ALGO SURVEY 2017

Standfirst tk

Quality not quantity

This year, The TRADE's Algorithmic Trading Survey gives an insight into developing industry trends in the final year before MiFID II. The result reveal a flight to execution quality and a rationalisation of broker and buy-side relationships.

This year's algo survey – celebrating its 10th year - reveals an industry in flux, with some fairly rapid transformation in the way long-only funds use algos, what their priorities are and which brokers they work with. This probably doesn't come as much of a surprise as a mix of commercial and regulatory pressures are mounting for both the buy- and sell-side and this is having a knock-on impact for the securities trader's most important tool, the trading algorithm.

The results of this year's survey were collected at a time when firms had less than a year left to implement MiFID II, which is expected to have a significant impact on the commercial fortunes of the investment banks and the extent to which the buy-side will be able to utilise trading in the dark and it seems that many of these issues are already starting to filter through to the way buy-side traders think about their algo strategy and broker relationships.

Beginning with the average ratings the buy-side have given their algorithm providers this year, Fig 1 reveals some interesting new developments in 2017. We can see that both market impact and anonymity have risen up the list for long-only asset managers this year. Market impact received the second highest average score at 5.89 while anonymity followed close behind with the third highest average score of 5.85. There are a couple of potential reasons for this. Firstly, many brokers have in recent years been censured by regulators for failing to properly protect their clients' order information and for indulging HFT firms over their buy-side clients. The effect could be that they are taking more care to ensure they properly protect client order information as much as possible, due to pressure from both clients and regulators. If that's the case, it seems they have been somewhat successful in allaying these fears. The second reason is simply that the sell-side might just be further refining their processes to provide clients with their key demands. Either way, it's a positive development for both sides of the Street if client orders are seemingly less prone to information leakage.

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However, the area which received the highest score was execution consulting. A relatively new term in the investment bank lexicon, execution consulting is essentially the process of helping buy-side clients to better understand their execution process and outcomes, analyse all the transaction cost analysis (TCA) data their receive, and use that knowledge to achieve the best possible execution. Again, regulatory and client pressures are thought to be largely responsible here. Upcoming MiFID II rules will force the buy-side to do more to achieve best execution and many

are seeking professional assistance from their brokers. Similarly, while algorithms have become highly commoditised, banks have been forced to seek new ways to make money and execution consulting is a way to get the most out of the expensive professionals they employ.

Similar factors that seem to be driving where algo providers invest their resources are also impacting what the buy-side prioritises when choosing its algorithms. To demonstrate just how quickly this change in attitude is happening, this year the area which topped Fig 2 was "consistency of execution performance" which was one of the lowest priorities back in 2015. Again, a regulatory focus on ensuring the buy-side achieve best execution from their clients is altering industry behaviour and increasing the need of firms to develop a more consistent and professional approach to their trading activity. Reducing market impact has always been a highly valued feature of algo usage and is becoming even more important it seems, with 13.9% citing this as their reason for using algorithms, while increased trader productivity, which dipped in 2016, has returned to being one of the key reasons to use automated trading.

Areas of declining significance include the ability to trade at speed. While 7.1% cited this as their main reason for using algos in 2015, just 5.8% think it important in 2017. This perhaps reflects technological advances meaning that, in most instances, the speed at which algorithms can help trade has reached its apex. The benefits of internal crossing have also fallen down the priority list, with just 7% citing it this year, up from 4.4% last year but down from 9.2% in 2015. As the main vehicles of internal crossing, broker crossing networks (BCNs), are to be banned under MiFID II and following several scandals relating to these dark pools in recent years, it may be the buy-side is less keen to trade internally via their broker. It's also worth noting that European legislators rejected internal crossing on a BCN as something that is potentially incompatible with the spirit of the best execution rules.

Client consolidation

A breakdown of the average number of providers used by asset managers of varying sizes reveals one undeniable trend, that most firms are using less algo providers than they were in the past. Mid-sized firms with between $10-50 billion of assets under management have increased their average number of algo providers since 2016, but only a slight rise from 3.75 to 4.07, while some very small fund managers saw a bigger increase from 1.12 last year to 2.2 this year.

So what can we garner from this information? Buy-siders interviewed by The TRADE in recent years have often said they are looking at rationalising their broker lists and cutting down on their broker relationships. There are a number of commercial and regulatory reasons why this could be attractive, not least to cut down on the technology burden of potentially connecting to myriad broker technology platforms.

The top 10

The TRADE would like to thank all of the sell-side and buy-side institutions that took part in this year's survey. As always, we encourage as many firms to take part as possible and to get their clients involved. Our top 10 of providers by responses shows that both Societe Generale and Kepler Cheuvreux put in that extra effort this year to elevate themselves above the competition here. We look forward to hearing you responses to our next survey in 2018, which will hopefully reveal some early trends of the post-MiFID II era.

Provider	Ranking by response rate
Societe Generale	1
Kepler Cheuvreux	2
BAML	3
UBS	4
JP Morgan	5
Exane BNP Paribas	6
Credit Suisse	7
Morgan Stanley	8
ITG	9
Citi	10

But at the same time, we are also seeing many brokers choose to focus more on their most profitable accounts. Most recently, Deutsche Bank announced it would be cutting down its client numbers quite significantly. The reasoning is that only around 20% of a brokers' clients are truly profitable, the rest

Fig 1: Average score by product feature

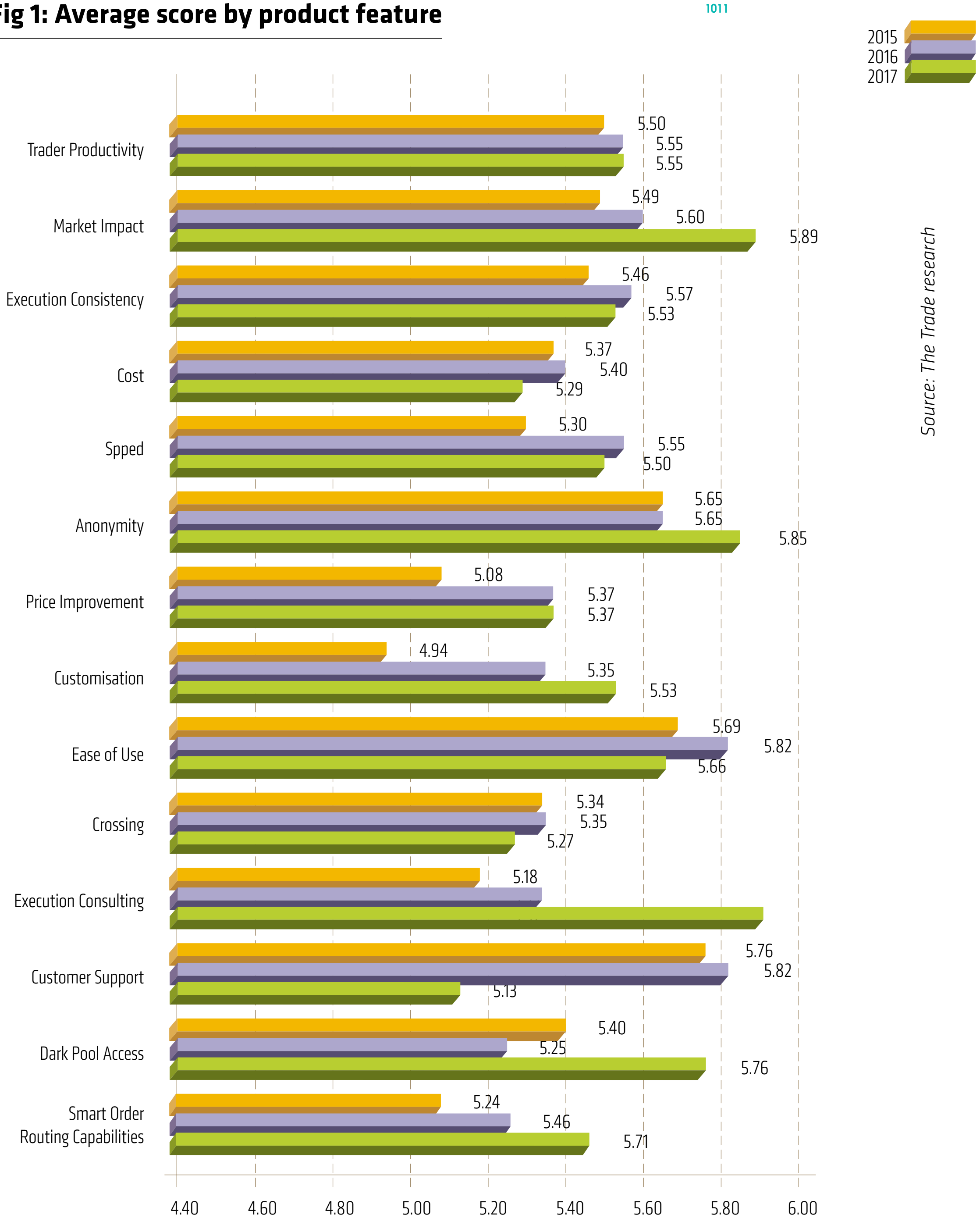
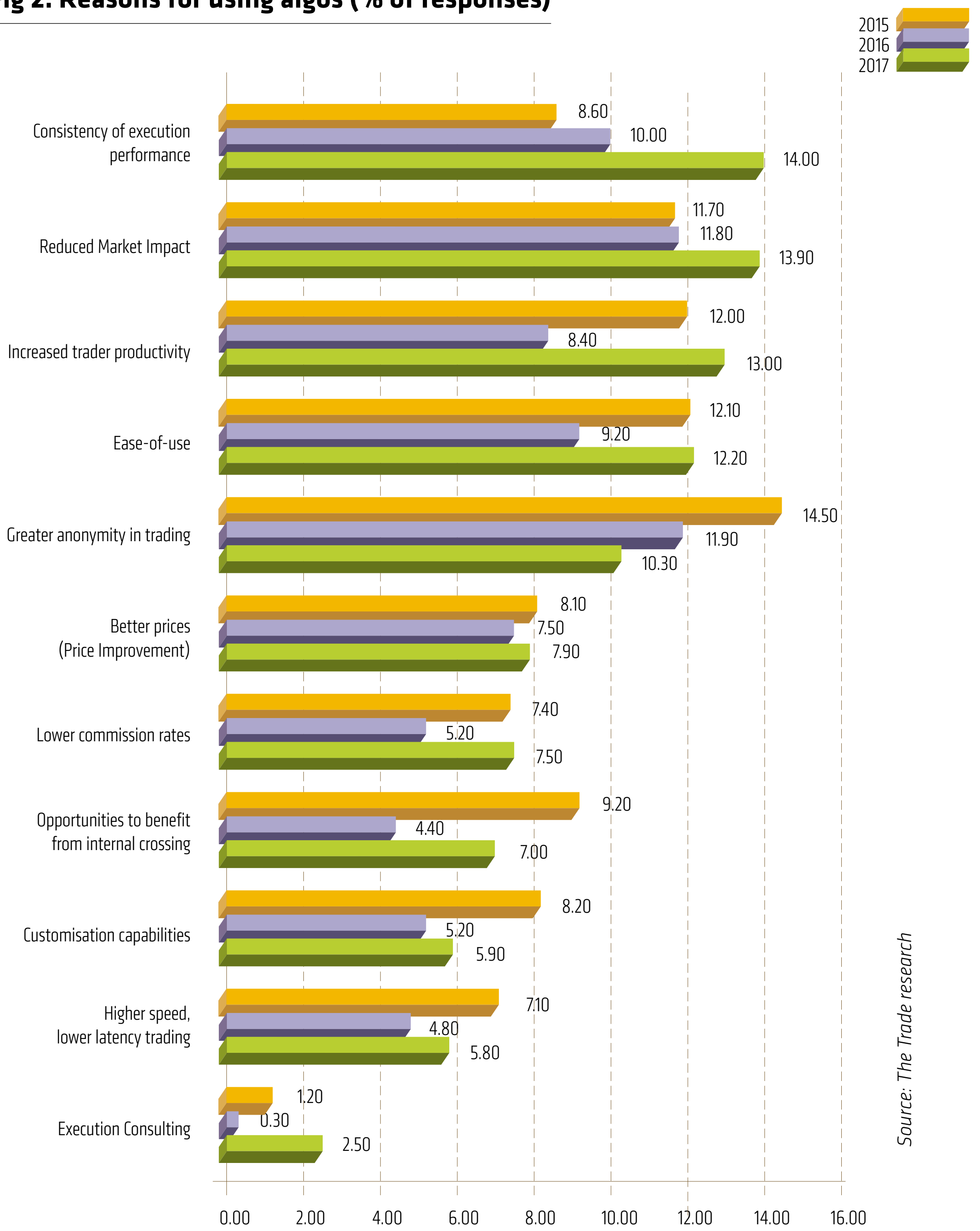


Fig 2: Reasons for using algos (% of responses)



Source: The Trade research

simply don't trade enough with them to make serving them worthwhile. While this situation was allowed to exist in the past, a more challenging business climate for investment banks means many now need to rationalise their client lists.

Among the smaller funds in particular, many now only rely on a single broker to provide their algorithms. While this may be a tolerable situation for the time being, when MiFID II is introduced early next year, it could cause problems with meeting best execution requirements when you only have access to a very limited pool of algorithmic trading options.

The same trend can be clearly seen when looking at the proportion of firms using different numbers of providers seen in Fig 4. While the percentage using five or more providers increased considerably from 40.5% in 2015 to 54.5% last year, but this has now fallen back even harder in 2017 to 34.9%. The particularly large shift seen here is likely reflective of the mix of buy-siders reducing their broker relationships voluntarily and those with whom the sell-side is forcibly cutting ties. It has not been unknown for asset managers to use as many as 10 different brokers (sometimes even more than that) but realistically, with such a large broker pool, the amount of business some brokers receive must be minimal and in many cases the relationship may only exist to give the asset manager an additional pool of analyst research to draw from. Both best execution and unbundling rules that will be part of MiFID II clearly make this situation unsustainable for both sides of the Street. However, using five or more brokers still makes up more than a third of firms, and more than any other category, indicating firms remain relatively diversified.

While there are less firms using 5+ brokers, there has of course also been an increase in the proportion using fewer brokers. Significantly, the percentage of firms using only one or two algo providers has reached 34%, only just short of the proportion using five or more,

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showing that many more firms are now making do with only a very limited selection. As alluded to above, this could pose problems for the future if firms narrow their broker selection too much and risk missing out on best execution opportunities.

CROSSHEAD

While provider numbers may be on a downward trend, one area which never ceases to head upwards is the proportion of trades handled by algorithms. The number of firms trading 40% or more of their value through algorithms has rocketed in recent years and 2017 is no exception. While back in 2015 only 24% of firms traded such a significant proportion of their securities via algo, this has steadily grown to 34.3% in 2016 and 43.3% this year.

It seems almost inevitable that the continued march of technology would push ever increasing volumes of trades to be executed through algorithms. Traders are becoming more comfortable with the technology now and are gaining more experience, meaning they are now more able to make the most of the algo tools on offer. It's also true that both asset managers and brokers have seen their resources strained and, in these circumstances, it makes sense to let an algorithm deal with much of the day-to-day trading activity so that a human trader's time can be spent on more complex or sensitive orders. The real question is, have we peaked? It certainly doesn't seem like the growth in electronic and algorithmic trading is set to slow down any time soon and regulators are now attempting to push other asset classes such as fixed income into the electronic and automated space as equities was in the past. Given the circumstances, The TRADE expects algo trading number to continue to grow in 2018. The only potential stumbling block is a greater expectation by regulators that buy-side traders have a comprehensive understanding of how the algos they use actually work, but this is unlikely to put anyone off using algos, it will simply increase the onus on brokers and the buy-side to make sure traders are well trained.

Interestingly, the area which has shrunk the fastest is those firms trading from 30-40% of their volume via algo. This has gone from

Fig 3: Average no. of providers used by asset manager AUM

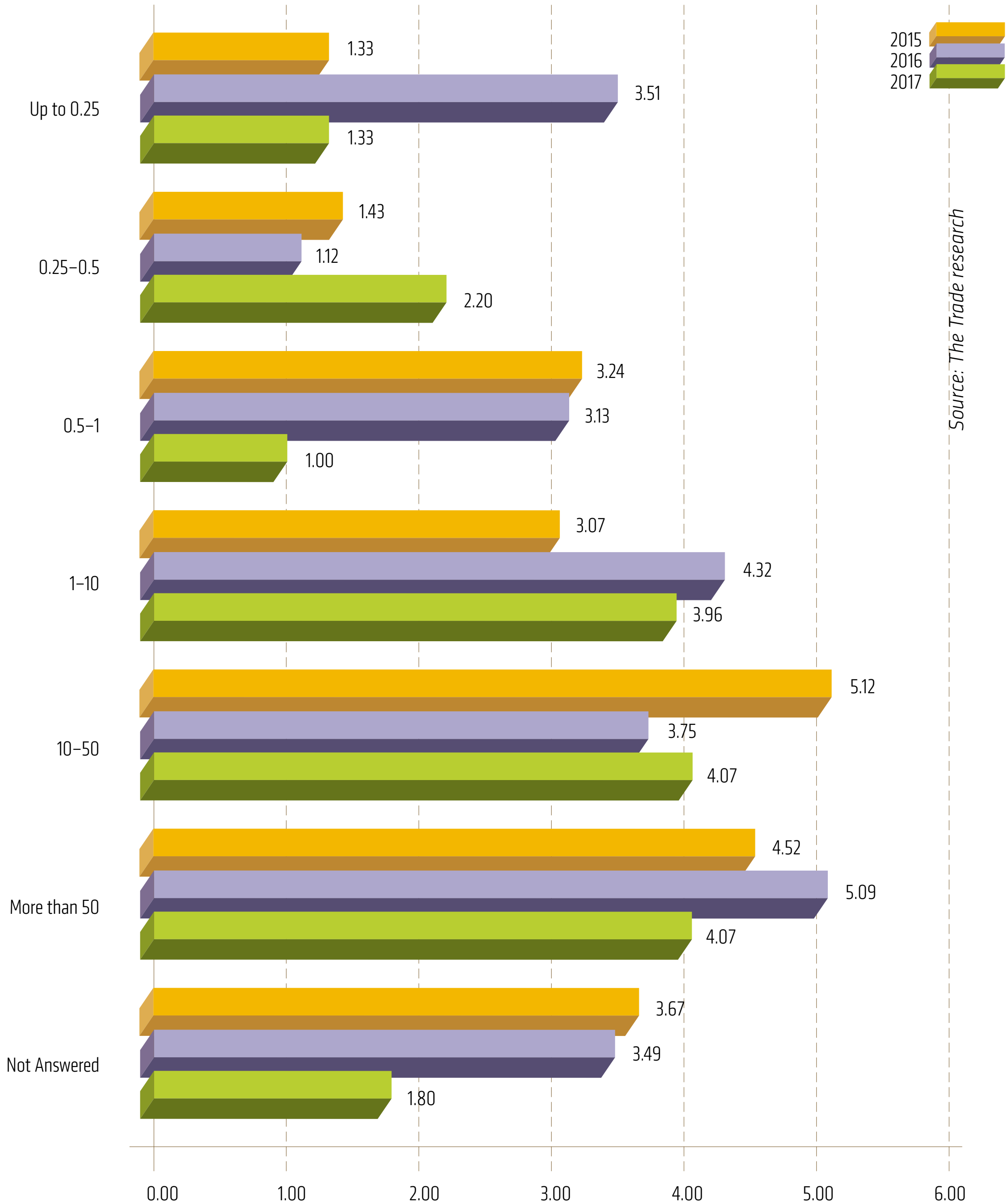
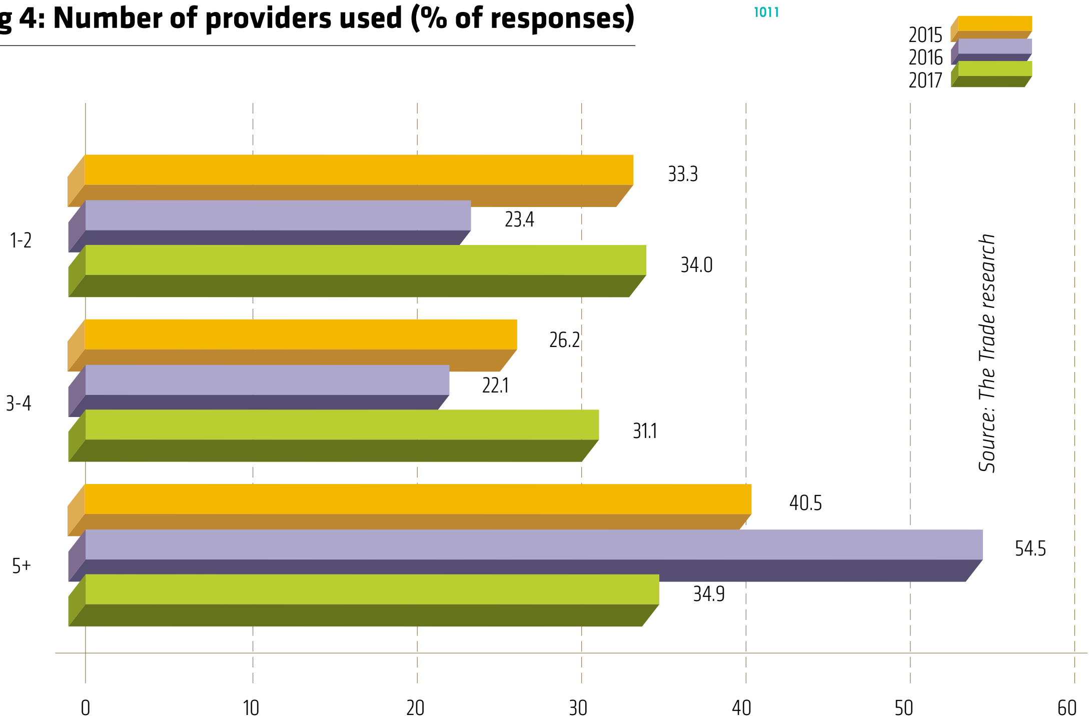


Fig 4: Number of providers used (% of responses)



24.7% in 2015 down to just 4.8% in 2017, almost the exact opposite of the higher bracket. This suggests that, those firms which were already heavy users of algos have simply become even fonder of them and shifted more trading into the automated space. Lower-down the scale, only the sub-5% category reveals any interesting trend, having grown from 3.9% in 2016 to 9.4% this year, though this is still well below the 13.3% seen in 2015. Still, it seems some firms may be cutting back on the automated trading, perhaps due to a realisation that algorithmic trading does not always produce the best results, especially for those with more complex needs.

And finally we come to Fig 6, which shows the percentage of firms using particular algos. Straight off the bat we can see that participation-based algos have continued their fall in popularity seen last year, dropping down to 52.9%, well below the 79.1% seen in 2015. Last year's most popular choice, the dark liquidity seeking algo, continues to lead the field this year with only a small decline from 81.9% in 2016 to 79.9% this year. It is unclear what the impact of dark pool caps in Europe will have on this. While it could push more firms to execute large-in-size orders (because they're excluded from the dark pool cap) that are normally not automated, it could also increase the importance of being able to tap into dark liquidity when it is available.

TWAP's popularity has fallen over the past couple of years and is now used by just 16.3% of firms, while VWAP staged a recovery after falling from 50.2% in 2015 to 43.7% last year, it's now back up to 48.7% meaning this particular strategy seems to be relatively adaptable to changing market conditions.

This year's survey definitely paints an interesting picture and gives some insight into how 2017 - which is bound to be dominated by discussion of MiFID II in both Europe and other parts of the world - is seeing changing attitudes towards automated trading. However, readers may already be keen to know what will be discovered in next year's survey, when the new rules will be in force and the true consequences for buy-side trading will begin to become apparent.

Fig 5: Proportion of trades executed with algos by value (% of responses)

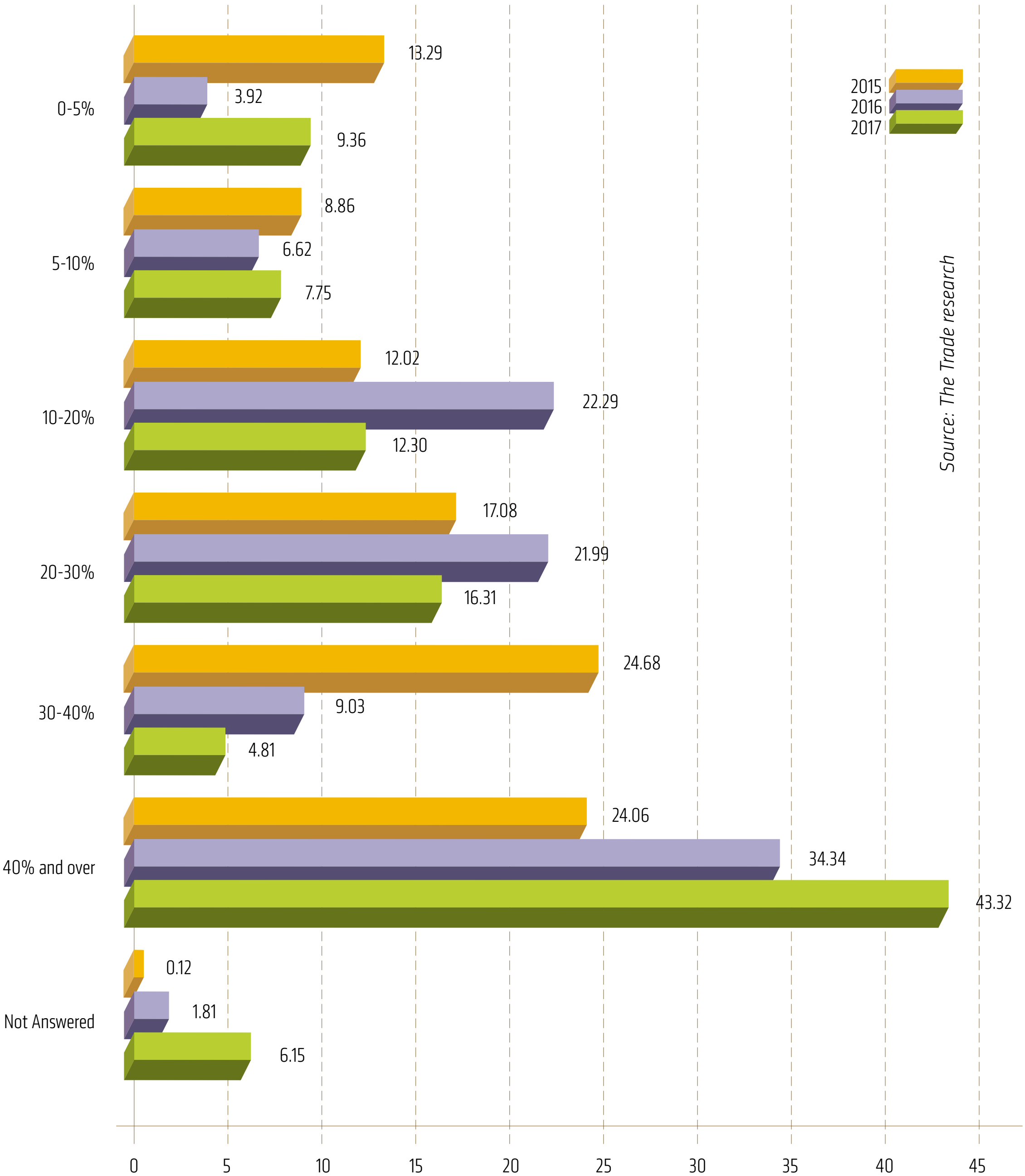


Fig 6: Type of algo used (% of responses)