



The Changing Role of the Buy-Side Trader

Technology and other advances are giving traders input into strategy

BY NANCY OPIELA

As buy-side traders have taken more control of their trading execution, their role within the firm has changed. “Five years ago, the buy-side trader’s function was little more than a delegation process,” says Larry Tabb, founder of The Tabb Group, a financial markets consultancy in Westborough, Mass., and New York, NY, USA. “They parceled out their orders based on their knowledge about which brokers executed best on particular stocks or in different circumstances. Now that technology provides more direct access to the market, buy-side traders are being looked to more strategically to improve the firm’s profitability.”

Of course, nobody ever said that would be easy. John Giese, president and CEO of the Security Traders Association in New York, NY, USA, notes that technological advances (combined with changes in market structure stemming from the 1997 Order Handling Rule and the move to decimalization) have eliminated some of the opportunities for profit that previous market inefficiencies created, with a negative effect on liquidity.

“In today’s environment, spreads have been either very significantly reduced or eliminated,” explains Giese. “While people were willing to invest in the old, inefficient environment because there was a visible opportunity to earn a reward for risked capital, today we’ve evolved to a point where the economics are much less attractive and, therefore, the liquidity that was once there has been reduced.”

In fact, as Tabb reports in *Institutional Equity Trading in America: A Buy-Side Perspective*, the average trade size for US equities declined from over

1,400 shares per trade in 1997 to approximately 500 shares per trade in early 2004, making the job of the buy-side trader more difficult. While algorithmic trading models can spare traders the extra time and effort to process the increased number of trades, Tabb says it has become more difficult to move large blocks without affecting the market, because the volume required to push a stock’s price decreases as liquidity decreases.

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Plexus Group

Accordingly, traders are breaking their tickets into much smaller pieces, explains Wayne Wagner, chairman of the Plexus Group in Los Angeles, Calif., USA. “Traders are chopping the big trades into little pieces and sliding them quietly underneath the door to interact with the marketplace in little nibbles,” Wagner says. “It is much harder to read those nibbles than it is to read the block.”

With big trades sliced down into 400- to 500-share pieces and run through Electronic Communications Networks (ECNs) or Designated Order Turnaround (DOT) systems to minimize their market impact, traders are left with a relatively small number of

KEY POINTS

- Technology provides more direct access to the market, enabling buy-side traders to take control of their order flow and improve the firm’s profitability.
- Traders now have the ability to concentrate on a smaller number of difficult trades, with the potential for significant impact on portfolio returns.
- Traders’ career paths are evolving as they begin to think more like portfolio managers.

difficult trades for which their performance can greatly affect the portfolio’s returns.

“Five years ago, the trader had 100 orders on his desk. That was clearly too much to handle, and the trader needed to outsource,” says Michael McCauley, president of Pulse Trading, an independent agency trading desk based in Boston, Mass., USA, that focuses on quality ECN execution. “Now, although trading volume has increased substantially, technology has lightened the load, so there may be just five orders on the trader’s desk. These are difficult trades where the trader can add value — and with more pressure to control trading costs, the incentive is really there for traders to dig in and learn the new trading technology and work it hard for the firm’s benefit.”

To execute these difficult wide-spread, low-liquidity trades, Tabb says firms typically turn to crossing networks to match off as much liquidity as possible away from the market in order to limit information leakage and market impact. After crossing, firms typically trade the balance of the order using an aggregation platform that allows them to locate opportunities, time their orders, and achieve their goals.

As advanced as technology has become, however, Wagner insists that human interaction will always be necessary in the most difficult trades. “Algorithmic trading is based on the presumption that there is a flow of buyers and sellers to interact,” Wagner explains. “If you have a rough balance between the number of shares people

want to buy and the number of shares people want to sell, the electronic market is pretty efficient. However, that balance is not always there in every situation and in every market. You may have a situation where a pharmaceutical company gets the hammer from the FDA and you have nothing but sellers in the market. Human interaction at the center of the market is essential when buyers and sellers are imbalanced and no one knows the price which will allow the market to clear.”

Communication and Strategy

Another important driver behind the trader's changing role in the firm is improved communication. Today, improving profitability requires the trader to better understand the portfolio manager's acquisition strategy and the portfolio manager to appreciate the nuances of the trading process.

“Each day, the buy-side trader has a list of orders he has to implement in the marketplace, and he has to do it with minimal friction to capture the most alpha possible,” says Mark Hoffman, CEO, president, and co-founder of Upstream Technologies in Boston, Mass., USA. “Ideally, as the trader manages the risk of moving from point A to point B, he thinks strategically. That is, in addition to getting through the list of transactions, he thinks about the goals of the firm from an investment management perspective.”

With today's emphasis on controlling costs, Hoffman says that traders have to think about what trading strategy they are going to apply, then actually apply it, and then measure how well they have done, as opposed to always thinking about the here and now. “In some ways, traders have to become like jet pilots rather than bush-aircraft pilots. They don't get to fly real low to the ground anymore,” he says. “The trader's job has become more sophisticated in that they have to employ more strategic thinking. And as they think more like portfolio managers, they become more valuable to the firm.”

Hoffman says for a trader to think more like a portfolio manager, more of the portfolio manager's ideas have to be

transparent to the trader so he can take part in some of the decision-making. “Active asset managers have a list of securities they have ranked highly, but some stocks have very good substitutes,” he explains. “Portfolio managers should communicate clearly to traders what is acceptable to put in the portfolio. Perhaps Hewlett Packard and IBM do not look that different from the portfolio manager's perspective. If that's the case, the portfolio manager needs to let the trader know it so he can decide which one is easier to trade.”

As firms see future investment returns gained not only as a result of investment selection but also as a result of investment acquisition and disposition, traders will become a more integral and respected part of investment firms, according to Tabb. “Traders' career paths are becoming more accelerated,” he notes. “We are seeing traders moved into portfolio management as well as into hedge funds as their skills and responsibilities increase.”

In fact, Hoffman anticipates that the hedge fund model in which the portfolio manager and trader are often the same person could one day be standard on the institutional side. “As traders are given the opportunity to add their view of the world,” says Hoffman, “the portfolio manager and trader can look at the investment process together and firms will realize the benefit of viewing the investment process from a single point of entry.”

Leveraging Skill and Insights

McCauley notes that although the basic tenets of trading have remained the same — know the unique characteristics of trading a name, capture and maximize liquidity, maintain anonymity, and minimize market impact — the traders' tools are radically different and will continue to change. Once exclusively a relationship-based business, trading now is driven by technology. Shouting in the trading room has been replaced by the clicks of keyboards.

“No matter what side of the street you are on, you need to embrace technology to maintain your competitive edge,” says McCauley. “The old-fash-

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MICHAEL MCCAULEY
Pulse Trading

ioned way of doing business is becoming more and more obsolete. Traders are looking ahead, excited by the prospects of change. It's an exciting time because, if we do it right, we could be laying a solid foundation for the next 20 to 30 years.”

Hoffman says firms that are most successful in improving profitability will use technology in a way that “leverages the skills and unique market insights of traders and portfolio managers.” Transaction cost analysis (TCA), too, will be important as more firms seek to measure the benefits of using technology. Tabb says that while TCA traditionally has been used to “beat up brokers,” as the buy-side takes greater control of their orders, these tools will be used more effectively to help guide traders and portfolio managers to better understand how well they traded — and how they might work together to change their strategies to improve performance. ▀

Nancy Opiela also writes for the Journal of Financial Planning and Focus, Fidelity's magazine.

RECOMMENDED RESOURCES

Equity Trading: Execution and Analysis
2003 CFA Institute Conference Proceedings
(cfapubs.org)

“The Transaction Process: Evaluation and Enhancement”
2004 CFA Institute webcast
(cfawebcasts.org)

“Best Execution”
2002 CFA Institute webcast
(cfawebcasts.org)