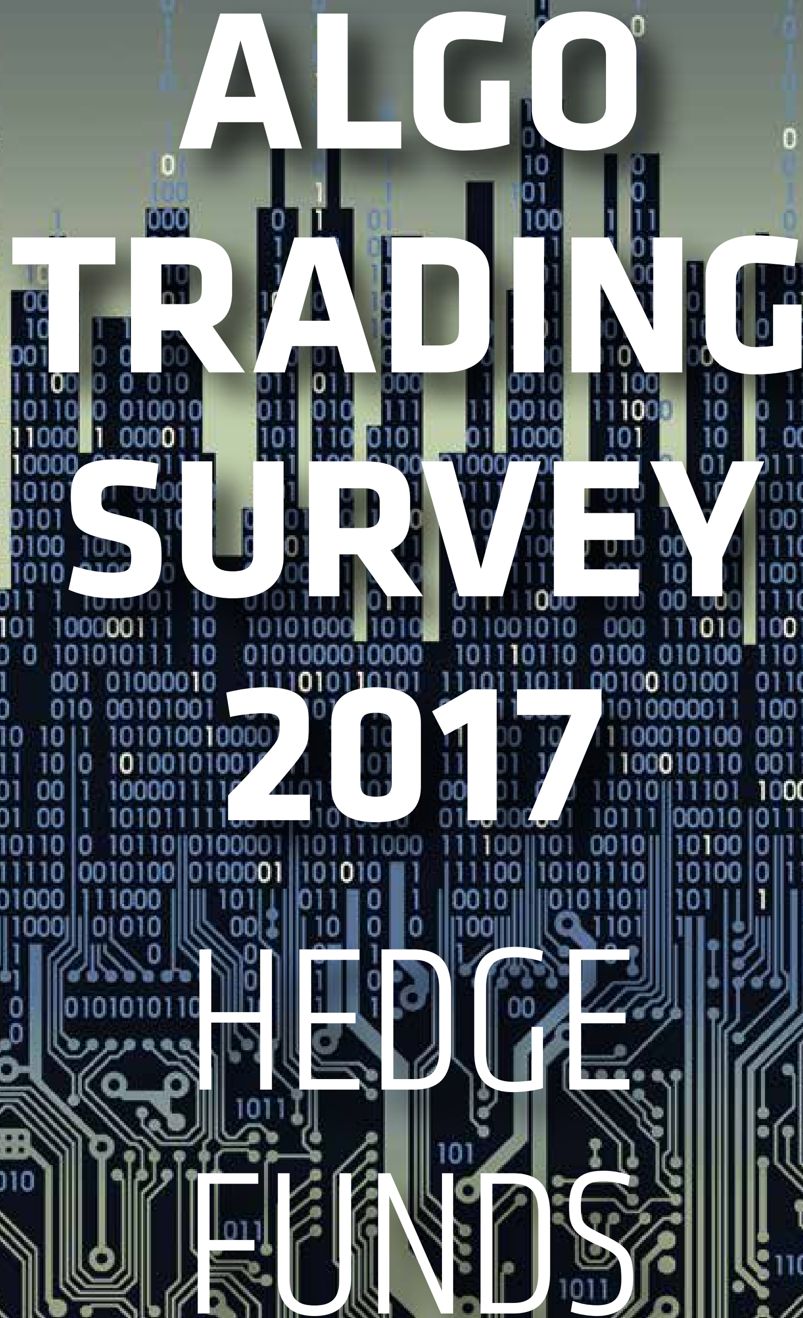
ALGO TRADING SURVEY 2017

HEDGE FUNDS



Making an impact

A comparison of hedge fund and long-only priorities on algorithms reveals some intriguing trends.

The results of our survey of algorithmic trading among long-only funds (The Trade 51 pg 66) found the industry was seeing a flight to quality. As market conditions become more challenging and banks see a squeeze in revenues, both the sell-side and the buy-side were looking to rationalise their relationships and stick with their best clients and providers respectively.

It also found there was a growing need for more complex services to help long-only managers truly understand the execution process and get the most from every algo they deploy in the market.

This issue we take a look at how the priorities of hedge funds differ from their long-only peers as these two important pillars of the asset management industry seek out different approaches to major transformations in regulation, market structure and the economic environment.

Looking at scores given to key product features by the two types of asset manager (Fig.1) we see some key points of divergence.

Among long-only managers market impact scores soared to an average of 5.89 and this has been even more pronounced among the hedge funds, who gave market impact an average score of 6.06. This is likely due to the extra attention hedge funds will require over an issue so important to the kind of arbitrage strategies they commonly deploy, something their providers will no doubt put extra effort in to providing.

Another key point of difference is in execution consulting. While this is now the highest scoring area for long-only funds at 5.91, scores from hedge fund clients were far lower at an average of just 5.24.

"There was a growing need for more complex services to help long-only managers truly understand the execution process."

This seems at odds with what The TRADE has been hearing from the sell-side about execution consulting services, which many now view as a key priority ahead of the introduction of MiFID II's stricter rules on best execution. However, it may simply be that the kind of execution consulting services developed so far are more appropriate to the much larger market for long-only strategies, or it may simply be that hedge funds feel comfortable with their execution capabilities and thus see less value in such a service.

However it certainly does not seem to have led to a feeling among hedge funds that they aren't getting good service levels, with a very high average score for customer support of 6.0, much higher than the fairly dismal 5.13 given by long-only managers. Algo providers can rest assured their hedge fund clients appear to be very content with the customer support they receive.

For the most part, hedge funds seem to have similar reasons for using algorithms as the long-only funds as shown in Fig.2. Issues such as reduced market impact, consistency of execution, ease-of-use and increasing trader productivity are at the top of the list for both. While the exact numbers vary there are few significant

Fig 1: Average score by product feature

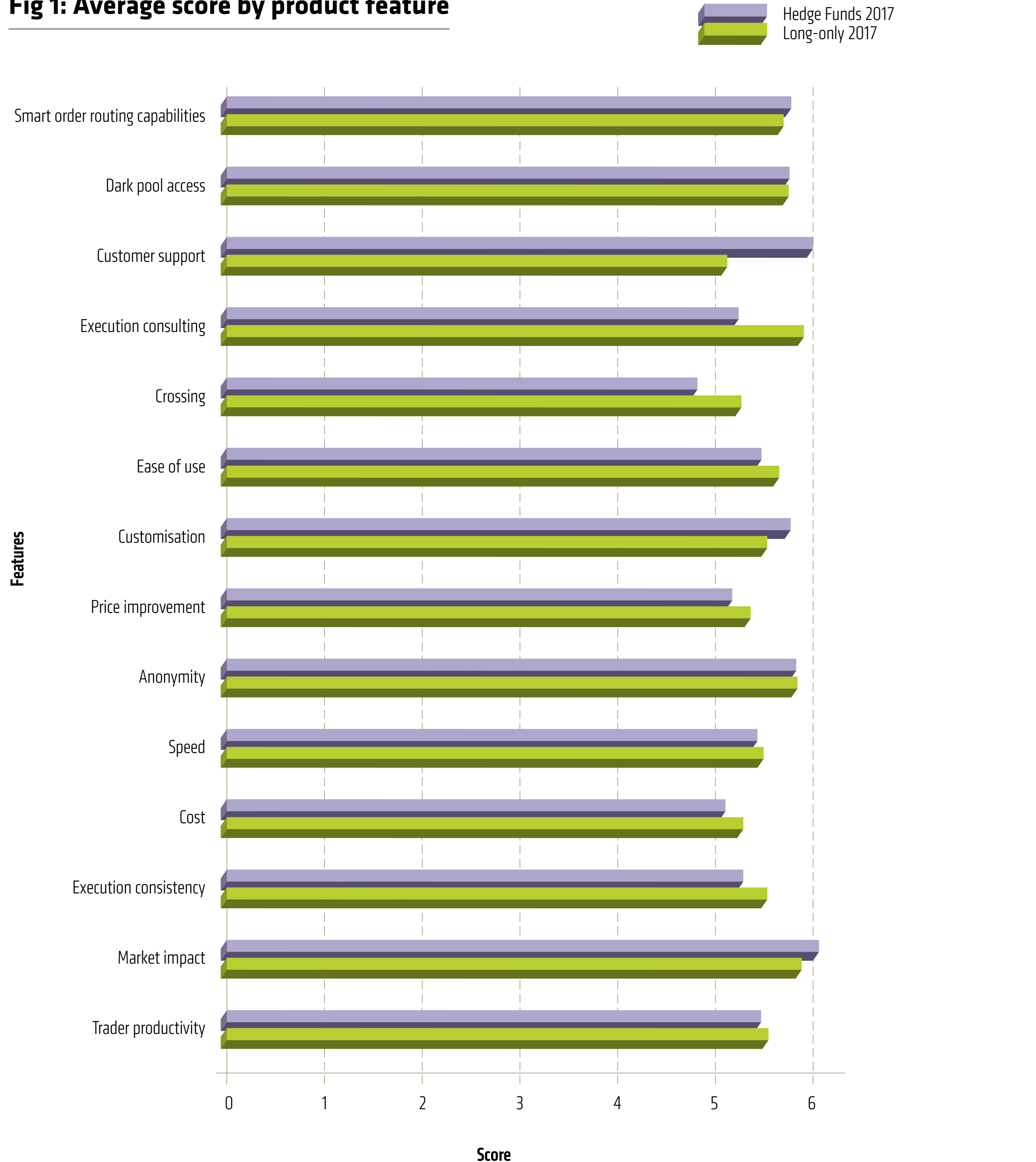


Fig 2: Why traders use algos

Hedge Funds 2017
Long-only 2017

Reasons for using algos

Execution consulting
Higher speed, lower latency trading
Customisation capabilities
Opportunities to benefit from internal crossing
Better prices (price improvement)
Lower commission rates
Greater anonymity in trading
Increased trader productivity
Ease-of-use
Consistency of execution performance
Reduced market impact

0.0 2.0 4.0 6.0 8.0 10.0 12.0 14.0

Percent of responses

Fig 3: Types of algo used

Algo type

Vwap

Twap

Implementation shortfall (single stock)

Implementation shortfall (basket)

Dark liquidity seeking

% Volume (participation)

Hedge Funds 2017

Long-only 2017

0.0 10.00 20.00 30.00 40.00 50.00 60.00 70.00 80.00 90.00

Percentage of respondents

differences.

However, some minor discrepancies can be revealing. Over 9% of hedge funds said lower commission rates were a priority for them compared to 7.5% for long-only funds. Given that at least some part of a hedge fund strategy is to make returns from trading activity, rather than purely on increasing security prices and dividend income. Keeping fees low is thus vital to realising their goals. Customisation was also a bigger priority for hedge funds, at 7% compared to 5.9%, again perhaps reflecting their desire to take more control of their trading to be able to use their sophisticated strategies to the best effect.

Hedge funds on average tend to use less providers than long-only funds. Fig.4 shows over half use only one or two providers, while 19.1% use three-four providers and 29.1% use five or more. This compared to a fairly even split of around a third of long-only funds in each category. This may be because less providers in general offer the kind of specialist services hedge funds need, but could also be due to rationalisation of client books falling particularly heavily on hedge funds compared to long-only funds.

For a fuller view of the major trends seen in this year's Algorithmic Trading Survey, check out our write-up from the Spring 2017 edition of The TRADE, available in print and online.

Fig 4: Provider usage by AUM

Hedge Funds 2017
Long-only 2017

Total assets billion (USD)

Not answered
More than 50
10-50
1-10
0.5-1
0.25-0.5
Up to 0.25

0 0.5 1 1.5 2 2.5 3 3.5 4 4.5 5

Average number of providers

Fig 5: Proportion of algo executed trades by value