Survival of the Fittest

Part I - Evolution of the new smart broker

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It is now widely acknowledged that the world's financial markets have undergone broad structural changes in the past couple of years. For some time, the true nature and scale of these changes has been obscured by the fog of the global financial crisis. Increasingly, brokers are realising that far from being a short-term dip in response to difficult economic circumstances, they are in fact witnessing the emergence of a 'new normal'. Their traditional role in the financial markets has undergone profound and potentially permanent change and they are now at a crossroads where success can no longer be guaranteed simply by intermediating between clients and sources of liquidity.

Brokers' business models are evolving as they try to find traction in the new business environment and these broadly follow two routes: get bigger, or get smarter.

This paper examines the evolution of the 'smart broker' who is able to add value to every step of the trading process and take advantage of the opportunities this new world presents.

The perfect storm

Discussions of the current climate as if it were an interesting outlier or a temporary blip have lost their relevance. In financial markets, the sell-side in particular has seen its natural ecosystem undergo fundamental changes.

The ever-changing execution landscape

The first of these relates to the pattern of liquidity itself which continues to get more and more complex. Execution venues are in their own battle for growth and survival and so are releasing an endless stream of new platforms and business models, all with different target clients and rules of engagement. On top of this, the larger brokers, in their quest for scale and cost savings, have formally entered the venue space with their own dark pools and automated crossing networks. The challenge for small and mid-tier brokers is that navigating this ever-changing landscape effectively just keeps getting harder and, ultimately, more expensive.

In an attempt to address this, an increasing number of these firms are electing to outsource execution to those larger brokers that can afford all the necessary infrastructure and smart routing paraphernalia. In the short term this undoubtedly saves money, moving from a high fixed cost model to a lower variable cost one. But, if not managed properly, it could potentially have negative long-term implications as clients may step around any middle-men that can't demonstrate the value they add to the execution process.

For the research specialists, Commission Sharing Agreements (CSAs) don't appear to be the answer either. Rule changes were expected to allow them to step out of the execution space, while at the same time ensuring a fair slice of the commission pie for themselves, but this hasn't materialised. Reports suggest that the pool for research-only providers is around 5% of the total client commission pot. With so much left to play for, operating and maintaining an effective transactional cash register remains the only viable mechanism to get paid.

Wave after wave of regulation

The second factor reshaping the brokers' natural habitat is regulation. The original intentions of RegNMS and MiFID were about increasing competition, fairness and transparency in how various asset classes (but especially equities) were traded. This regulatory agenda has now been extended to include other asset classes, such as derivatives, but also to make markets safer in the wake of the Global Financial Crisis.

This has dragged markets reluctantly down the path of unintended consequences as regulation and technology intertwine in a never-ending litany of call and response. One of the best examples of this is high-frequency trading (HFT) which was originally given a huge leg up by regulators when they encouraged HFT-friendly multi-market structures to proliferate. Now, however, HFT is the subject of much controversy and regulators are frantically trying to curb its growth.

The fact that regulators are increasingly looking beyond their own shores presents another problem too, as brokers are being swamped by regulatory changes coming from multiple geographic epicentres. Where this overlaps on the same issues, the potential for greater confusion and cost only seems to increase.

Commissions spiral downwards

The final element contributing to the perfect storm affecting brokers is that (for equities particularly) there is clear evidence that, from their peak in 2009, trading volumes have declined materially and the fiercely competitive environment has served to drive commissions down substantially. This potent mix has had severe implications for many market participants.

Activity across the Fidessa network only goes to confirm this - addressable trade volumes are down. While HFT trading continues to contribute liquidity to the market, albeit at a declining rate, much of it distorts and inflates the true overall levels of addressable liquidity available.

Loyalty, like liquidity, has been fragmented too, and asset managers are more than willing to shop around for broker services. The traditional relationship between buy-side and prime broker has all but disappeared; buy-side firms now routinely send flow to a number of different brokers but, crucially, are demanding more value from each one of those brokers in return.

As a result of all this, the volume of 'free' business has shrunk considerably, leaving sell-side firms battling for a meaningful share of a far smaller pie.

So brokers face a multi-pronged attack on their natural habitat - execution complexity, regulatory uncertainty, falling addressable volume and declining margins. One answer is to go for size and this will be the subject of a second paper in this series.

For smaller and mid-tier firms, though, scale can only really be achieved through consolidation which brings its own challenges of integrating different businesses, cultures and technology platforms. An alternative approach is to equip yourself with the right tools to exploit the new environment, re-examine your relevance to your customers and then effectively market these new capabilities to an increasingly discerning client base.

Those firms going down this route have worked out that their value proposition is as much about interpreting the performance of third party outsourced technology, and the different routes to market they are using, as it is about understanding the underlying mechanics of the technology itself.

Wading through the 'big data' swamp

The complexities surrounding liquidity fragmentation and interconnected regulation are broadly recognised, if not yet perfectly understood. However, as firms come to terms with the new multi-market structure and the opportunities it presents, a new challenge has appeared in the form of 'big data'.

Traditional fundamentals and underlying technical data are no longer enough to secure optimal trading outcomes and, as they are now available from many standard sources, they are no longer a source of effective competitive differentiation.

The pressure is on to find ways of combining a growing universe of regulated and unregulated data with specific firm-wide intelligence and using this to power a more valuable service to clients. This creates an operational challenge: finding the relevant information from the deluge of data, and then extracting, normalising, translating and storing it in order to make it available in the most appropriate and suitable time period. More than anything, this capability needs to be deeply embedded in the broker's regular daily workflows.

The 'smart' response

Act on actionable data

At a pre-trade level the new buzzword is 'actionable' data. In today's uber-competitive environment, this means being the first to react - locating and combining different pieces of information and turning them into revenue-generating opportunities. This helps turn good traders into great ones and, more importantly, makes the whole firm stand out from the crowd.

Achieving this is by no means easy, but the key lies in combining information that is publicly available about a particular stock with information held within the firm itself. In this way, a broker might receive an order, look at which buy-side clients are already holders of the stock and combine this with custom historical information about previous activity, trading patterns or expressions of interest. Done correctly, this gives the sales trader an automatic action list providing the best chance of optimising the outcome.

The vast majority of brokers are already sitting on a wealth of valuable (actionable) data. In addition to the externally-sourced market data, records of public and private holdings, trade adverts, IOIs and integrated news, they have equally valuable internally-sourced data on current and historic client activity and areas of particular interest. The challenge is to transform this uncorrelated raw material into weapons-grade information that supports a truly customer-focused approach.

Real-time execution consulting

This pre-trade visibility needs to extend into the real-time execution process too, and is another way that smaller and mid-tier brokers can demonstrate their new-found relevance. Real-time intelligent execution services are the new weapon in the broker's arsenal that helps turn the regulatory obligation of best execution into real competitive edge. As more brokers outsource their execution to the larger firms, the real value will lie in the ability to interpret and analyse the myriad of available execution offerings, in real time and without bias.

This requires the capability to communicate likely execution outcomes to clients in real time but, above all, it needs to be embedded in the firm's trading workflow so as to ensure maximum flexibility and deliver a premium client service. Orders and outcomes need to be monitored and, where necessary, changes made mid-flight, in real time.

The cost/revenue dynamic

In the post-trade space much has been made of the role of transaction cost analysis (TCA), especially by brokers seeking to justify their results to their clients. As such, metrics such as VWAP, TWAP and Implementation Shortfall are ubiquitous indicators of execution quality and play an essential role in fulfilling a broker or buy-side's best execution obligations. In many cases, though, they suffer from a lack of neutrality and are often hard to compare because, more often than not, the way in which they are compiled and presented varies widely.

Some firms, however, are taking the whole concept of TCA a step further and using it to better understand their own business and, crucially, to map costs far more effectively onto revenues.

Historically, the financial industry has focused almost exclusively on raising revenues while cost management remained firmly strapped into the back seat. Provided that income rose faster than expenditure, the operational costs tended to attract less scrutiny. However, with the arrival of the perfect storm, the sell-side is being forced to rethink this approach.

Greater internal visibility enables firms to better understand and manage their cost and revenue dynamics. This requires them to monitor and interpret their own trading performance, analyse the results and make the necessary adjustments in order to exploit areas of strength and identify (and then improve) areas of weakness. The same information can also be used to improve the service they offer, through the delivery of better and more timely information that increases their relevance and results in deeper and more meaningful client relationships.

Intelligent trading

When combined, these activities allow for truly intelligent trading: carefully targeted activity that is informed and driven by accurate data and in-depth analysis and which improves real profitability and enhances client relationships as efficiently and effectively as possible.

There's no doubt that narrower margins are here to stay. Nor that this is a universal challenge affecting all brokers, regardless of geography, size, sector or strategy. Costs are up, revenues and margins are down and, at this point in the cycle, conditions remain the toughest seen in a generation.

But the tried-and-tested means of dealing with these challenges are no longer appropriate.

The structural changes in the marketplace have transformed intelligence into the new super power and now place an ever-increasing premium on 'smart' trading.

Evolution at work

Despite the establishment of the new normal, some things remain the same. The incontrovertible truth is that the firms best able to adapt to serve their clients are the ones that will not only survive, but the ones that we will see prosper and grow.

Those with the most intelligent tools at their disposal will be the ones that can help their clients navigate the transformed landscape and turn the challenges presented by fractured liquidity, greater regulatory burdens and the data explosion to both their and their clients' advantage.