CTAs piece together fragmented market

Commodity Trading Advisors are looking to tech vendors and brokers to help them navigate an increasingly complex market structure.

Futures markets across the world are going through a period of unprecedented change. Regulatory reform and a new wave of exchange competition are forcing market participants to innovate to find solutions to fragmented liquidity and consolidation among brokerages and Futures Commission Merchants (FCMs). On 28 May 2015, FOW met with a group of Commodity Trading Advisors (CTAs) and proprietary trading firms to discuss the market evolution and the impact on their businesses.

LIQUIDITY FRAGMENTATION: COSTS OUTWEIGHING THE BENEFITS

A plethora of new trading venues have launched globally over the past five years. This has heralded a new age of exchange competition with look-a-like contracts launched on new and incumbent exchanges.

This trend for competition has combined with two-speed regulatory reform across Europe and the US, and resulted in a fragmentation of liquidity in local and global futures markets. While competition puts pressure on the incumbent exchanges and liquidity holders to reduce fees and innovate, this has to be weighed against the costs of new markets and fragmentation of liquidity.

For CTAs and managed futures funds, the benefits of competition and innovation are often dulled by increased complexity and distortions of price discovery.

While firms that trade in and out of the markets many times a day benefit from lower fees, CTAs that pursue strategies requiring fewer trades say that cost of liquidity fragmentation and increased slippage outweigh the fee reductions.

Shorter-term funds whose market selection is liquidity-weighted are among the most adversely impacted by the fragmen-

> Clearing firms and software vendors have to invest time and resources in building to new venues or facilitating access to new contracts, often on the basis of client demand that is not backed up by trading volumes when the venue or contract launches

OBJECT TRADING COMMENT:

MINIMISING SLIPPAGE

Firms define execution quality and slippage differently based on their trading strategies. Proprietary firms and short-term traders using latency sensitive arbitrage strategies tend to need to be first to a book.

Firms with long-term or large positions, however, are most concerned with the financial impact of slippage on large orders. For both types of firms, the changes in market structure combined with a recent decline in many large CTAs' performance has shifted the spotlight to the importance of best execution and reducing slippage.

Regardless of whether a firm needs to get to the book first, manage slippage on larger positions or pay for immediacy by crossing the spread, their market access infrastructure has a dramatic impact on execution quality. This can be a key determinant of a strategy's profitability and longevity.

Furthermore, firms need to be focused on Research and Development to both refine existing strategies and evolve new strategies that are responsive to today's market conditions. Running production trading and simulated models for trading strategy R&D on an integrated, single market access infrastructure allows for real-time tracking of system performance, slippage, and risk, and allows directly comparable equity curves.

This will help firms better predict slippage and model potential market impact prior to scaling-up their strategies in production. In all cases, the buy side trading group's primary concern is to minimise slippage.

tation of liquidity, and these funds often choose not to participate in new products or on new venues as liquidity can dry up at any point, harming the precision of the strategy.

One solution suggested would be for more Trade at Settlement (TAS) functionality across futures markets. TAS, which allows a trader to enter an order during the trading day at a price equal to the settlement price for that contract, is already prevalent in some commodity futures markets and guarantees execution of an order.

CTAs reported that price discovery is being significantly impacted by fragmentation. Markets are a source of information on price and volume. If all that information emanates from one source, it is easy to monitor and process.

Fragmentation spreads this information across multiple venues making aggregation harder, so funds are being forced to develop methodologies for aggregation against a rapidly changing market.

While arbitrage traders benefit from fragmentation, the lack of fungibility among futures contracts reduces the opportunities for arbitrage in the futures market. As a result, there are fewer arbitrage players in the market reducing efficiency.

In the equities markets, fragmentation brought on by the Mifid reforms reduced execution costs and increased execution choice. However, the benefits of competition in futures markets are often outweighed by the associated complexity of liquidity fragmentation.

The disincentives of incentives

The challenges that futures markets face in launching new contracts or attracting liquidity in look-a-like contracts are well documented. What is less well understood is the impact on market participants that strategies and incentives used by exchanges to launch new contracts or wrest liquidity are having.

Clearing firms and software vendors have to invest time and resources in building to new venues or facilitating access to new contracts, often on the basis of client demand that is not backed up by trading volumes when the venue or contract launches.

Cheaper fees are often used by venues as the key weapon in the fight for competition but this is not the only cost of market proliferation. Market data fees, the cost of infrastructure, clearing fees and higher margins resulting from central counterparty fragmentation are also considerations in the cost of a new contract for market participants.

Often proprietary trading firms and market-makers are provided with incentives to trade a market, which makes it more attractive to them and mitigates some of the other costs. However, there are also downsides to such methods, even for those that are the beneficiaries.

Market-makers at the forum reported frequent struggles to rationalise their strategies with trading patterns on markets incentivising market participants. Incentives can result in shallower, more transitional liquidity.

Often firms trade to establish a long position in a market not because the underlying is rising but because they are caught on a leg on another exchange. This results in more unpredictable market movements driven by the structure of the market rather than fundamentals, making market moves harder to understand, predict and respond to.

For CTAs, who are rarely part of the early incentive programmes, the fact that much of the liquidity is incentivised poses deeper challenges. CTAs said the benefits of fee reductions are often outweighed by increased instances of slippage and the fact that liquidity is distorted or shallower than liquidity generated by a diverse and deep market of buyers and sellers.

One participant in the forum went as far as saying that exchanges are doing the industry a disservice by launching look-a-like contracts.

Are competition, fragmentation, and regulation affecting trading outcomes?

Velocity of Change Demands a New Approach

Take control with market access infrastructure that scales as you grow.

Download our research report

www.objecttrading.com/nolimits

Get more information
UK: +44 20 3763 2220
US: +1 646 583 1850
www.objecttrading.com

Remove Limitations to Growth
Object Trading provides a global, managed DMA Service Platform that offers on-demand flexibility optimized for the front-office.

OBJECT TRADING COMMENT:

REGAINING CONTROL OF CHANGE

The markets are changing quickly, and this velocity of change is affecting every aspect of the trading business. Buy-sides are impacted by the higher direct costs. Buy-sides that trade across geographies are also affected by overlapping and non-harmonised compliance requirements. While many of the rules are aimed at achieving similar goals, they differ in implementation.

The way that sell-sides respond to the regulatory fragmentation affects how they manage risk for their buy-side clients. In many cases, the way risk constraints are applied will differ between trading systems, between markets and between regulatory regions.

This lack of uniformity can complicate the process buy-sides use to road-test strategies and get an accurate picture of their viability.

In an interview earlier this year, one short-term CTA told us: "It's become incredibly complicated to test one strategy across various markets, asset classes and geographies given that all things are not equal across systems.

"But really…the only free lunch out there today is financial diversification. To be successful in this area, you need to stack the cards in your favour by reducing all the inconsistencies that are under your control."

Buy-sides can take advantage of new ways to access markets that improve their ability to deploy new systems. Leveraging a normalised market access infrastructure that uses a single interface for pricing, execution, and risk constraints across markets can reduce the effect of those inconsistencies, improve trading results, speed up the R&D process, and reduce overall costs.

This normalised interface also enables re-use, facilitating strategy portability and making the trading strategy R&D process more efficient, thus allowing firms more opportunity for financial diversification.

If firms can trade the same way across markets, then they won't need to re-engineer market infrastructure every time they trade on a new market. They can focus more resources on their strategies instead of the market interface or idiosyncrasies in handling order flow.

Liquidity is not simply a one-to-one equivalent to trade volume in today's markets. A position that is hard to exit has a different cost to the same position in a deep and liquid market. This is forcing CTAs to measure and understand liquidity in a different way than they have traditionally.

One participant said a "liquidity mirage" was being created by incentives. A new contract might be showing 5,000 but it is only actually 10 deep and the price moves against the trader when the order goes in.

The liquidity mirage also means that strategies dependent on certain signals are having to be reviewed so as not to trade on a false signal or one distorted by trading around market incentives.

While volumes have remained constant or even grown in many contracts, firms are finding it harder and harder to execute their orders without moving the market.

Understanding and measuring the market impact of a trade is becoming more complex and firms are using more complex methodologies to calculate and establish the liquidity of a contract as well as splitting orders into smaller lots to trade larger positions. All this adds to the complexity and uncertainty.

It also can make CTAs more reluctant to participate in new contracts, which harms their growth and perpetuates the lack of depth of liquidity in new contracts. While props and market makers are often there from launch, frequently incentivised to be so, CTAs are not early adopters.

They need larger open interest and longer track records against which to test strategies and have confidence to commit to a market.

But there is hope for exchanges seeking to launch new contracts and participants in the forum said these efforts should be focused on replication of OTC contracts.

For new contracts replicating the OTC markets, firms can trade off risk in the liquid OTC markets – so even if the volumes are lower in these contracts, the risk of getting stuck in a position is far lower. So too smaller CTAs can get involved in contracts at an earlier stage as their smaller size makes them more nimble by reducing market impact of trades.

Ultimately, CTAs need real liquidity to trade a market. The well documented travails of exchanges seeking to build liquidity in new and look-a-like contracts are, on this reading, to a large extent down to their own strategic aims. A more fundamental rethink on how to build real liquidity is required across the industry.

REGULATION: LACK OF PROPORTIONALITY CHALLENGING THE BUY-SIDE

The scale of regulatory reform in the derivatives market is unprecedented. But whether it is the Alternative Investment Fund Managers Directive (AIFMD) or Mifid II, concerns over the lack of proportionality of the new regulations are running high among CTAs and proprietary trading firms.

For CTAs, a key concern is that AIFMD is politically-motivated rather than industry-driven and as with UCITS, the scope is widening; and more and more firms targeting professional investors are being caught in the net of regulation intended to protect retail clients.

Perversely, the changes in regulation are increasing costs for the people they are intended to protect and in some instances increasing risk. One example cited was the well-publicised use of total return swaps to meet certain UCITS restrictions.

As current UCITS rules do not allow direct investment in commodities, the perception of risk of investing in CTAs is skewed. Outside the largest CTAs, few offer UCITS authorised products, which makes it tougher to attract investment.

The UCITS badge creates an "illusion of lower risk" according to one CTA. The only certain way to reduce risk is through diversification yet regulations are mandating against such diversification by restricting investments.

Lack of concentration

Regulations around the concentration risk of cash held by CTAs in banks also came under criticism for increasing risk and complexity. Attempts to mitigate the concentration risk are forcing firms to spread cash across multiple institutions, where holding it all at one custodian bank as they did in the past was safer and more efficient.

CTAs are also finding the fragmented nature of regulatory reform challenging.

Not only are firms having to be regulated differently across multiple jurisdictions, the opaqueness of regulatory reform in Europe is posing significant operational challenges.

While AIFMD was being drawn up, there was a range of possible impacts on market participants, and hard and fast rules were not being issued in good time. Larger funds were able to hire lawyers with a mandate to protect and prepare them for any eventual outcome, but for smaller firms this was not a viable option.

AIFMD also increased the costs of being regulated. A fund doing exactly the same thing as previously now has to be regulated as an Alternative Investment Fund under AIFMD.

Proprietary trading firms will undergo a similar experience with the implementation of Mifid II, bringing many firms into a regulated environment for the first time. Again, the uncertainty of what exactly this will entail poses the key challenge.

The impact Mifid II will have on the liquidity of markets is also a major concern.

CLEARING PROVISION: SPECIALISATION AND RETRENCHMENT

Pressure from regulation is not limited to the client – prime brokers are under pressure like never before. Capital requirements, returns on equity and the burden of regulation and transparency are forcing firms to review client bases and business models.

The landscape of clearing provision is changing. As the traditionally dominant players in hedge fund clearing pull back from certain clients and reduce their balance sheets, tier two and three banks are enhancing their offerings and taking on new clients.

In the over-the-counter markets, several high profile firms have pulled away from clearing altogether due to the onerous capital requirements and the balance sheet impact of clearing.

At the same time, the recent closure of a high profile futures broker has reflected the pressures firms offering traditional services are under and the need for further consolidation in the market.

Go back 10 years and the trend among banks was towards scaling up as quickly as possible to aim to provide a global, cross-asset service to as many clients as possible.

Low returns on equity and capital constraints combined with a realisation that the complexities of such a business model often outweighed revenues in a depressed market dogged by near zero interest rates, has led to a rethink of the clearing business model.

Prime brokers are increasingly looking to specialise with ambitious tier 2 and 3 FCMs that traditionally served high end professional trading clients tailoring their services to meet the demands of hedge funds.

Whereas traditionally these firms would have simply seen themselves as service providers, today they are partners advising on a range of issues including the allocation of collateral across CCPs and other operational processes within their clients.

Scale is still an important factor but not the singular advantage it used to be. Clients are still looking at the credit rating of their prime broker, the asset protection capabilities and the scale of product coverage.

But prime brokers are no longer seeking to increase their client base as the key business goal as they focus instead on the impact each client has on its balance sheet and the return on equity.

Part of the problem is how some prime brokers have structured their businesses with an execution team, a custody team and a clearing team operating within internal silos. Sometimes this results in clients having to fit a profile in which revenues are being generated across all business lines, and clients that are profitable in just one area are no longer attractive to the firm.

All this creates a higher barrier to entry for emerging managers who will need higher Assets Under Management and more intensive trading strategies to appeal to prime brokers in today's changing landscape.

RAISING ASSETS: THE CHALLENGE OF DIFFERENTIATION

Competition to raise assets has always been an issue for any hedge fund, but it is a particular challenge to smaller funds in the UK CTA market.

These funds are finding the challenge is to differentiate and distinguish their busi-

“In the over-the-counter markets, several high profile firms have pulled away from clearing altogether due to the onerous capital requirements and the balance sheet impact of clearing”

OBJECT TRADING COMMENT:

CHANGING RELATIONSHIPS

Relentless reform from regulators, and the associated increased capital and compliance costs, is heaping pressure on clearing providers.

Some FCMs have exited the business completely, and many of those who are left are increasing the commitments they require from their clients.

Consequently, many smaller proprietary trading firms, some CTAs, and small hedge funds are finding themselves forced to find alternatives – both in new FCM or prime brokerage relationships and in a new approaches to accessing the markets cost effectively.

Market access, risk controls and cost-effective execution management are now becoming the buy-side's responsibility. This is leaving buy-sides exposed to many challenges the sell-side used to solve on their behalf but now can no longer afford to offer.

If the buy-side can bring their own execution infrastructure along with an independent risk control framework that meets the sell-side's regulatory obligations, they make themselves more attractive as a commercially viable client.

OBJECT TRADING COMMENT:

INCREASING PERFORMANCE THROUGH EFFICIENT R&D

One of the largest investments and main source of differentiation for buy-side firms is in trading strategy research and development.

Competition is ruthless, and market evolution is constant, so buy-sides must continually adapt and refine their strategies. R&D is a core function that creates a buy-side firm's only truly enduring and sustainable competitive advantage.

Firms can no longer generate alpha by simply banging away faster and faster at a single product. Today, only the largest firms can survive using classical latency arbitrage strategies. Active traders, such as proprietary trading firms, CTAs and hedge funds can no longer rely solely on nanosecond latency reductions to deliver outsized or even acceptable returns.

So the bulk of buy-sides are now developing smarter, more sophisticated trading strategies across multiple geographic regions, products, and asset classes.

When they find a strategy that works in one market or asset class, the need for diversification leads them to look for ways to quickly leverage the strategy in other markets. As a result, the ease of portability of strategies into new markets and asset classes becomes a very strong point of differentiation.

To simplify and expedite the R&D process, firms need robust R&D tools supported by a scalable market access infrastructure that can simplify connecting to new markets and handle all phases of trading system development.

Running the entire R&D process from idea generation through to deployment on the same infrastructure allows trading houses to more swiftly research new market/system combinations without high development, test and deployment costs.

Faster velocity through the development cycles extends life spans for strategies in production, delivering a better Return on Investment for the overall R&D process.

> Smaller funds need to maintain management fees to cover the rising costs of everything from regulation to market data, especially during adverse market conditions or periods of drawdowns

nesses from common misconceptions and broad brush CTA definitions that distort investors' understanding.

One issue facing CTAs is the extreme cyclical nature of investment flows into the industry. Months, and sometimes years, of relatively slow performance fosters little interest from investors. Then the phone rings off the hook during the periods in which CTAs post stellar performances.

One firm spoke of the challenges it experienced last year finding investment from seeding companies that were only interested in long/short equity strategies. Then towards the end of 2014, it was inundated when systematic funds performed well.

Educating investors in the cycles is crucial as many returns disappoint when investment pours in only after the latest bull-run hits the headlines and CTA returns are celebrated across the industry.

More and more CTAs these days are not strictly trend followers in the traditional sense and need to work hard to distinguish their strategies from the broad brush definitions used to describe CTAs as a whole.

The emergence of more specialist family offices in Europe that will only invest in systematic funds and a greater understanding of the nuances of CTAs is resulting in longer term, more sticky investments.

However, understanding in Europe of the strategies employed by CTAs lags significantly behind the US where there is a more inherent comprehension and much greater access to CTA funds.

One CTA said that they were turning away investment from certain types of investors because of the short term nature of their investments, choosing to focus on systematic specialists who better understand the cyclical nature of their strategies.

For traditional trend followers, the prevailing attitude for investors used to be that the strategy would deliver huge returns to those who could stomach the drawdowns. It was a case of lengthy periods of slow or negative returns and then a double digit return in one month.

More and more though, firms are seeking to limit the downside at the expense of the upside to offer a smoother path of returns.

Fee structures

Few funds today consistently charge along the 2 and 20% model in which they would take a 2% management fee and retain 20% of profits. Larger investments into a fund will get more preferential terms and investors tend to negotiate harder during the well-publicised downturns in the industry.

But smaller funds need to maintain management fees to cover the rising costs of everything from regulation to market data, especially during adverse market conditions or periods of drawdowns.

Smaller CTAs report due diligence focusing on whether they will be able to survive long enough to ride the next wave, and investors need to understand that the management fee is crucial to that. Unlike other strategies that could be expected to perform positively in all seasons, CTAs are inherently cyclical.

Investors also tend to focus on the larger funds. The old adage of no one got fired for buying IBM, applies in the hedge fund market to the expense of smaller, emerging funds, which often provide better or more consistent returns.

In the same way that large trend following CTAs promote themselves as a non-correlated investment, smaller CTAs today are differentiating themselves from the returns of their larger counterparts.

For the investor that is prepared to analyse smaller CTAs, the rewards are there for the taking.