery and the number of counterparties they go to in order to source that best price. At the other end of the buy-side spectrum lies the alpha-seeking hedge funds that are only interested in one simple question – did the order execute or not?"

Given that there is such a wide spectrum of buy-side clients, can a sell-side bank reasonably expect to be able to offer order management services to suit both the corporates and the alpha-seeking hedge funds? "If you're on the sell-side, it is important that you have the ability to accept as many different order types as possible and this requires banks to have the right technology," says Heidingsfeld.

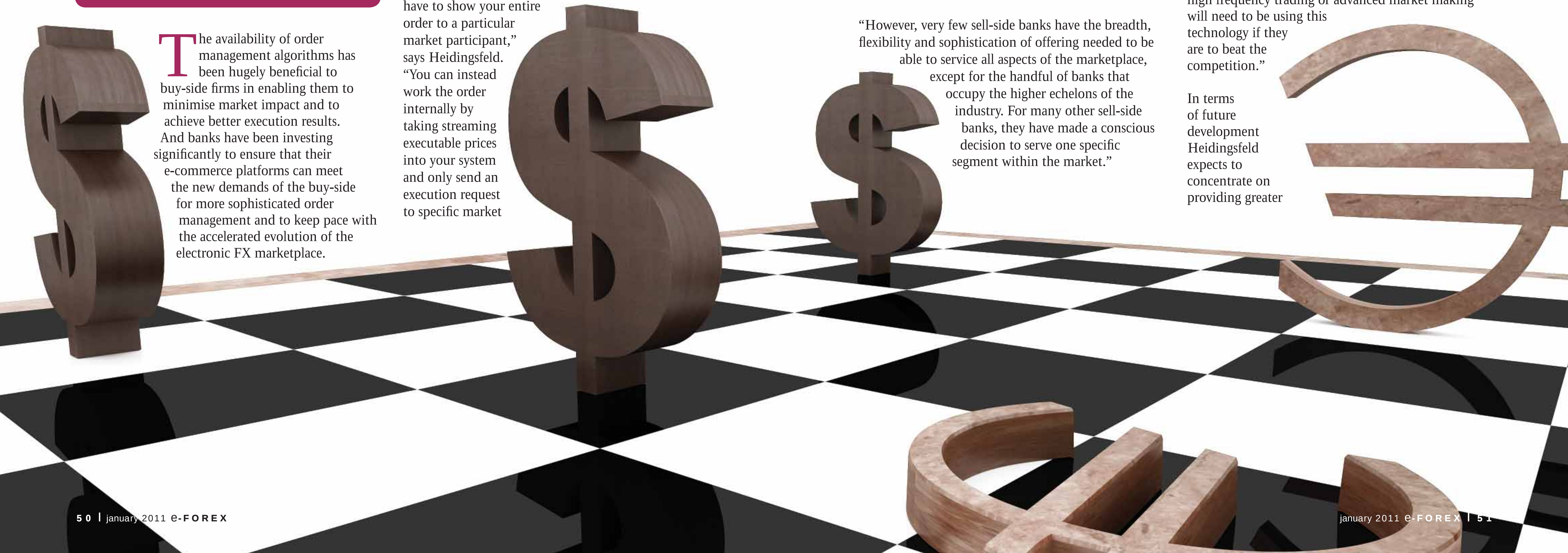
"However, very few sell-side banks have the breadth, flexibility and sophistication of offering needed to be able to service all aspects of the marketplace, except for the handful of banks that occupy the higher echelons of the industry. For many other sell-side banks, they have made a conscious decision to serve one specific segment within the market."

Use of algorithms

Algorithms are being more commonly adopted among the buy-side says Heidingsfeld. "It is a developing trend, although it is still a far cry from being the standard practice. We are getting lots more inbound calls from buy-side firms – particularly hedge funds and alpha players that are looking to become market-makers – wanting to incorporate algorithms into their order management systems. So although it is not the market standard practice, I expect the adoption of algorithms and related technology such as complex event processing to increase during 2011."

So is it simply a matter of time before algorithms and CEP do indeed become the standard market practice and are adopted by all participants or will the technology always remain unsuitable for some? "The technology will be more prevalent than ever but the market will continue to splinter," says Heidingsfeld. "The corporates that are more service-focused than price-focused and the hedge funds taking a long term position are not going to need a high level of sophistication. But any firm looking to do high frequency trading or advanced market making will need to be using this technology if they are to beat the competition."

In terms of future development Heidingsfeld expects to concentrate on providing greater



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functionality for his existing client-base as opposed to rolling out the same technology to a greater range of clients and a larger number of first-time users. "We have had to extend our API to meet the growing demands of our customers (the sell-side banks) who are in turn looking to provide more functionality to their buy-side clients."

The aftermath of the financial crisis has led to a slight readjustment in the marketplace in the last 18 months. "Customers are returning to smaller banks, their more traditional counterparties, due to the lack of availability of free prime broking and similar mirage-like promotional offers from the top banks. The challenge for the smaller banks is to provide these returning clients with same level of functionality they enjoyed when working with the big banks," says Heidingsfeld.

This functionality includes offering a greater range of order types and also the ability to offer certainty of execution as the order types become ever more complex," says Heidingsfeld. "For example, banks must be able to provide their clients with the ability to engage in a sophisticated synthetic cross but also offer them a facility whereby they can be sure that both legs of the cross have matched and then only execute or cross the trade when both sides are suitably priced."

Above all Heidingsfeld sees the market evolving rather than changing. "I think the market will continue to grow at pace through the improvement of existing technology. Speed to execution will continue to fall, availability will increase and additional order types will be made available electronically."

Changing client demands

Many of Heidingsfeld' sentiments are shared by the numerous sell-side banks that have spent time and money investing in their FX trading platforms and have noticed the changing behaviour and demands of clients over the last decade, particularly when it comes to the management of their orders. "Every single client trades for different reasons and depending on the scale of the assets they manage has to execute in a range of styles of pairs," says James Dalton, director of FX algorithmic execution at Citi. "There is no one-size-fits-all answer to the best way to trade orders. We like to work with clients to find out what is driving their execution and offer them the appropriate range of execution services. For some clients, leaving an order with the desk is the right thing to do and for others, putting an order on an electronic platform is more appropriate. And for others, the best option is to use execution algorithms. It all depends on the market conditions, the currency pairs and the trading objectives of the client."

It is a far cry from the days when the only FX execution many buy-side firms were engaged in was on the back of equities or fixed income trades or an overlay account. But there is now a range from macro models to systematic currency portfolios that have emerged, all with their own execution timeframes and objectives. Furthermore, Dalton says that recent research carried out by Citi as part of its latest development efforts suggest that individual clients and not just client segments are looking to mix up their order types based on the market conditions. "They are looking for logic that allows them to automatically switch to an electronic execution or even an algorithmic execution in more extreme conditions."

If a bank is looking to improve the way they execute orders, they need to look at the flow they generate and consider the platform they are using, says Dalton, and this is leading many banks to turn to the single dealer platforms. "If you are using a multi-dealer platform, it can be hard to turn away from that. But there is nothing to say that you should not have a number of other platforms available to you both for contingency reasons and for the greater availability of execution services that are available on single dealer platforms. It is also easier to maintain banking relationships through single dealer platforms."

There has been a fairly significant rise in the buy-side's adoption of order management algorithms, says Dalton. "It took a while to educate the buy-side in terms of what an algorithm could do for them and what was available but I very rarely have to have those conversations with clients. If they are not already using them, they are about to." Consequently much of Citi's focus for 2011 will be on marketing the core algorithms to a wider range of clients. "Distributing algorithms en masse is not necessarily the right approach because they are not for everyone but it is certainly true that there is a much bigger buy-side market out there now."

Smart order routing

Buy-side FX firms are also showing much greater interest in smart order routing technology, says Dalton, however they need to be discerning when considering investing and appreciate the fact that some smart order routers are simply smarter than others. "There are a lot of companies out there selling smart order routing platforms that often offer nothing more than the ability to find the best price at a given time. There are others that will go stage further and look at the total execution costs but this is just the first building block to developing an execution capability.

"If you are dealing in the interbank market, you need to know who else is participating in the trade and be able to grade them in terms of their toxicity. There may be some gaming or flashing going on and maybe the supposed 'best price' is not always the best price. So you should be able to grade the execution venues in terms of how they're run, the type of participants on them and the rules that are in place to protect the underlying client."

In many ways the banks need to educate their clients as to how best to use the SORs and to prevent any unintentionally toxic flow, says Dalton. "Smart order routing is definitely here to stay in FX and I can foresee a lot more investment in routing technology and anti-gaming logic – all of which is very mature in the equities market – in the FX market over the next 12 to 18 months."

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Differentiation

Nomura International is another bank making a significant investment in its FX dealing platform and according to Jeff Leal, head of FX e-trading at Nomura, there is an increasing interest from clients looking to execute their orders differently. "One way to do this is by using algorithms to work orders. This has the advantage of giving clients different ways of participating in the market and we have a suite of algorithms that are designed to reduce the cost of participating and to reduce market impact." he says.

The algorithms you offer clients may differ, says Leal. "For example, you are likely to offer some degree of direct market access to short-term focused clients that are looking for alpha whereas others which are more interested in transparency and reducing their market impact you may offer more passive algorithms. Essentially it comes down to the risk profile of each customer and it is our job to give them enough tools to perform the pre and post-trade analysis that helps them to decide which strategy best suits their objectives."

He goes on, "As the FX market becomes increasingly fragmented, the liquidity available becomes much more critical and you have to keep up with these changes and

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be able to offer clients good access to liquidity. We have many years of experience in smart order routing so we feel that gives us an advantage over our peers but the changing landscape requires constant development and investment to ensure that you have a consistent service to offer your clients. In the long term I think strategies that incorporate more predictive algorithms for market-making and execution will become more of a focus.

A lot of clients like the ability to back-test their algorithms and see how they have performed historically and to be able compare different algorithms to see which ones best suit their workflow and to have more choice when it comes to working their orders."

There is a lot of focus on being able to access liquidity effectively. It is not just about connecting to as many liquidity sources as possible but also about how you treat that liquidity and how efficiently you access it, says Leal.

Future development and demand

Given the fast pace of the developing electronic FX market, can we expect the demand for order management and execution algorithms to continue to grow or are we rapidly approaching the point at which development and demand cannot be reasonably expected to increase much more?

"It is possible that the uncertainty around regulation and the use of central clearing in the FX market could mean that execution algorithms become less differentiating as trading would take place on fewer venues with deeper liquidity and offering more consistent execution. But in the short-term we are seeing greater demand for more configurable algorithms that are transparent to clients and these are the type of products that we will continue to develop", says Leal who stresses that it is important for any bank looking to be successful in this space to stay flexible and to keep pace with the rapidly developing world of electronic FX, be that the ability to accommodate new liquidity venues, to match the changing market conditions and to meet client's demands.

"At the moment we are still seeing a lot of clients interested in advanced order functionality and better execution and I think this trend will continue to drive the main players in the market to continue to develop more efficient and smarter algorithms," he concludes.