Technology

A Must Read For Plan Sponsors

Changing Buy And Sell Side Trends And The Implications

By: Jackie Chung

Plan sponsors can leverage technology and other tools to turn challenges into opportunities for more effective return generation and risk management, writes Jackie Chung, of Competitive Metrics Inc.

In the last two years, major changes have taken place in the global industry and regulatory arenas. These changes have reshaped the investment landscape for the buy and sell sides.

For plan sponsors, these changes can create opportunities for more effective return generation and risk management. To take full advantage of these new developments, plan sponsors need to understand their implications and how they can leverage technology and other tools to turn challenge into opportunity.

Global Investing, 24-hour Trading Shift Landscape

In the face of mounting pension liabilities, leading pension funds have been driving a wholesale asset reallocation out of public Canadian equities into other asset classes to deliver higher returns. As a result, global investing has become a rising trend. The elimination of the Foreign Property Rule will likely induce further globalization of investing and expose the industry to new risks and opportunities.

As national boundaries become less and less relevant to investing, exchange hours will also become irrelevant to trading. Before we know it, 24-hour trading will be a reality. As Gary Brinson wrote[1]: "In the future, asset markets will … transact over 24-hour periods without defined opening and closing prices. Portfolio pricing will be set to an agreed Greenwich Mean Time to facilitate uniform reporting for clients, but the markets themselves will become continuous and globally available." Recent attempts for cross-continent stock exchange mergers – the NYSE's combination with electronic marketplace Archipelago and NASDAQ's purchase of Instinet – are only the beginning of this inevitable development.

The rise of global investing highlights the need for pension funds and money managers to effectively manage foreign currency exposure in order to minimize alpha slippage. With more and more new markets to look at and to clear trades, manual processes no longer meet firms' risk management needs. In this environment, automation is key.

The anticipated increase in global investing reinforces the sector versus country investing debate. It also casts doubt on the relevance of domestic benchmarks, which most pension funds use to measure the performance of their investment managers, down the road. A major overhaul in the benchmarking process may be required.

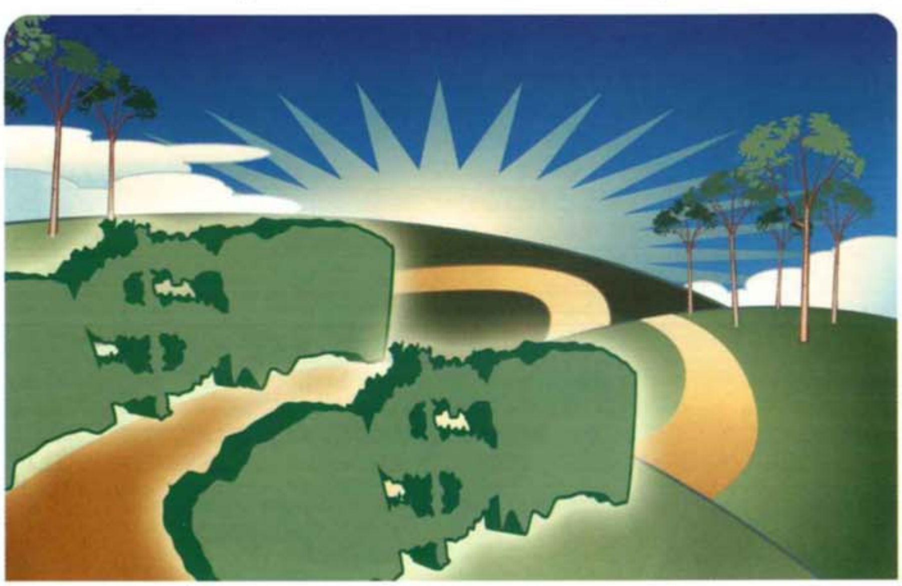
More important, global investing comes with a significant compliance cost. As plan sponsors allocate more assets overseas, buy and sell side firms become more exposed to foreign securities regulations. The resulting avalanche of new regulations raises firms' compliance risks and the costs of compliance. It is important to automate manual compliance processes to reduce costly errors and the reputational risks associated with them.

Hedge Funds Change Tradition

The wholesale asset reallocation is also fuelling major growth in alternative investments around the world. The global hedge fund industry has reportedly exceeded US$1 trillion in assets. In Canada, hedge fund assets have jumped more than tenfold since 1999 to more than C$26 billion in 2004[2].

The increasing participation of pension funds in hedge fund investing is 'institutionalizing' the hedge fund industry. As reputational risk is high for pension funds and their trustees, risk management is critical to them. As a result, pension funds demand transparency, independent valuation, and governance structure from the hedge funds they invest in.

As the 'institutionalization' of hedge funds accelerates, boutique players who do not fit the due diligence requirements and risk criteria may lose out; eventually causing a consolidation that would completely change the nature of the hedge fund industry.



As hedge funds surge in popularity, a convergence in investment strategies between hedge funds and traditional asset managers is also taking place. Traditional asset managers are now acting more and more like hedge funds as they increasingly use derivatives, long-short strategies, and structured products to enhance performance or pursue absolute return in the long-only space.

The hedge funds universe is also expanding as they diversify into the traditional long-only space and private equity. It's now getting harder to draw the line between hedge funds and traditional asset managers. Worse, it further complicates the valuation challenge that complex investment vehicles such as hedge funds pose, causing a huge pricing issue for pension plans and other investors.

Meanwhile, the hedge fund industry may have trouble inventing new strategies fast enough to absorb the significant money inflows as pension funds and other investors continue to pour in new cash. With a huge influx of new money chasing after a finite set of opportunities, the space is getting crowded and hedge funds strategies are starting to concentrate. For example, arbitrage opportunities seem to have dwindled. The spectacular returns that hedge funds have delivered in the past are becoming increasingly difficult to reproduce. In 2005, the CSFB/Tremont Hedge Fund Index returned a meager 7.6 per cent[3], compared to 22 per cent[4] by the S&P/TSX Composite Index.

So is there any risk that the wrong money may be chasing after the wrong assets for the wrong reason? Would it be a knee-jerk reaction from under-funded pension plans seeking to narrow their funding gaps? Can all pension plans afford to invest in hedge funds? After all, what investors really want is alpha, not hedge funds per se as an asset class.

Above all, transparency and governance issues are critical to alternative investing. Each hedge fund is unique in the strategy and financial instruments it employs, thus producing diverse risk reporting, performance measurement, and regulatory compliance requirements. At the end of the day, the question boils down to: 'Do most pension funds have the internal governance structures to monitor complex investments?'

Best Execution Mantra Raises Stake

As investing and trading become more complex, regulators around the world have also heightened scrutiny and compliance requirements on firms involved in the capital markets. The U.S. Securities and Exchange Commission has tightened the safe harbor clause on soft dollar practices and passed Regulation National Market System (Reg NMS) which includes, among other things, an Order Protection Rule that stipulates trade-through protection for orders that display the best price. The Financial Services Authority in the United Kingdom has also begun to implement a new regulation, PS 05/9, that limits investment manager soft dollar usage to certain allowed expenses. Going forward, these global regulatory changes will likely spill over to Canada.

There are signs that this is already happening. The Canadian Securities Administrators issued a concept paper on '*Best Execution and Soft Dollars,*' a discussion paper on '*Trade-Through Obligations*,' and conducted a public forum on this.

Trade-through protection is going to cause a major increase in the compliance burden of broker-dealers as they have a fiduciary duty to achieve best execution. To prove to regulators that the best price has been obtained for each order, brokers would need to create detailed internal audit trails. But trade-through protection may cause a massive increase in quote messages and transactions as buy-side firms conduct more trades electronically to take advantage of the best price protection for fast market electronic orders specified in the U.S. regulation. Sell-side firms would need to invest in technology to cope with this data avalanche. The huge costs involved could make it onerous for the smaller firms to stay in business.

Whether or not the CSA passes trade-through requirements in Canada, Canadian buy and sell side firms will still be subject to the Reg NMS' Order Protection Rule as long as they buy and sell stocks in U.S. exchanges.

To ensure that their managers meet regulatory requirements, plan sponsors need to find answers to these questions:

- Do money managers have the skill-sets, processes, and technology in place to take full advantage of electronic trading?
- Are Canadian broker-dealers ready for this avalanche of trading data and traffic if the CSA passes trade-through regulations?
- Are they equipped with sufficient compliance procedures to meet regulatory requirements?

Unbundling A Reality

Just as the regulators step up pressures on soft dollar practices, a ground-breaking 'unbundling' deal took place in the U.S. last fall between a leading investment manager and a major broker. Fidelity and Lehman Brothers entered into a research 'unbundling' relationship[5] that would see Fidelity write Lehman a $7 million cheque for research and Lehman charge Fidelity a commission of only two cents to 2½ cents for execution. This deal has turned 'unbundling' from a debate into an industry reality.

Few Canadian firms would have a $7 million research budget. But the real issue behind soft dollars and 'unbundling' is about making something opaque, transparent. In some ways, electronic trading has set the stage for 'unbundling' by carving out the trade execution component from the traditional broker service and attaching a price tag of two cents or lower to it.

In fact, institutional trading technology has taken the Canadian industry by storm and caused fundamental changes in the way the Canadian equity market operates. A study that interviewed 30 Canadian money managers with $1 trillion in aggregate assets[6] found that nine out of 10 buy side firms already execute a portion of their equity trades on electronic trading systems. The '*Buy-side Electronic Trading and Best Execution in Canada Study*' also found that buy side firms planned to direct an average of nearly 20 per cent of their institutional equity business to electronic trading systems in 2006. Hedge funds are also driving use of black-box algorithmic trading strategies. The adoption of electronic trading will amplify the pricing transparency it creates.

If trading commissions are unbundled, brokers will be forced to examine which clients are profitable for them and focus their research and trading resources and capital commitment on them.

Meanwhile, buy side firms have started to streamline their broker list in order to supply enough commissions to their brokers to receive the value-added service they require. To cope with dwindling margins, sell side firms are being forced to cut research jobs and explore innovative ways to more efficiently distribute their research to buy side clients in order to add more value and lower costs.

To cope with an increasing need for best execution, the industry will need to automate its commission and soft dollar tracking. Buy side firms already face scrutiny from pension clients and their trustees on why they pay commissions to various brokers. Regulatory scrutiny of soft dollars will force money managers to become more disciplined in tracking how they spend money on broker commissions and third-party services. The buy side will need to formalize its 'broker vote' and go beyond an anecdotal, subjective assessment twice a year to measure the actual value they obtain from broker research.

Change Is The Only Constant

The investment landscape has changed and will continue to change. Globalization is here to stay, and with it comes new opportunities for return generation and risk management. The Canadian industry will be more and more exposed to global industry, regulatory, and technology changes. Plan sponsors will need to ensure that money managers and brokers have the right tools to take advantage of them. In this shifting landscape where change is the only constant, the best defence for plan sponsors and the buy and sell sides is to continually reinvent themselves in order to survive and thrive in the change. ■

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1. The Future of Investment Management, Financial Analyst Journal, July/August 2005
2. AIMA Canada
3. CSFB statistics
4. TSX statistics
5. Wall Street and Technology, December 2005
6. The 'Buy-side Electronic Trading and Best Execution in Canada Study' was conducted by Jackie Chung and published in August 2005