Crossing frontiers

Until recently, cross-asset trading has been more hype than reality for much of the buy-side, but the recent period of recent volatility across the financial markets has made increased correlations – and opportunities – harder to ignore.

Bob Giffords

Suddenly everyone is doing it. “The days of equity sales traders not knowing about other asset classes are long gone,” says Alexandra Foster, head of execution sales, UK, at BNP Paribas. “Our whole process is to look at things from a cross-asset perspective.” For Foster, morning meetings cover credit and interest rates or FX as much as equities, convertible bonds or options. “We need to understand the markets in terms of these interconnections,” she explains, “and our research is published very much in the same way.”

“The buy-side is further out on the curve in terms of having one person trading multiple asset classes,” says Brian Fagen, co-head of liquid markets sales, Americas at Barclays Capital. “It’s been going on for quite a few years.”

According to Brian Mitchell, head of dealing and portfolio control at Baring Asset Management, the firm’s centralised Hong Kong desk facilitates equities and equity derivatives while London handles these along with fixed income, money markets, FX and related derivatives. “The majority – although not all – of our traders have cross-trained sufficiently to trade all the products day-by-day,” confirms Mitchell. “However, we’re probably still in the minority.”

“Does a tightening on the bond spread reflect a change in equity sentiment or not?” asks Paul Squires, head of trading at AXA

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Alexandra Foster, head of execution sales, UK, BNP Paribas

Investment Managers. “People need to understand that. Intraday volatility means that the opportunity for these arbitrage or timing plays is increasing.” Some of these linkages are simply due to increasing risk awareness. “We have to track credit spreads regularly now in reference to choosing our counterparties,” says Squires. “We’re starting to use these general correlations for trading decisions as well.”

Correlations abound

The markets are forcing people to see the world in all its colour. “At a high level, correlations between assets around the same underliers have grown exponentially,” notes Fagen at BarCap. “For example, the impact of what happens to credit translates now quickly into equity.”

“The classic high-frequency trader wants to buy cheap and sell rich at any given second,” says Abe Kohen, director of trading strategies at FlexTrade Systems, “so you have to know the fair value price of the interchangeable assets. Even the more traditional, long-only traders may still want to know whether the futures price is too rich or cheap as a signal for how the underlying market is likely to move.”

“It’s been estimated that in London 30-40% of equities trades are now driven by contracts for difference (CFDs),” says Steve Grob, director of strategy at Fidessa. “Since the counterparty has to hedge in the cash markets, you can’t really escape the cross-asset nature of the market these days. So now all venues, including MTFs (multilateral trading facilities), are thinking of listing CFDs.”

One MTF, Chi-X, has already made its first foray into the multi-asset world with the introduction of exchange-traded commodities in April.

“Equity options are another play,” says Squires at AXA. “We saw that last year with Volkswagen. It can tie down liquidity or signal market moves, so we use that as a checkbox too. The different desks share their views all the time.”
In October 2008, German car manufacturer Porsche made a profit of €6.8bn on options trades that increased its stake in Volkswagen to 75%. The resulting scramble for liquidity saw Volkswagen shares rise 400% in a matter of days.

New asset classes are always emerging. For example, in a research report published in May, Simon Carter, head of BNP Paribas’ equity derivatives flow research team, highlighted the significant upside potential for EURO STOXX 50 dividends, based on bottom-up stock-by-stock analysis. This follows the huge sell-off in dividends relative to equities in September and October 2008. “Interestingly, dividends have become one of the best performing asset classes in recent weeks, but we see further upside,” said Foster at the beginning of June. “A wide range of clients has been entering long dividend positions, with the trend increasingly moving towards using dividends as a separate asset class.” According to Foster, investors have been looking at buying dividends from a number of angles, including portfolio diversification, the use of dividends as an inflation hedge, and as alternative beta strategies, which involve replacing a long equity position with dividend exposure.

In Italy, even retail investors and some day traders trade multiple asset classes in multiple markets. “Retail bonds and warrants markets are the main battlefields for these kinds of professional traders,” says Luca Lancelloti, head of account management at technology firm List Group. “However, for now, the demand is for basic, low-latency, multi-asset market data and trading capabilities, not optimised performance metrics and benchmarks. It will come, but first we just need to be able to support aggregation and trading.”

**Strategic intent**

There are many kinds of cross-asset effects. For some it is more about awareness than action. “So now there’s fluid access to our information flow across all divisions,” says Fagen at BarCap. “Market reports and commentary for example. In some cases, people trade cross-asset as well and share tools between cash, program trading and derivatives all on the same platform. Where they want it, clients can also have a single point of contact across all products. The impact is growing significantly.”

For others actually trading across assets to gain alpha, exposure is the focus. “Volatility is making cross-asset much more relevant,” continues Fagen. “When a trader gets an idea how to...”

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*Brian Fagen, co-head of liquid markets sales, Americas, Barclays Capital*
create some alpha, he now looks at the spectrum of ways to implement it – stocks, options, credit etc. – and the impact cost of products and venues.” Traditionally, multi-strategy hedge funds might do this, but now long-only funds are starting to think this way. “We’re training our sales force to advise clients this way as well,” says Fagen. “We want to understand what kind of exposure they’re looking for, and then we can suggest the products to achieve it.”

“The liquidity just isn’t always there,” argues AXA’s Squires. “So my role as head trader is to ask the fund manager what his objective is and to suggest how we might do part on the credit side or as a single stock future if there’s not enough liquidity in the cash market. We add real value by feeding this market colour back to the fund manager, but it’s his ultimate investment decision.”

Mitchell at Baring agrees that the investment manager must take the lead. “If you are running a global, balanced mandate with base currency in US dollars, when trading in Hong Kong local currencies, you inevitably have FX decisions to make about funding or hedging, unless you’re still simply having custodians implement your FX requirements using standard settlement instructions. If investment managers are thinking around that, then so should your traders, when it comes to timing.”

“Most shops have separate roles for trader and portfolio manager,” observes Kohen at FlexTrade. “The PM may monitor the execution management system (EMS) to get a feel for the market, while the trader executes. Other shops will integrate the roles, and then the trader has a definite advantage with a real-time EMS to exploit all the multi-asset dynamics.”

“Larger buy-side firms are starting to bring in new people to sit between the portfolio manager and the trading desk,” says Fagen at BarCap. “These derivatives strategists work with the PM to help them to think about how to express their alpha.”

Broader horizons?
Trading a basket of instruments to achieve your investment objective is becoming much more common. “Traders have been using exchange-traded funds (ETFs) to gain exposure to market sectors for some years where there aren’t the index futures,” continues Fagen. “Now those ETFs are joined with other instruments or even custom ETFs to build highly specialised structures to deliver performance. However, one might want to limit that if the spread against some benchmark gets out of line, based perhaps on an historical threshold, as one might...”

“As equity transparency increases, people look for ways to avoid leakage.”
Steve Grob, director of strategy, Fidessa
expect reversion. It also depends on one’s alpha horizon.”

In some cases, client mandates restrict the cross-asset options. “Naturally, every trade has to be looked at individually depending on the client’s performance metrics and trading horizon,” says Foster at BNP Paribas. “If you’re constrained to maintain a certain participation, then cross-asset effects may be less relevant. But if there’s some discretion in the trading style, then the cross-asset context might determine how aggressive or not you are.”

In other cases, the investment strategy dictates the asset class mix. “It’s being driven by the hedge funds to some extent. The total return funds and other strategies encourage this tight coupling of the different asset classes,” notes Squires. “Connectivity between asset classes has never been greater,” says Fagen. “Exchanges and ECNs (electronic communications networks) want to move in that direction, but there’s a cost. We’re not there yet.”

“As equity transparency increases, people look for ways to avoid leakage,” explains Grob at Fidessa. “We’re moving towards a scenario with two to three pan-European exchange supermarkets and a range of niche MTFs who may not have the financial muscle to support all the different asset classes. Derivatives are particularly sticky because, unlike equities, the venue owns the ‘products’ that are being traded.”

Cross-asset performance
Best execution is still mainly focused on single orders on single instruments, says Lancellotti at List Group. “Initially, the banks just followed a static, paper-based process, confirmed their conformance, and everyone was happy. Thanks to the technology now available, some big banking groups are providing dynamic best execution services for retail customers following an order-by-order approach. For multi-asset trading we are still at the compliant process stage. When the banks talk about advanced performance solutions, they mean strategy algos for institutional or prop desks,” he says.

“For best execution, we just take a snapshot of all the prices and analytics at the point of trade to show what rules applied and what process was followed,” says FlexTrade’s Kohen. “The trader sets the criteria and we provide the audit trail.”

The analytics are just not there yet, says Mitchell. “Even in equity TCA, you still struggle to get decent real-time data consolidated due to the fragmentation,” he asserts. “So what chance do we have with over-the-counter bond markets, outside of very basic high-low-open-close usage or interpolated curves that some MTFs offer?”

“Standard TCA approaches just won’t work for cross-asset trading. It’s too idiosyncratic,” argues John Halligan, president, Global Trading Analytics, a TCA provider based in New Jersey, US. “You have to customise it for each situation and look at the actual trading context ideally with time-stamped data.” According to Halligan, traders need a ‘white-box’ methodology they can understand for best execution that looks at what they want to do in context, both in terms of market conditions and the way they work, including technology and controls. “Then we evaluate what the trader achieved using relevant benchmark data for equities, fixed income and FX,” he says. “That will soon cover futures and other
Cross-asset trading

asset classes when data become available.”

Halligan gives an example. “We might start with something as simple as a pension plan that relies on a custodian for FX and demonstrate the high costs of separating the cash trade from the hedge,” says Halligan, “or we can demonstrate the value of tight intraday controls. What you might lose on the cash trade you must gain on the hedge. Some people have gained double-digit basis points in the recent volatility, while many others have actually lost net returns. Every situation is different.” Consequently the challenge for Halligan is that people just don’t think trade cost analysis is possible for cross-asset trading, “But we know it is,” he says.

No limits?
Increasingly, traders are thinking cross-asset to cut costs. “Many people start with a simple FX hedge to avoid slippage,” says Jonathan Wykes, European head of AES FX sales, Credit Suisse. “As they get filled on an equities order, they want to slice in the FX as well. Our algos do that. On an equities trade they might be paying 4.5 or 5 basis points, but could pay 20 basis points on the currency moves.”

That just leaves the technology. “Traders want a platform that can both integrate all the asset classes and do the math as well for the analytics, the Greeks, the real-time P&L and risk metrics,” says FlexTrade’s Kohen. “It obviously needs to do the aggregations and let you work on lists of trades rather than individually. Finally, each trader wants to configure the system in their own way, with the analytics they want to see and lots of visual clues.”

However, significant challenges remain. “For stat-arb traders that truly track cross-asset correlations and spreads, extremely low latency is critical, but very few people do that today,” says Wykes at Credit Suisse. “It’s too complex to monitor all the dynamic positions and leverage credit properly. Those kinds of traders typically just want a fast DMA pipe from their systematic models to the markets.”

“Of course, it takes time to develop the systems, and that inevitably hampers things,” acknowledges Foster at BNP Paribas. “Perhaps expectations are rising faster than technology can develop. The markets are certainly challenging at the moment.”

As for the traders themselves, Wykes at Credit Suisse has a final word of warning: “Specialist traders can be more skilled, while a jack of all trades is still a master of none. With fragmented markets and dark pools, it’s not easy.”

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