THE TRADE
WORKING FOR THE BUY-SIDE

The 2014 Algorithmic Trading Survey

hedge funds

Recognising excellence in the delivery of algorithmic trading solutions

Featuring

- Market review
- Broker roll of honour
- Market feedback
- Buy-side forum

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‘Alternative’ funds less distinct from the mainstream

Contented hedge funds not tempted to diversify algo use

Similarities in hedge fund and long-only use of algorithms revealed in the 7th annual Algorithmic Trading Survey suggest scope for sell-side convergence.

The growing convergence between hedge funds and long-only firms that has been a theme of institutional investment for more than a decade is increasingly evident in their use of algorithms, according to the results of the 2014 Algorithmic Trading Survey.

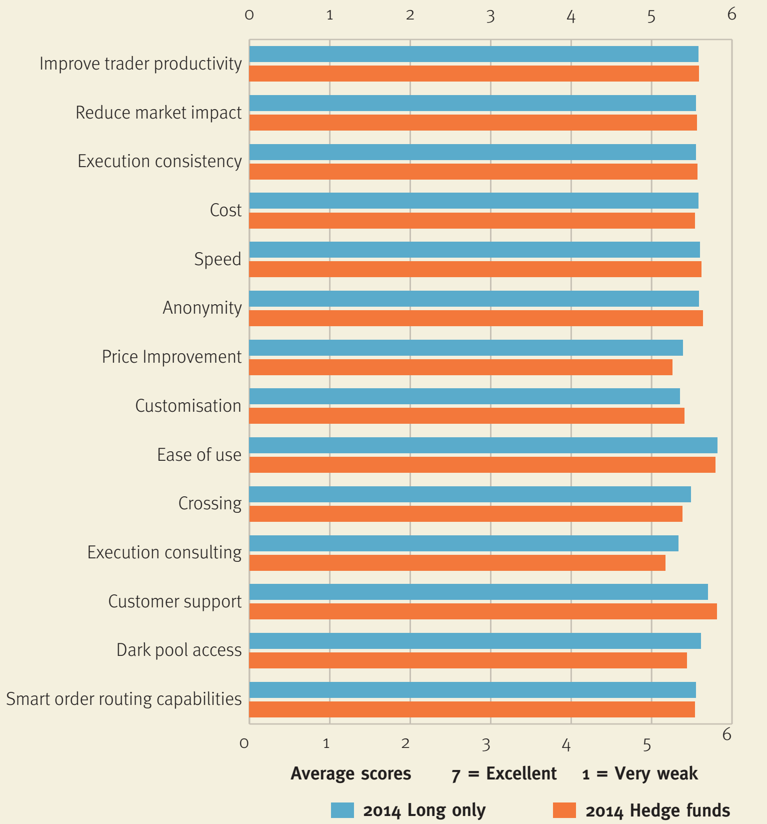
As was noted in the Q1 2014 issue of The TRADE, this year’s survey is being reported in two parts. While the previous quarter’s edition focused on a concentration of algorithmic trading activity by long-only firms among core providers, this second component covers the position of hedge funds responding to the survey and specifically compares and contrasts their perspectives with those of long-only funds reported on previously.

Full convergence?

The sector is highly diverse, but it is still fair to say hedge funds are natural users of algorithms for trading. Many hedge fund strategies are underpinned by use of technology to identify and exploit trading opportunities. The level of trading activity relative to assets is high and the small size of many firms makes it imperative that their trader

Lower scores for execution consulting probably reflect less interest on the part of users and commensurately less attention paid by providers.

FIGURE 1: RATING OF ALGORITHM PERFORMANCE



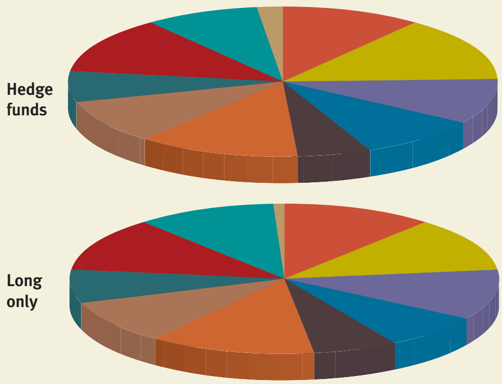
Source of all charts: The TRADE Annual Algorithmic Trading Survey

productivity is optimised. Their enthusiastic embrace of algorithmic trading over the last decade is testimony to its suitability and effectiveness in meeting their particular trading needs. Many long-only firms have also embraced algorithmic trading over this period. To what extent are the priorities and assessments of the two sectors converging? From a provider perspective, it is critical to know whether the needs of different groups can be met through a single process of product development.

In terms of overall levels of service satisfaction, it is clear that hedge funds are happy with provider offerings. In this their position closely mirrors their long-only counterparts. The overall survey average scores for hedge funds across the 14 questions of the survey was 5.51, statistically no different to the 5.54 recorded by long-only respondents. As Figure 1 illustrates, hedge funds gave high scores for customer support (5.18 versus 5.70 for long-only funds). Their lower scores for execution consulting probably reflect less interest on the part of users and commensurately less attention paid by providers. Hedge fund traders, like their long-only counterparts, appreciate the benefits available from internal crossing capabilities, but are at least as sensitive to information leakage. Coupled with lower scores for price improvement, this suggests that hedge funds remain

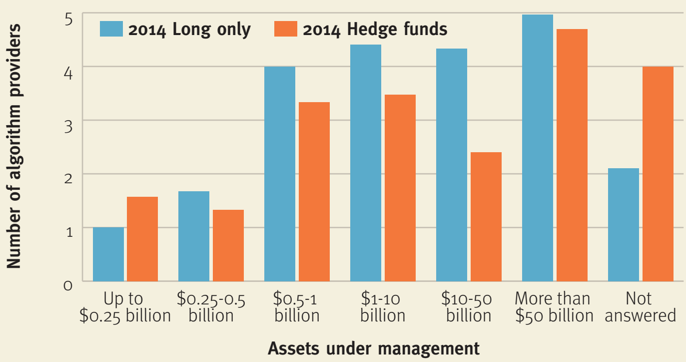
Market review: hedge funds

FIGURE 2: REASONS FOR USING ALGORITHMS



2014	Hedge funds	Long only
Trader productivity	10.6%	11.4%
Reduced market impact	14.0%	11.9%
Execution consistency	9.7%	10.7%
Commission rates	9.2%	7.5%
Speed	5.6%	6.4%
Anonymity	12.2%	12.6%
Price improvement	9.5%	9.4%
Customisation	6.5%	7.2%
Ease of use	12.3%	11.7%
Internal crossing	8.5%	10.5%
Match pre-trade estimates	1.9%	0.7%

FIGURE 3: AVERAGE NUMBER OF PROVIDERS USED BY AUM



Hedge funds' enthusiastic embrace of algorithmic trading is testimony to its suitability and effectiveness in meeting their particular trading needs.

keen on the core virtues of algorithmic trading.

Divergent priorities

Figure 2 shows how the different priorities of each group vary between different aspects of service. For hedge funds, the key to success with algorithms is their ability to reduce market impact, which accounted for 14% of all elements mentioned. This is almost a 20% greater share of mentions than the 11.9% noted by long-only funds for this aspect of service. Ease of use was also more important to hedge fund clients. Lower costs and commissions accounted for 9.2% of mentions by hedge funds, more than 20% higher than for long-only respondents. In contrast, internal crossing was less important (8.5% of mentions versus 10.5%) as were customisation and low latency. In the case of the former, the longer experience of hedge funds in using these tools and their still more focused use of providers may explain why this is now less important.

The role of prime brokers has always been a key

FIGURE 4: NUMBER OF PROVIDERS USED

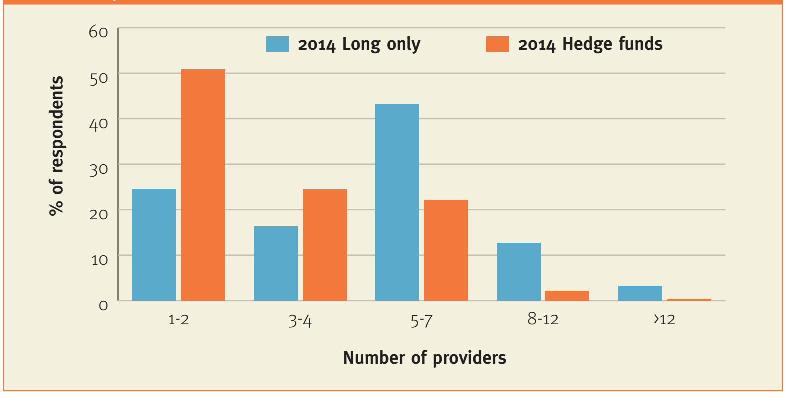
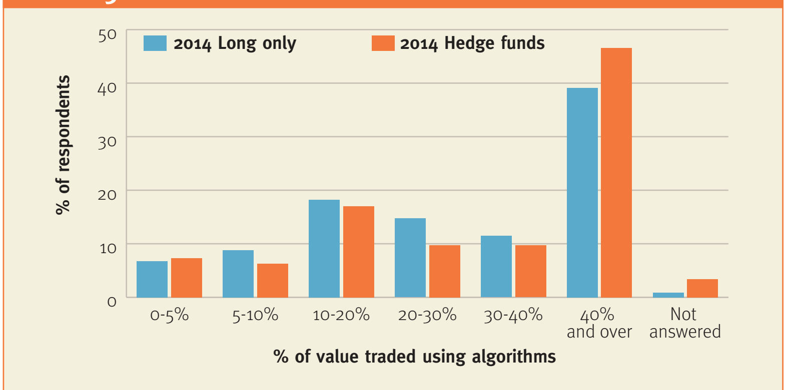
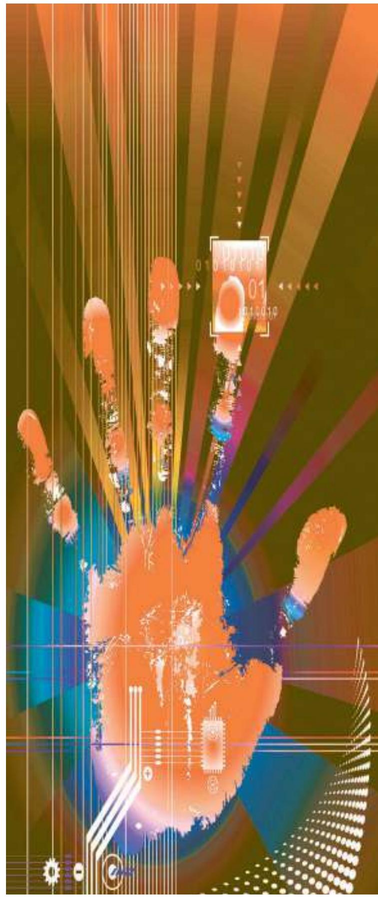


FIGURE 5: ALGORITHM USAGE BY VALUE TRADED



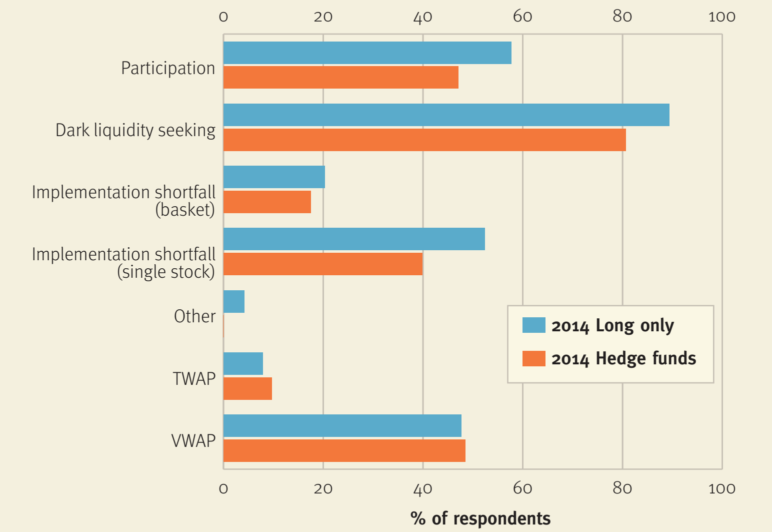


factor in determining how hedge funds trade and the tools they use. The days of a single prime broker are long past for almost all hedge funds, but the number of brokers they use remains somewhat lower than for long-only funds at nearly every level. For funds with less than US$500 million assets under management, one or two prime brokers are most commonly used. As Figure 3 highlights, the use of different algorithmic trading suites remains typically between two and four, even for funds with up to US$50 billion under management. The number of providers is generally around one less than the equivalent long-only fund. This differential may be expected to be extended in future as long-only funds look to all of their 'tier one' brokers to offer algorithmic trading tools. Offsetting that is the fact that having experimented with many providers, growing maturity within the industry means that a process of concentration is now taking place.

It is unwise to over-generalise about long-only firms or hedge funds or indeed

Market review: hedge funds

FIGURE 6: TYPES OF ALGORITHMS USED



Although hedge funds are much more open to the use of multiple providers, the effectiveness of brokers in penetrating that opportunity seem to have been modest.

firms that offer the full gamut of fund types. Certainly the comments from hedge funds about what more they are looking for from algo providers reflect a range of requirements. Calls for greater reporting and transparency ("visibility on my routes in the market – where they are resting, how many shares are sitting on which exchange") and improved transaction cost analysis are frequent, as are calls for more customisation. More specifically, a trader at a US fund that already uses algos for more than 40% of orders is looking for algos to trade small-cap stocks more effectively, while another US-based trader at a large fund called for "better charting and user interfacing analytics especially for options".

Growth opportunity

Figure 4 shows the general position in respect of providers used. Even today, more than half of the hedge funds who responded to the survey use either one or two providers. For long-only funds, the equivalent is less than one-quarter of respondents. At the other end of the spectrum, less than 2.5% of hedge fund respondents report use of more than seven algorithmic providers, compared with 15% of long-only funds. So although hedge funds are much more open to the use of multiple providers than they once were, the effectiveness of brokers in penetrating that opportunity seem to have been modest so far. Given the extensive use of multi-broker execution management systems by most hedge funds, the lack of diversity suggests some failure of sales and marketing and/or an inability to demonstrate serious competitive differentiation to the satisfaction of prospective hedge fund clients.

Long-only funds are now using algorithms for a similar percentage of trades to hedge funds. Around 40% of all respondents use algorithms for more than 40%

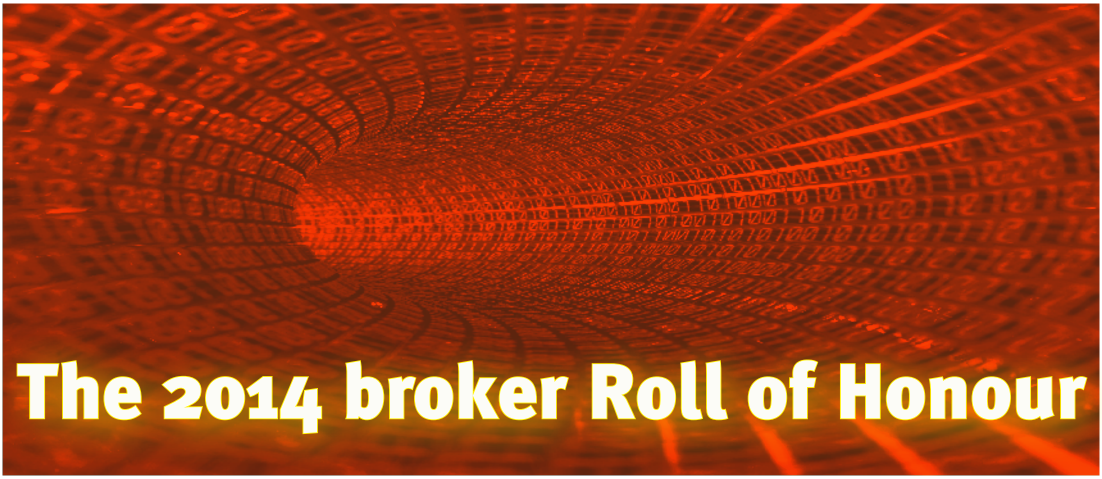
of their trading activity measured by value. For hedge funds the number is 46% while for long-only funds it is 39%. The number using algorithms for 20-40% of activity is much lower for hedge funds. This suggests that having made a commitment, hedge funds like to use it to the fullest extent possible. The numbers making occasional use of algorithms (10% of trade value or less) is similar for both groups at around 15% of respondents. These differences are reflected in the numbers shown in Figure 5.

The main chance

Finally, Figure 6 shows what kinds of algorithms are used by the different types of respondent. In general, hedge funds use fewer types of algorithms than long-only traders. This may reflect a more focused approach to trading generally. Interestingly almost half of both groups continue to use VWAP algorithms (47.7% of long-only funds and 48.5% of hedge funds). Fewer hedge funds use dark-liquidity-seeking algorithms, but they remain the single most important category for all respondents, with at least four out of five respondents using them. Of perhaps more interest is the lower number of hedge respondents making use of implementation shortfall algorithms, whether based around single stocks or basket trading. The most likely reason for this is the opportunistic, event-driven nature of many hedge funds, which prioritises securing the investment opportunity ahead of rivals over best execution from a pure trading perspective.

The data from the survey clearly suggests that use of algorithms by hedge funds and long-only funds is becoming more similar. This will benefit providers in terms of efficiency of new investment in product development. However, differences remain, especially in terms of simply how many providers are being used. Whether better sales can change that in the years ahead remains to be seen. If it cannot, then the 'land grab' phase will be seen as being critical in establishing long-term market share. That will no doubt inform all product development by brokers in the future, not just algorithms. It may also be bad news for employees tasked with sales and marketing of electronic trading products.

Illustration: iStockphoto



Functional capabilities

MEASURING FUNCTIONAL CAPABILITIES

Survey respondents were asked to provide a rating for each algorithm provider on a numerical scale from 1.0 (very weak) to 7.0 (excellent), covering 14 functional criteria. In general 5.0 is the 'default' score of respondents. In total nearly 30 providers received responses and the leading banks obtained dozens of evaluations each yielding thousands of data points for analysis. Only the evaluations from clients who indicated that they were hedge funds have been used to compile the provider Rolls of Honour described below.

Each evaluation was weighted according to three characteristics of each respondent; the value of assets under management; the proportion of business done using algorithms; and the number of different providers being used. In this way the evaluations of the largest and broadest users of algorithms were weighted at up to three times the weight of the smallest and least experienced respondent.

In arriving at the overall Roll of Honour the scores received in respect of each of the 14 functional capabilities were further weighted according to the importance attached to them by respondents. The aim is to ensure that in assessing service provision the greatest impact results from the scores received from the most sophisticated users in the areas they regard as most important. Finally it should be noted that responses provided by affiliated entities are ignored and a few other responses were also excluded where the respondent was not able to be properly verified.

As in previous years, the 14 functional capabilities are grouped into three categories; those that impact on actual execution performance; those that effect direct and indirect costs of trading; and capabilities that are of a qualitative and more subjective nature.

REDUCING MARKET IMPACT

ROLL OF HONOUR[1]

- Bloomberg Tradebook
- Citi
- UBS

For hedge fund respondents, reducing market impact is the most important attribute that they consider in evaluating providers. It accounted for 14% of all mentions from this client group and was mentioned as one of the top four elements by more than half of the hedge funds who identified priorities. Among UK- and US-based respondents, the proportion was even higher. For an area of such relative importance, overall scores were a little disappointing. The

1 Roll of Honour recipients are listed in alphabetical order throughout the survey.

Broker Roll of Honour: hedge funds

average was 5.56, marginally better than long-only scores, but ranking only midway among all the questions in the survey for the hedge fund client group.

As might be expected for an attribute that is a point of focus for providers and respondents alike, scores were quite consistent among the leading providers. The difference in average points scored between the highest and lowest scores was 0.78 points and the standard deviation of the scores was 0.24. In both cases, these were the lowest among the 14 areas of service covered. Clearly leading providers are performing largely in-line with one another in this area.

Among the Roll of Honour names, Bloomberg Tradebook scored particularly well with UK respondents. UBS was strong with large-sized funds and in Europe, while Citi scored at a good level across a wide range of respondents.

EXECUTION CONSISTENCY

ROLL OF HONOUR

Deutsche Bank
Goldman Sachs
Morgan Stanley

More than one-third of hedge fund respondents consider execution consistency among the main reasons for using algorithms. For hedge funds with high numbers of trades to complete and limited trader resources, being able to rely on algorithms to deliver consistent results is obviously a major benefit. While a slightly higher proportion of long-only firms mentioned this aspect, no group surpassed the UK hedge funds, almost 80% of whom consider this to be key, the highest of any question in the survey.

Among the Roll of Honour names, Morgan Stanley scored well with larger hedge fund respondents and also with those from North America. Deutsche Bank received good scores from UK clients while Goldman Sachs scores at a good level across a wide range of different types and sizes of respondents.

Scores were fairly consistent across all main providers. The standard deviation of the scores of the leading firms was 0.30 while the difference between the best and worst scores was 0.94 points. Both of these were at the lower end of the range of scores across all the questions in the survey. Scores from hedge funds were statistically the same as those from long-only clients (5.57 against 5.55). This was in the second quartile of scores across the entire survey. That level of performance and the consistency across different firms, suggests that it would be hard to establish meaningful competitive advantage at this stage. It is worth noting however that some of the less well-established names did score particularly well in this area and clearly are attempting to offer a ‘superior’ product.

DARK POOL ACCESS

ROLL OF HONOUR

Credit Suisse
ITG
Morgan Stanley

For all of the publicly voiced concerns about ‘gaming’, long-only clients actually scored dark pool access third highest of the 14 questions. Hedge fund respondents by contrast gave one of their lower scores and at 5.41 overall it was fully 0.17 points below the long-only score. This was the largest negative difference of any question. Large funds in particular seem to be disappointed by the performance of some of the leading providers. Among those funds using more than five providers the range of scoring was considerable at nearly 1.50 points. Across all hedge fund respondents, the difference was slightly less pronounced but the implication would seem to be that clients do notice differences in performance in this aspect of service.

Across the survey as a whole, dark pools are important but not the most critical factor in assessing providers. However, for North American hedge funds, almost 80% mentioned dark-liquidity-seeking algorithms as one of the key

Broker Roll of Honour: hedge funds

components of service. As the most popular type of algorithm for all survey respondents, it is perhaps surprising that it garnered mention as a top four consideration from less than half of the clients. This may well reflect the fact that effectiveness is hard to measure and demonstrate and this remains a challenge for providers going forward.

Among the Roll of Honour names, ITG scored well with UK clients while Morgan Stanley was particularly well regarded by some of the largest respondents. Credit Suisse had generally strong scores across a range of different client types and locations. Among smaller players, there was a wide range of scores with Jefferies performing noticeably strongly with a small group of respondents.

PRICE IMPROVEMENT

ROLL OF HONOUR

Goldman Sachs
ITG
J.P. Morgan

It is perhaps an interesting reflection of how hedge funds use electronic trading tools that price improvement was not seen by half of respondents as being one of the top four most important aspects. Among US respondents the figure was slightly higher, but even then it ranked only around halfway in terms of their view of its relevance. This relative lack of interest could be the result of disappointing outcomes but is more likely a reflection of the fact that it is very difficult to demonstrate consistent better execution results. This applies as much to hedge funds as any other group.

The Roll of Honour names scored at higher levels than others but the differences were probably not large enough to provide a sustainable competitive advantage. ITG did well with UK clients, while J.P. Morgan scored highly with the largest respondents and Goldman Sachs did well in North America.

Overall however, the scores were somewhat disappointing. The average score of 5.26 ranked next to last among the 14 questions covered. Scores from hedge funds were 0.13 points below those recorded by long-only respondents, again among the weakest in the survey. Again this could reflect disappointed expectations or just an inability to effectively demonstrate differentiation. Either way it would seem that providers have some work to do to satisfy hedge funds that algorithms really can and do deliver price improvement on a consistent basis.

SMART ORDER ROUTING CAPABILITIES

ROLL OF HONOUR

Citi
J.P. Morgan
Morgan Stanley

Efficient use of dark pools necessitates the development of sophisticated smart order routing capabilities. Constant updating based on experience of individual venues is also required. This places a large burden on providers, but the real results of their endeavours are often invisible to the end-clients. In some cases, they may not even know where individual child orders of their trades were executed and are often ill-prepared to analyse them even where the information is available.

Nonetheless, hedge funds have strong opinions about the merits of different providers and certainly do not regard them all as equal. Among those that use more than five algo providers, J.P. Morgan is clearly well regarded based on absolute and relative scores received. Morgan Stanley did better with North American clients while Citi was strong with a range of different client groups.

Overall scores were in mid-range within the context of the survey. The average score across all hedge fund respondents was 5.54. This was virtually identical to the 5.55 seen from long-only clients. It ranked as just-below-median score when compared with the other 14 questions. Given the amount of development effort involved such limited appreciation might be considered disappointing. But the range of scores suggests that some providers are outperforming and, more important, their clients appear to notice.

EASE OF USE

ROLL OF HONOUR

Bloomberg Tradebook
J.P. Morgan
Morgan Stanley

Fully 85% of North American-based hedge funds regarded ease of use as one of their top four considerations when assessing the services of algorithm providers. By some margin, this was more than any other factor for these clients. It was also much higher than the survey as a whole. For many long-only respondents, ease of use is predicated on successful integration of algorithmic trading into portfolio management, risk and other systems. For hedge funds, the process is typically more direct and immediately apparent.

Given their importance in enhancing productivity of traders, providing easy to use systems should by now be straightforward for all providers. While the best providers score extremely well, others lag some way behind. The standard deviation of scores across all major respondents is 0.32, which is about average across the survey as is the difference of 1.13 points between best and worst. However for an area of such importance the variation is considerably more than might be expected. Overall however scores are high. The average of 5.79 was the second best in the survey and close to the level of 5.82 offered by long-only clients. This suggests that those who have fallen behind are at a considerable competitive disadvantage, which could easily affect their ability to win business in the future.

Scores from clients comparing more than five providers were actually lower than others. J.P. Morgan did well with this group however. In contrast Bloomberg Tradebook scored better with smaller firms, as might be expected. Morgan Stanley achieved solid scoring with all sizes of respondent.

CROSSING

ROLL OF HONOUR

Bank of America Merrill Lynch
Goldman Sachs
UBS

As was noted in the introduction, internal crossing is simply not as important a feature for hedge fund respondents as long-only clients. It was mentioned by less than 40% of hedge funds as one of their top four considerations. Among UK and US funds, the interest was slightly higher but still below 50%. While hedge funds value the ability of brokers to eliminate the spread on their trades, that is less of a consideration for many than getting the order completed and maintaining the anonymity of their trading ideas.

Against this background, the relatively low level of scoring on the question was perhaps not as troubling to providers as it might have been elsewhere. Overall hedge funds gave an average score of 5.38. This was higher than only two of the 14 questions. It was also somewhat lower than the scores offered by long-only clients (5.49). In fact, very few scores of below 4.0 were seen among respondents. This suggests that disinterest rather than service issues was the main reason for lower scores. However the combination suggests that even the Roll of Honour names may struggle to use this as an area of differentiation. This conclusion is supported by the relatively narrow range of scores across the major providers.

Scores for the Roll of Honour names reflected some differences based on location and possibly therefore the different capabilities in different regions. While UBS scored well in the UK, Bank of America Merrill Lynch were highly regarded by US-based hedge funds.

Broker Roll of Honour: hedge funds

As was the case in some other service aspects, Goldman Sachs performed well across a range of different clients.

TRADER PRODUCTIVITY

ROLL OF HONOUR

Bloomberg Tradebook
Goldman Sachs
Instinet

Scores for trader productivity were very solid across all respondents. Hedge fund clients gave an average score of 5.59. This was marginally higher than long-only respondents. It was also the fifth highest score across the survey. North American clients scored this question highly, while those in the UK were less satisfied, even allowing for their generally lower scoring profile. Other somewhat less happy groups included the very largest of respondents and those using more than five providers, groups that had considerable overlap.

Among the Roll of Honour names, Bloomberg Tradebook received its best scores from UK clients while Instinet was highly regarded by the largest hedge funds and Goldman Sachs scores strongly with North American clients. The range of scores overall was in line with other questions. The difference between highest and lowest was just over one point with a standard deviation of 0.34. Providers can distinguish themselves in this area, but to some extent their success is dependent on how effective users are as well as the underlying product design.

Trader productivity is one of the four most important aspects of capability that hedge funds look at. However it is less important for this group than for long-only clients. Overall a little under half of respondents placed it in their top four items. The percentage was slightly higher mong US hedge funds than others, but even here the figure was only marginally more than one in two respondents.

COSTS AND COMMISSIONS

ROLL OF HONOUR

Bloomberg Tradebook
Goldman Sachs
J.P. Morgan

For long-only clients, costs and commissions are an important element of algorithmic trading. For these clients, algorithmic trading represents a way of conducting business within a broad overall broker relationship, but to incur lower commission costs on a proportion of trading. That can drive not only how much business is done electronically but also what kind of business. For hedge funds the motivation behind the use of algorithms has traditionally been different, reflecting overall costs as well as just commissions. The latter include indirect costs such as set-up and maintenance as well as direct costs. While that still seems to be the case outside North America, within the US particularly there is a growing focus on commission costs. Nearly 75% of respondents regard the level of commissions as a key factor, compared with a little over half in the UK and less than half elsewhere.

Bloomberg Tradebook scored well with UK clients, but was less prominent among US respondents. Meanwhile J.P. Morgan scored best with the largest firms who responded across multiple brokers. While a focus on commissions naturally makes brokers nervous, for clients the economic benefit must be demonstrable before more qualitative factors are likely to be taken into account.

Compared with some surveys, scores for costs and commissions are strong among clients here. Scores across all respondents ranked midway among all questions and at 5.54 suggest that providers are comfortably meeting expectations, whatever occasional client rumblings may suggest. Perhaps that is because commissions are indeed lower and productivity is indeed higher for trades done with algorithms than those involving sales traders.

CUSTOMER SUPPORT

ROLL OF HONOUR

Bank of America Merrill Lynch
Bloomberg Tradebook
Credit Suisse

Hedge fund clients gave customer support their best score out of the

Broker Roll of Honour: hedge funds

14 survey questions. The average score of 5.81 overall was fully 0.11 points higher than long-only respondents produced. That represented the single largest positive difference in scoring between the two client groups. The question that remains is whether these scores reflect on algorithmic trading support per se, or whether it simply results from the fact that brokers are better at providing customer support overall to their hedge fund clients.

Like everything in trading, there is no doubt that traded value and total commission levels count for a lot. It is also the case that many hedge funds are among brokers' most attractive clients in terms of 'total value of wallet' that they represent. It would be naïve to assume that this does not play a role in the overall level of customer satisfaction. In addition, electronic trading was designed to reduce the level of coverage required to generate trading activity. However the particular requirements of customer support related to algorithms are more and different than those reflected in more general client coverage. There is considerable technical and technological knowledge involved as well as the opportunity to provide direct feedback on the outcomes associated with client usage of different algorithms in varying circumstances. Overall the level of scoring for customer support should be regarded by all providers as a source of some satisfaction.

As was the case in some other categories, Bank of America Merrill Lynch performed well among the largest and most diversified respondents. Bloomberg Tradebook saw good scores from UK clients and Credit Suisse as a recognised market leader was well regarded by many different respondents.

ANONYMITY

ROLL OF HONOUR

Goldman Sachs
Instinet
J.P. Morgan

Long-only clients value preservation of anonymity because of the large positions that they are typically trying to create or unwind. Hedge funds need anonymity to protect investment and arbitrage ideas from competitors. Based on the scores provided in response to the survey it would seem most are satisfied with the performance of algorithms in this area. The average score across all hedge fund clients was 5.64. This was the third highest score of any question, a little ahead of the long-only score (5.59) on the same question.

Scores were however not uniformly good across all major providers. This may reflect individual circumstances of particular transactions rather than a generalised concern. Even so, for the providers affected it should be a competitive concern. The range of score between high and low was 1.26 points and the standard deviation was 0.41. Both of these were among the highest seen among this client group.

Anonymity ranked as the third most important aspect affecting client evaluation of services. This was true across all client groups. Almost three-quarters of US respondents named it as one of their top four, even higher than UK and European hedge funds. Competitively the problem is that it is 'hard to prove a negative'. Clients only know that providers algorithms do not preserve anonymity when information leakage occurs. Until that time everyone states and believes that it will never happen. The Roll of Honour names clearly have a good record to date but even if they keep it, it is hard to see it winning business for them.

SPEED AND LATENCY

ROLL OF HONOUR

Bank of America Merrill Lynch
Credit Suisse
Morgan Stanley

Latency in terms of fast connectivity to venues is an important part of successful smart order routing and hence overall algorithmic performance. For hedge funds wanting to exploit trading opportunities however, getting an overall position established or reduced quickly is more important that a few microseconds in latency. As a result, the sense of priority that hedge funds attach to this aspect of service varies considerably. This is shown by the number of funds that rank it very highly and those who care little about it, both of which are a relatively high proportion of the total. Overall latency attracted less than 6% of all mentions. Only around 20% of US clients considered it important, with UK clients being

Broker Roll of Honour: hedge funds

somewhat more sensitive but still only around one-third.

Speed and latency are difficult to measure in a consistent fashion. Firms may know over time if their orders are slow to market (by seeing apparent 'missed fill' opportunities) and will recognise if positions are not established properly before opportunities disappear. Nonetheless, meaningful quantitative measurement is hard. However in general it would seem that perceptions are solid. The question saw the fourth highest score (5.62) with good scores coming from North American clients in particular. Scores did vary across leading providers with the best and worst seperated by 1.35 points. However the Roll of Honour names scores quite consistently across different client groups. Among smaller players Sanford Bernstein did well with a relatively small client sample.

CUSTOMISATION

ROLL OF HONOUR

Instinet
ITG
Morgan Stanley

Customisation means different things to different types of clients. It may mean simply having the flexibility for the user to set trading parameters. All providers offer this capability, but the level of options and the aspects they cover may vary. At the very highest end of the spectrum, clients may be looking for providers to design algorithms to meet very specific trading circumstances. These bespoke versions of standard algorithms require a great deal more work and are generally only offered to the very biggest and best clients.

This question evoked better scores from hedge funds than long-only clients, perhaps reflecting the fact that the very largest clients in this sector are indeed receiving excellent service. On the other hand, the range of scores among major providers was quite narrow. The gap between highest and lowest being second smallest across all questions at 0.88 points, while the standard deviation of scores was only 0.29. Scores overall were at acceptable but not outstanding levels.

Among the Roll of Honour names, ITG distinguished itself among larger clients, while Morgan Stanley and Instinet were well regarded across most sub-groups. Customisation is not viewed as especially important by clients. Less than one-third regard it among the most important four features of services. It would appear that most opportunities for differentiation are too easily copied by competitors to offer a sustainable advantage as the industry matures.

EXECUTION CONSULTING AND ANALYTICS

ROLL OF HONOUR

Bank of America Merrill Lynch
ITG
UBS

In the 2014 survey, this question was changed to reflect the growing business of execution consulting rather than a previous focus on pre-trade cost analysis, though the latter is a component of algorithmic analytics. This area still remains a 'minority interest' among hedge funds. Less than one in six respondents regard it as important to their review process. This reflects the failure of analytics to deliver actionable results in many cases, as well as the work involved in collection of key data and analysing it in context. Execution analysis and consulting is hard and not all clients will respond to initiatives from providers, however well-intentioned.

The fact that some efforts in this area are deemed to be self-serving does not help perceptions. The average score across all providers was only 5.17, easily the lowest score in the survey. It was well behind the long-only score, perhaps reflecting the different approaches to trading across the two client groups. Scores did however vary considerably between different providers. The gap of 2.20 points between best and worst scores was the largest in the survey as was the standard deviation of 0.65. Clearly where clients are receptive and providers put in the effort the results are appreciated.

To turn execution consulting into a competitive advantage will require providers to convince clients of its value. This is the challenge facing the Roll of Honour names in particular. They have invested and certainly have convinced some respondents of the merits of the process and service, but not yet enough of them. Time is probably not on their side, but next year may well give an indication of the true extent of progress.

Ones to watch

In previous years, the survey has highlighted names to watch in each category of service. With the greater number of questions in this year's survey and the presentational split between long-only and hedge fund respondents, continuing previous practice would have risked dilution of the value of the Roll of Honour mentions.

As a result, and following the example of the awards presented by The TRADE each year, Ones to Watch have been put into two simple categories. First are those firms that seem, based on response numbers, to be winning clients. Second are those that, based on scores achieved, appear to be highly regarded by the clients that they have.

RESPONSE NUMBERS

ROLL OF HONOUR

- Barclays
- Jefferies
- Sanford C Bernstein

Clearly there are providers of algorithmic trading services who may not see the totality of their business reflected in survey responses. Some clients simply do not choose to respond and others are prevented by internal policies or procedures. As such it is difficult to assess whether a growing but still relatively small number of responses, reflects a growing business or merely a higher participation level across a static client base. Both factors are especially relevant for hedge funds for whom a decision may be as much about prime brokerage services broadly as opposed to a simple reflection of algorithmic capabilities.

In any event, based on responses received this year and comparisons with prior years it seems relevant that the survey should seek to recognise institutions who appear to be successful in the marketplace but who have not generated responses from a sufficiently broad base of clients to qualify for Roll of Honour status outside the 'ones to watch' category. In that context, the three names listed are very much ones to watch, whether by the competition or by clients looking to expand their algorithmic broker list.

CLIENT SCORES

ROLL OF HONOUR

- ConvergEx
- Fidelity
- Jefferies

While fewer responses does not necessarily mean fewer clients there is a clear correlation in the survey between the number of responses received and market presence. Having a smaller number of clients does not always make service delivery easier, but it can help, particularly if clients are concentrated in more specific regions or type of business.

The Roll of Honour names here did achieve scores in a number of categories that were similar to those seen by the best providers. However they did so across a smaller number of respondents. Hence their inclusion in a 'ones to watch' Roll of Honour. If scores are maintained and client response numbers grow, then they will doubtless feature in the Roll of Honour in one or more categories in future years.

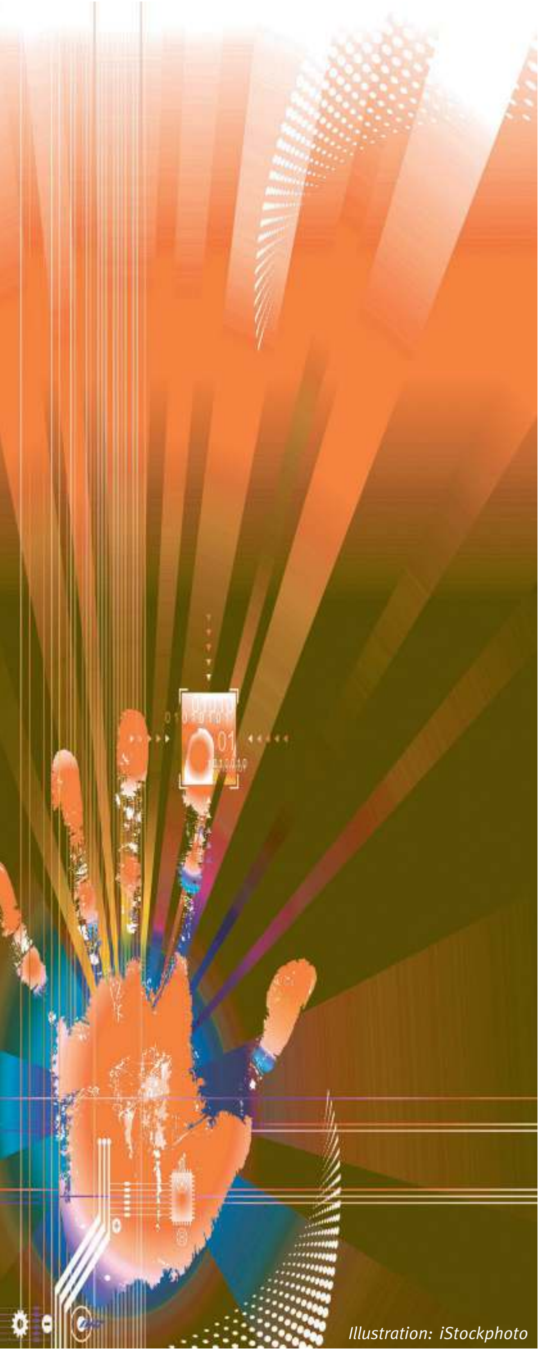


Illustration: iStockphoto

Automation with an increasingly human face

Brokers report that the trading strategies and execution priorities of hedge funds are gradually becoming more similar to those of long-only firms.

When comparing hedge funds to long-only institutional investors, brokers agree the differences in strategies are more subtle than was perhaps once the case, with both groups looking for liquidity, reduced market impact and transparency when trading in the equities market.

In some cases, telling the difference between a hedge fund and traditional long-only firm is not possible, according to some brokers. In an age of market fragmentation, finding liquidity is at the top of everyone's agenda, but a slight preference for automation sets the hedge funds apart.

Usage of algos varies from firm to firm, however. At London-based hedge fund Marshall Wace, for example, head of trading Nick Nielsen says just over 95% of trades go through algorithms (see buy-side algo forum on page 79). While a number of hedge funds large and small have been at the forefront of trade automation for several years, firms like Marshall Wace represent the cutting edge rather than the norm.

Nevertheless, The TRADE's 2014 Algorithmic Trading Survey found hedge funds execute a higher percentage of trades via algorithms, with 47% of respondents saying 40% or more of trades are executed through algorithms, compared to only 39% of long-only funds.

Chris Jackson, head of sales, Europe, electronic trading, Citi, said the use of algos depends on the investment focus and related characteristics of any particular hedge fund. On one side the needs of the hedge fund community are distinct, while on the other, many hedge funds behave similarly to asset managers. "What drives the difference is a function of size and scale," he said.

Many hedge funds have higher turnover than long-only funds, and therefore are more attracted to low-cost trading strategies, according to Jackson. "Hedge funds are trading in and out of stocks on a far more frequent basis than perhaps most long-only firms, so they are going to be far more sensitive to higher transaction costs," he says.

Another potential reason for greater hedge fund use of algorithms is that many of them 'grew up' in an era of increasing trade automation in the equities space and did not have or need long-held relationships with sales traders to find liquidity. In comparison, many long-only firms had a tradition of reliance on capital commitment and human interaction with brokers.

"Algorithms price more competitively than a high-touch service. Reducing market impact is also clearly important to them and the right algorithm would be good at doing that. Many of the dealers in the hedge fund community are also ex-sell-side and therefore have a greater familiarity with trading algorithmically," says Jackson.

Overcoming fragmentation

Rob Shapiro, head of trading and execution consulting, Bloomberg Tradebook, says hedge funds appreciate the anonymity and the ability to source liquidity in an effective manner. This means balancing access to multiple pools of liquidity with the need to leave the smallest possible trade footprint. "Market structure is terribly complex and the ability for an algorithm to source your liquidity in a fragmented world is certainly very important."

Many hedge funds put an algorithm in motion and then ask the broker to watch it, Shapiro says. "A well-stocked desk might be using algorithms, but also picking stocks and using a direct market access tool."

According to Rupert Fennelly, managing director, electronic trading, Europe at Morgan Stanley, hedge funds now had access to smarter algorithms that allow them to do what

"Hedge funds are trading in and out of stocks on a far more frequent basis than most long-only firms, so are more sensitive to higher transaction costs."

Chris Jackson, head of sales, Europe, electronic trading, Citi

larger firms have been doing for years, such as auto routing.

"If easier orders hit the desk, for example, orders that are a smaller proportion of the average daily volume where traders may not necessarily add value, they are becoming auto routed," he says. "Now that's a phenomenon that has existed with our larger long-only clients for a few years, but hedge funds

Market feedback: hedge funds

“The ability for an algorithm to source your liquidity in a fragmented world is certainly very important.”

Rob Shapiro, head of trading and execution consulting, Bloomberg Tradebook

“Hedge fund traders are engaging more with sales traders, while trying to source liquidity through that low-touch channel.”

Rupert Fennelly, managing director, electronic trading, Europe, Morgan Stanley

are starting to do that. It’s about productivity.”

There has also been an increasing trend towards multi-asset trading among hedge funds, according to Shapiro, with any one trader often trading more than one class. “Tradebook’s execution consultants interface with that type of trader not only to help them navigate the execution toolkit, but also to manage the market structure challenges of multi-asset trading,” he said.

The TRADE’s 2014 Algorithmic Trading Survey showed hedge funds have fewer broker relationships than institutional investors, with 22% and 43% having five to seven algo providers respectively. According to Jackson, this is due to them typically being smaller, with less commission to go around.

Hedge funds are typically more concentrated in the stocks they follow as well, Fennelly notes. While the average hedge fund has perhaps 30 long positions and maybe 60 to 70 shorts, large asset managers might run 600 to 700 different names, and therefore require more support from the sell-side.

However, despite hedge funds overall being bigger users of algorithms than other funds, they are increasingly agnostic on how they seek liquidity. “Hedge funds have always been adopters of electronic trading, but they are now looking at how to

"There is now more focus on 'how you are policing your pool?' and 'how are you protecting my order flow?'"

Eric Krueger, head of EMEA program and electronic sales, Barclays

concurrently work more with the high-touch side to find liquidity," says Fennelly.

"Hedge fund traders are engaging more with sales traders in terms of what orders they are working on, while trying to source liquidity through that low-touch channel."

Desperately seeking answers

Liquidity may be at the top of everyone's agenda, but transparency is also a priority for hedge funds, who have started a quest for more detailed answers about how trades are routed.

"We are encouraged to see hedge funds ask more questions about what's happening with their orders, demanding transparency around venues and where their orders have been sent," says Fennelly.

There has been an increasing debate about the influence of high-frequency trading (HFT) on market structure, particularly following the publication of Michael Lewis' 'Flash Boys', which focuses on the rise of HFT in the US market and makes the assertion that the market is rigged against investors.

"The makeup of liquidity in the market has changed tremendously," says Fennelly. "Not every venue is created equal. Different venues have different rules, which means information in a client's order may have varying levels of protection depending on which venue they are exposed to. It's important for the hedge fund to understand where their orders are being exposed."

Eric Krueger, head of EMEA program and electronic sales at Barclays, agrees that transparency is an issue of growing concern for many hedge funds. In the past, the focus was on the size of your dark pool and the crossing rates it provided. It was a question of size," he says. "Clients still look at the liquidity you provide, but I think there is now more focus on 'how you are policing your pool?' and 'how are you protecting my order flow?'" Krueger suggests that hedge funds are also more focused on post-trade market structure analysis than previously, in line with a broader appreciation of overall trading costs on the buy-side more generally.

Going forward, Citi's Jackson said hedge funds would likely have more influence on how brokers organize their trading coverage teams. "Typically there has been separate program, cash and electronic trading. However, people are exercising more choice over that model. Funds want more coverage in all three trading styles from the same person, or the choice to opt in and out." As for long-only firms, the hedge funds' priority remains liquidity, and they are they are not prepared to accept silos or any other barriers to finding it. "Clients are really happy if we can find liquidity," says Jackson.