

FX: in from the cold

The global financial crisis has accelerated the drive by many buy-side firms to integrate foreign exchange more effectively into their trading operations.

Richard McClure

Until recently, foreign exchange was not considered an asset class in its own right by most large institutional investors. Instead, FX was widely viewed as simply the cost of doing business – a back-office consequence of international equity and fixed income trading activity. That is all changing, however, with FX trading evolving into a value-added front-office business.

The reason? Returns of course. “The perceived lack of correlation between the FX and equities markets enables asset managers to find growth opportunities in FX regardless of how volatile the equities market might be,” says Sang Lee, managing partner at research and advisory firm Aite Group. The opportunity has always been there of course but not perhaps the incentive. “Some asset managers have started to focus on it over the past couple of years purely

because returns in equities have diminished,” according to David Hastings, global head of FX sales at solutions provider FlexTrade.

A market transformed

Over the past decade, FX has been transformed from a phone-based, over-the-counter market to one dominated by rules-based automated technology. According to research by TABB Group, less than one third of FX trading was executed electronically in 2000, a figure which grew to 62% by 2006 and which is now expected to approach 80% by the end of 2010. The e-commerce boom of the late 1990s and early 2000s saw FX business flood onto bank-owned and multi-bank portals such as FXall, Currenex, FX Connect and Hotspot FX.

But few of these new trading platforms, if any, found their way on to equities-focused buy-side desks,

The multi-asset trading desk

where ‘by-product’ FX trades were handled perhaps by the back office or, in many cases, by custodian banks.

Meanwhile FX automation carried on apace for other market participants including banks and specialist hedge funds, a trend accelerated by the global financial crisis. As FX markets were lifted by historic levels of volatility and the inflow of investors seeking liquid markets and ‘plain vanilla’ assets, overall ‘e-forex’ trading volume in 2008 surged 37% year-on-year, although volumes have since reduced following stabilisation of the markets.

In April, research from Greenwich Associates showed that the growth of e-forex has far outpaced the expansion of FX trading as a whole. The 37% growth rate in e-trading was almost triple that of the 13% year-over-year increase in total FX trading volume. Growth was strongest in Europe, particularly in the UK where e-trading volume jumped some 78%.

In part, the reason for the outperformance of e-forex results from the increased availability to a wider range of market participants – including institutional investors – of the technologies and techniques needed to

trade FX seamlessly. These include: connectivity to multiple venues; price aggregation across multiple venues; multi-asset execution management systems (EMSs) and order management systems (OMSs); clean, historical market data; appropriate execution benchmarks; and rules-driven trading algorithms.

The bottom line

Because the FX market is so fragmented, a key buy-side priority is aggregation of liquidity across trading venues and a virtually consolidated view of market data to aid informed decision-making.

“Buy-side awareness of what is available has increased dramatically over the past two years, especially as people scrutinise where and how costs are incurred across their business,” claims James Dalton, head of FX algorithmic execution, Citi. “More people are looking for some integration of FX capabilities into their OMSs. The automations and efficiency gains from implementing a professional OMS solution have been achieved in the main asset classes they trade and FX has often been treated as something on the side. Now it is getting bolted in as well.”



“Algorithms may construct synthetic currency pairs to create pairs that wouldn’t be ordinarily available.”

*Dr Giles Nelson,
senior director
of strategy,
Progress
Software*

With all market participants under increased pressure to pursue best execution and reduce trading costs, the days of clients blithely relying on custodian banks to cover FX needs are certainly drawing to a close. That changing landscape will only be hastened by events in California where state attorney general Jerry Brown is suing State Street Bank and Trust, seeking \$200 million in damages for allegedly overcharging the state’s giant pension funds CalPERS and CalSTRS for FX trades across eight years and trying to cover up the charges by altering transaction records. CalPERS, the US’s largest public pension fund, is estimated to have lost almost a third of its value during the financial crisis.

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While some buy-side firms do utilise a separate trading front-end or GUI solely for FX, the majority use off-the-shelf platforms that can support multi-asset class trading. Various solutions from the likes of FlexTrade, Portware, Aegis and other vendors make the integration of FX into the buy-side trading environment a much less complex proposition.

The increase in straight-through processing (STP) rates realised via greater systems integration has reduced the need for voice-broking to complete particularly large or complex deals. "This allows the institutional investor currency trader to concentrate more on minimising the cost of execution and implementing value adding strategies," observes Glen Sargeant, head of FX trading, Schroder Investment Management.

Sargeant believes that, over the past 18 months, the functionality offered by single-bank FX solutions has improved immensely. "These platforms are now providing better order management with access to research and technical analysis, as well as providing electronic limit order placement and streaming executable prices provided by their own in-house liquidity," he says.



"The FX platform sits within our OEMS so we get the same kind of STP process as we do for the other asset classes."

Paul Squires, head of trading, AXA Investment Managers

Shared experience

AXA Investment Managers is one of a growing number of buy-side firms that can be classified as trading in multiple asset classes. AXA IM trades equities, fixed income and FX (total turnover in 2008: €488bn), with some derivatives included within each asset class. Regardless of the amount traded or the number of transactions, all 25 traders – split between offices in London and Paris – sit at the same desk where possible, regardless of which products they are dealing.

To handle trading in all asset classes, AXA IM uses the Minerva OEMS solution from Fidessa LatentZero. Extra connections have been added, such as FIX, to facilitate STP in every asset class.

"When FX was added to the trading desk, we wanted to replicate as much as possible the infrastructure that we have built and which works

successfully for equities and fixed income," says Paul Squires, head of trading, AXA IM. "Rather than being standalone, the FX platform (FXall) sits within our OEMS so we get the same kind of STP process on FX as we do for the other asset classes."

The demand for integrated platforms that can deal with multiple asset classes is growing, says Steve Grob, director of strategy, Fidessa. "As well as enabling the buy-side to trade FX on a spot, forward or swap basis," notes Grob, "we can automatically generate those orders from a settlement perspective, or aggregate all the FX exposures across different portfolios or even at the company level."

The growth in electronic trading and the fragmentation of liquidity has meant that FX algorithms are becoming more common on the desktops of buy-side and sell-side traders alike. Broker-supplied execution algorithms have long been used by buy-side firms to execute equities transactions, but they have only been adopted over the last couple of years in the FX markets. "We are definitely seeing an increase in the adoption of execution management systems that look a little bit

The multi-asset trading desk

more like equity execution tools, including algorithmic order types,” confirms Dalton at Citi.

Sargeant at Schrodgers welcomes the arrival of algorithms “which probe liquidity from the otherwise unobtainable aggregators”. FX smart routing and algorithmic execution strategies are integrated into the Minerva OEMS, but AXA IM’s Squires says his firm has yet to implement them during FX trades.

Partly because of the different paths taken by the FX and equities markets to automation of trade execution, the introduction of FX execution algos remain a “little behind the curve”, admits John Meisner, head of global sales at Hotspot FX. Nevertheless, predicts Meisner, they will form a bigger part of the marketplace. “Right now, we only offer a couple of simple algorithms, but the truth of the matter is that we expect to develop significantly more to meet increasing demands,” he says.

Where there’s a will

While some of the algorithm types commonly used to trade equities – such as VWAP, TWAP and percentage of volume – can be used with little modification for

exchange-traded derivatives, other asset classes, including FX, require variations on these or completely different algorithms.

“In FX, there is no concept of order volume, so a VWAP algorithm doesn’t really make sense,” says Dr Giles Nelson, senior director of strategy, Progress Software. “But algorithms may construct synthetic currency pairs that wouldn’t be ordinarily available, or be very illiquid, from a particular trading venue. In short, the situation is mixed. Some algorithms are portable and some are not.”

Despite the hype, it appears that fully-integrated FX is still a work in progress. According to Lee at Aite Group, while some of the more sophisticated hedge funds might be engaged in multi-asset integration, the majority of buy-side firms still operate on a siloed basis, which is also reflected in the way a lot of the brokers are organised internally.

“Typically, asset managers don’t integrate FX into their existing trading platforms,” agrees Nelson at Progress Software. “The execution of FX trades is separate and siloed from other asset classes. If integration occurs at all it is post-trade. Using



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existing platforms, it is very challenging to technically integrate them to enable the kind of multi-asset algorithmic trading many firms would like.”

Hastings at FlexTrade counters that the technology is in place, it is just a matter of buy-side willingness to integrate FX within the business. “It is a question of whether the institution has the will to incorporate FX,” he says.

So why haven’t more asset managers successfully integrated FX into their current trading system? AXA IM’s Squires believes scarce resources are being focused on equities, which still make up the bulk of most firms’ trades. “There is still the perception that FX is not a priority in terms of relative asset classes,” he notes. “We all have limited IT project budgets these days and you have to use those budgets more discriminately.”