As 2010 draws to a close, a chastened Wall Street has emerged. Financial services firms have been reined in by the strictest regulatory environment since the FDR administration, an uncertain macroeconomic landscape and choppy trading conditions.

Even as the global financial crisis continues its arduous slog into the rearview mirror, industry insiders say the buy side will remain cost-sensitive in 2011, with an eye on boosting assets under management while paying less for trading tools and executions. Meanwhile, as regulators sort out how the landmark Dodd-Frank Wall Street and Consumer Protection Act will function, experts predict buy-side firms will lobby hard in the nation's capital to ensure that they get a favorable interpretation of the new rules.

1. Growing Reliance on TCA

But with fund managers increasingly challenged to generate alpha -- a measure of a manager's ability to outpace general U.S. stock market returns -- the biggest buy-side trend next year will be firms' heavy reliance on transaction cost analysis specifically to entice investors, contends Fred Federspiel, founder and CEO of Pipeline Trading Systems, the New York-based operator of the Pipeline ATS, which specializes in block executions. "In the upcoming year we will see a real revolution in transaction cost analysis as firms deploy TCA that is completely focused on increasing assets under management," Federspiel predicts. "We are finally at the point where we can move beyond VWAP [volume-weighted average price] benchmarks, beyond noisy implementation shortfall benchmarks, into TCA that helps traders make decisions that increase alpha capture by the trading desk."

Federspiel says the controversy surrounding high-frequency trading in the aftermath of the May 6 Flash Crash has been a blessing in disguise of sorts for institutional investors because it raised their awareness of adverse selection costs, which essentially push the
execution of trades beyond the best possible price. Typically, he explains, institutional investors such as pension plans have relied on the volume-weighted average price, which is calculated by dividing the total cost of every trade in a given security for the day by the total number of shares traded.

But many market participants observe that high-frequency traders, whose black boxes are collocated at the exchanges, are able to outmaneuver slower-moving investors, forcing institutions to pay more for buys or to sell stocks for less than they could have -- discrepancies that are hidden from VWAP analysis. Federspiel argues that innovation in how TCA is used will level the playing field.

"In the last several months we've had intense scrutiny placed onto the question of high-frequency trading, its value and its negative impact on the institutional trading community," Federspiel says. "That scrutiny has led to a blossoming of our understanding of adverse selection costs. And we now have TCA methods that measure the adverse selection costs involved with different trading techniques, and we can identify -- and traders can now use -- those TCA techniques to minimize their losses to high-frequency trading operations."

As high-frequency traders continue to usurp the role traditionally played by market makers and specialists, TCA will help institutional investors source liquidity without paying exorbitantly for it, Federspiel explains. "You can't hide in dark pools -- [high-frequency traders] are in every market and in every dark pool, so the key is to properly identify trading techniques that minimize these losses in different market conditions," he advises. "The main goal is collecting sufficient liquidity but doing so without incurring excessive losses due to high-frequency trading operations."

In a difficult market where alpha has proven to be elusive, the buy side will take a more critical look at the TCA tools it gets from providers, adds Ethan Levinson, president of agency broker SJ Levinson & Sons. "From a TCA standpoint, how useful are the numbers?" he poses. "People are starting to evaluate the cost of doing business across the board."

Levinson, whose firm provides institutional clients with quantitative analytics along with global equity and derivatives strategies, contends that in today's volatile markets, static reports won't be enough to satisfy buy-side desks. Rather, buy-side traders will demand real-time service. "As volumes are down and people are a little bit more skittish on the market in general, [traders] need to go to a place where they feel they can trust the person on the other end of the phone," Levinson says.

2. Rising Use of Algorithms

In addition to increased reliance on TCA, experts also predict that the buy side's use of algorithmic trading will soar next year, as more and more firms opt for self-directed trading. Earlier this year, a Tabb Group survey found that 35 percent of buy-side firms plan to employ algorithms next year.
But the buy side will proactively seek to customize algorithmic strategies to fit their objectives, according to Bloomberg Tradebook president and CEO Ray Tierney. "On the buy side, at the end of the day, customization of the algorithm matters," he says. "Flexibility, whether at the portfolio or trading level, to develop customizations with your electronic trading partner is key."

3. Greater Cooperation with Regulators

The buy side also is taking a proactive stance toward the Dodd-Frank financial reform legislation, the most drastic rewriting of the rules governing Wall Street since the 1930s. Rather than let regulators control their destiny without a fight, buy-side firms have been busy trying to ensure that the new law doesn't hurt their bottom lines, according to Vlad Khandros, who analyzes market structure for institutional broker-dealer Liquidnet.

"The buy side is working more closely with the SEC -- it's getting more involved in working with the regulators to determine what the industry should look like," Khandros relates. "We've seen more buy-side firms get involved in that process. We've helped some write comment letters."

According to an October report by Bloomberg News, Wall Street lobbyists -- including some from hedge funds -- have swarmed the Commodity Futures Trading Commission in recent months as their firms look to secure exemptions from parts of the historic law.

4. Growth of Hedge Funds

As the calendar flips to 2011, hedge funds are carrying as much momentum as any buy-side segment. In October Chicago-based Hedge Fund Research reported that hedge fund assets under management soared by $120 billion in the third quarter of 2010, the sector's largest quarterly increase since 2007, to $1.77 trillion, their highest level since before the financial crisis began.

Against that backdrop, managers with an established track record at big firms such as Goldman Sachs and Morgan Stanley are going to be able to raise money to start new hedge funds, according to George Michaels, the founder of G2 Systems, a boutique consultancy and software integration firm. But these start-ups are going to look to shift the cost of their software onto the sell side, mirroring a growing trend throughout the rest of the buy side, he explains.

5. Increased Use of Sell-Side-Provided Technology

"What you're going to see a growth of is systems where the buy side can get a technology and convince the sell side to pay for it," Michaels contends. The sell-side firms that can provide those tools, likely through some sort of soft-dollar arrangement, he suggests, should be able to capitalize on the trend. "The big players in the execution space, … those guys are going to make money," Michaels insists.

In terms of functionality, he adds, the new funds are going to look to add as many functions as possible to their order management systems with an eye on doing their own
executions as a way to limit costs. "So the order management systems are going to have to become even more sophisticated," Michaels notes. And, "The execution management systems like Portware and FlexTrade are going to offer more features that resemble order management features."