TrendSpotters #005: Cross-Asset Trading, Part 2

Candyce Edelen: Hello and welcome to this installment of TrendSpotters. I'm Candyce Edelen and I'm so glad you joined me for the second of our two-part conversation on cross-asset trading. In part one, I spoke with my guests Harry Gozlan of smartTrade and Greg Wood of Credit Suisse about cross-asset trading versus multi-asset trading. This is a complex topic and I'm glad to get Greg and Harry's insights.

Harry Gozlan is the CEO and founder of smartTrade. They provide cross-asset liquidity management solutions that handle aggregation, pricing, routing, and matching for all OTC and listed asset classes. Prior to smartTrade, Harry managed OTC derivatives and FX trading in a number of banks.

Greg Wood works for Credit Suisse's advanced execution services on their multi-asset class algorithmic trading desk. He specializes in algorithmic and low latency execution of futures. He has a background in multi-asset execution initiatives, and has experience both on the business and the technology side.

In our first installment, we defined multi-asset trading as treating each asset class as distinct trades with discrete strategies, but handled in a single platform. In contrast, Cross-asset trading allows a trader to combine multiple asset classes into one integrated strategy. In this session, we discuss some of the business drivers that that are creating more cross asset demand.

There's so much more to the conversation, so let's continue.

Candyce: So we go from these big, complex structured products that nobody really understood that produced a tremendous amount of risk in the system to simplifying, to going to straightforward asset classes and simplification for better regulation. Does cross-asset trading almost bring in some of the complexity that allows for the advantages that the structured products gave in extra profit?

The reason people were trading these structured products was because there was more opportunity for gain -- more upside opportunity in those. There was more risk also. Does cross-asset almost bring back that opportunity for profit while still giving you the ability to look at your risk more succinctly because you're really combining trades with individual products?

Greg: If I can answer that first, I think it depends on what your reason is for doing this product, or doing the cross-asset trade. If you are looking at pricing anomalies across these different products, then, that's obviously where you're looking to make money. So, if there is a mispricing of a particular product based on the underlying basis of the trade, particularly if there's an interest rate component, or an FX component, or something like that, then that's a price anomaly that will very quickly be exploited and priced out of the market.

I think a lot of cross-asset trading, also, comes, actually, just from the nature of people trading these various products. It's not necessarily looking to make money out of any price anomalies, it's just a fact of life.

So a lot of people who will trade interest rates are, naturally, trading the basis between the cash bond and the future. Similarly, we know options, there is an inherent correlation with the underlying. And you have to trade, see, if you're hedging, and I'm being dealt a hedge, you have to trade the underlying there.

So, I think it depends on how you're approaching these trades. If you are trading a particular asset class because you need to have a certain exposure in a particular market, then chances are, you're doing cross-asset trading more as just the mechanism of performing that trade.

But you might be looking at it and saying, “OK, I'm taking more of a macro view here. Is there a price anomaly between these different markets? And that's what I want to exploit when I'm doing my trading”.

Harry: Yeah, I think the question is, who has interest to do cross-assets, or not cross-assets. What are the benefits that each actor can benefit from? And I would say if we compare the time where the multi-asset was embedded into a structured product compared to today, we say that the benefit of pricing, semi-obscure structure, the structures in some ways, is to take margins in the way, and on the pricing levels, or to offer a product that is complex to assemble.

And the benefit of the price maker is to take the margin on the price by assembling all the different ingredients and the making the client pay for the transformation of these ingredients into a kind of blended product.

Today, I don't think anybody's willing to pay for this transformation price anymore, because we can see, the United States now, individuals suing, now, banks for having not the best pricing for an exchange. And we see some banks are suffering a lot from these potential trials coming.

So, less and less people are willing to pay for exotic structure, the premium of transforming simple products into complex products. But there is still a demand to, in fact, not assemble the products, but execute multiple execution at the same time.

And where the complexity and the risk has been, I would say, moved from, is not so much in the horizontal way to assemble different products and to monitor the risk of a blended product. It's really much more in identifying the risk of doing many more transactions of a single asset class at the same time.

And trying to extract benefit in a much more controlled way of what each trade can bring back to me on a micro level, compared to, saying, I don't know exactly what I make on my FX component on my blended product, but I know I make so much in the blended that I don't care if I really make profit dollars on the FX component or the option component, etc.

Today, there has been, probably due to the high frequency trading space, a huge boost to really be able to extract profit and risk and monitor risk at the level of micro changes of every move, every transaction that is done on each asset class.

And that's where the risk management has been, I would say, shifted to. Because we moved to a more, I would say, a computational risk management where multi Monte Carlo systems are running for days to extract the option or third level Greek exposure on this and this structure to something where the challenge is throughput.

So, how can I manage other risk if I have 10,000 trades a minute coming in my risk system, which is supposed to do deal normally with one every five minutes. So, the kind of risk management has shifted to something, again, much more simple in principle.

It's, "What margin do I take? What is my exposure in futures or in cash, euro, or bonds, etc.?" But to something which is much more an industrial capacity constraint. And in fact, that, again, pushes all the industry to be much more industrial, to produce with very controlled margins some products that are manufactured and on a huge scale, a little bit the same way everywhere that the regulators can control.

But where the profits are extremely low, and extremely small, repeated millions of times. And that's probably why the differentiations at the end would come between those who can be industry or manufacturers, and those who cannot cope with it and have to give up their activity to someone else.

It is definitely, all this is pushing to differentiating the, some way, the winners from the less winners, and so on.

Greg: I think a key word there is transparency. I think, the buy-side demands transparency. The regulators are certainly demanding transparency. So I think that's a driving factor in both reducing the complexity of the instruments, as again, you make it simpler, it's easier to define. It's easier to measure both in terms of execution, and in terms of risk management.

And also, as the buy-side demands more transparency, they want to see that there is fair pricing, in what's been done. They don't want something that's opaque that they have no idea how it's actually defined, measured and priced.

Harry: Yeah, I agree. And to do that, so that everybody understands, means that the pricing variable that we talk about is simple to understand for everybody. Something that everybody can know if we say, again, the pricing parameter is a formula that nobody understands and nobody can agree on whether it was a good price or a bad price. So, you can always say it was a good price, but what's the benchmark? There is no benchmark, etc . So, it's interesting. And, in fact, it has, I think, in some ways, the first demand was to go into more complexity following the years of the '90s and the early 2000s where banks were trying to, in some way, take margins by assembling more complex products and package more complex products together to send it to the buy-side. So, we saw the end of it, probably, with the Lehman days.

And now, this suddenly has shifted to, more asset classes, but in fact, not so much to complexify the product, but to industrialize and make everything more transparent, which was exactly the opposite goal three years before, to make it more transparent and more controlled and more regulated.

Where, as, a bank, I can, as a broker or whoever is in action, I can measure whether I'm profitable or not and I can measure my return, etc., etc.

So, and I think it's kind of a, how do you say in English? It's backlash or going one way and suddenly thinking that the goal is exactly at the opposite, which is going from less transparency to more transparency, is, I think, disturbing a lot the industry of players who are not prepared to move to a kind of a boutique financial approach of the investment banking to massive industry.

There is industrializations, like producing tires or pizzas or something. So, it's disturbing and it creates a huge shift.

And the winners, in some ways, are not so many, so easy to count today. Probably everybody has to focus on the idea that its core assets, and if you focus on your core assets, you may end up giving up other assets. So, losing the multi-assets privilege that you were trying to do. So, there is a kind of strange looping effect.

Greg: The other English term is a U-turn. A U-turn from opaqueness to transparency. And certainly, one that we've observed is, businesses that have traditionally been opaque in how they price what they sell to clients are now having to adopt the same approaches that have been used for years in businesses that are demanded to be transparent. For example, equities. There is, obviously, a lot of regulation around equities and has been for years. Some of those approaches that we have had to adopt in equities, we are now taking into these other asset classes because we have to have that transparency in how those asset classes traded.

Harry: But even transparencies are, in fact, I would say, that it's more that I would say that the field has narrowed. So, it's a, the game is, let's be opaque, as much as we can, but the field of the limits of acceptable opaqueness have narrowed to infinite boundaries where you can say, "I can price my stuff at any bid, any offer, nobody will criticize me now". I will say the game is OK, you can do it, but stay in the BBO, for example, if it's equities, or stay in an acceptable range inside the bid ask of a euro swissie. And the money has to be made in working these very, very narrow bands, where in fact, the bank or the brokers or the traders or hedge funds are making money, but by working at the scalper level, being opaque, but very, very narrow level.

That's creating such a challenge, technically speaking, that again, many people can hardly even make money by being just trading on the official BBO, which is too narrow for them.

So in some ways, the technology and I think the buy-side has pushed everybody in the ropes, because they are able, the hedge funds, to make money on this very narrow band on the high frequency level or not high frequency level. And the producers of liquidity have had to adapt their market making or distribution capabilities, so that they can take margin in this very narrow band, because regulator says the game is over. If you want to play, you play inside the BBO or inside whatever is the rule that we set. But in the end, the game is still to try to be opaque, but make it a fraction of a fraction of what it was, and faster than the other one, etc.

And if we take a microscope, we probably have the same behaviors from the algo engines that are hitting the market or the algo engines that are pricing the market. We would see it in a much more compressed way as what we had ten years before with phone calls, where you see that Peter has offered a price that is much more — totally out of the market, and John did the reverse outside.

So today it is all compressed. And the game will always be at the end, the market makers have to take their margins by trying to take advantage of a slight micromovement in the way they distribute price. And the other side has to take advantage of it. So that's limiting sharply the field in some ways.

Candyce: So this whole process in the equities world has squeezed out the market makers. There's almost no profit to be made unless you're a “high frequency liquidity provider”, and I don't really personally don't categorize liquidity providers and market makers in the same sentence. I don't think they're doing the same thing. Are we going to see a squeeze on market making in the OTC markets as a consequence of these regulations?

Greg: That's an interesting question. I think it still remains to be seen, with regards to how the execution facilities for the OTC markets are going to evolve. Where there is concentration of liquidity, I think you will see people moving into that space who provide this short term liquidity provision in other markets. We already know that there are a lot of people who are making electronic markets, not as a market maker, because they don't have the same obligations as a traditional market maker would, who do this function or provide this function across equities futures, options, FX, wherever there is concentrated electronic liquidity that they can trade.

If the SEF environment moves into that space — and bear in mind, this is still evolving, it's still very open as to how it's going to actually look — then we may see some of this, particularly in the more standardized and liquid products.

Candyce: So the more transparent they get, the less money a market maker can make. And so it's going to ultimately squeeze margins. And we were talking about some of the squeeze that's going on with investment banks. And Harry, you mentioned some trends before we got started on the recording, maybe you can talk about that. Because I think all of this is coalescing to put a lot of pressure on these banks.

Harry: Yeah, and I had a question just before…because that relates to the question of who can provide liquidity, who is a market maker, who is a broker, who does what and, for Credit Suisse, for example, a leading provider of electronic liquidity, I would say. Which is your worst nightmare in terms of competition? Is it more Deutchebank, Citadel, or InstaNet for example. (I don't know if it's the right names, but in terms of category…)

Greg: I have to be very careful how I answer that. It depends obviously what part of the bank that you're looking at. For the part of the bank that I work in…

Harry: …For the wholesale, I would say the wholesale business or…

Greg: For the agency business, certainly in equities, we focus very much on providing access to liquidity. Within the advanced execution services business, our whole modus operandi is providing transparency, access to liquidity, providing our own liquidity in terms of a dark pool where we aggregate liquidity. But we're not making markets, and we're not making products for you to trade against. You would get a different answer other parts of the banks, where they are actually providing liquidity, and in terms of making markets or providing quotes…

Harry: …On the books of the bank…

Greg: …On the books of the bank, yes. So it depends on maybe if you're looking at the principal or the agent side of the business.

Candyce: So it sounds like with the squeeze on market making, and the margins, and having to trade so tightly within the BBO, the regulators have taken away a lot of the areas where the big investment banks and the smaller ones were making profit. So what are they doing, how is this affecting these banks, at a time when also these regulatory demands are placing higher demands on their technological innovations, and what they need to do to comply? So there's a lot of costs and squeezing margins, I would say?

Greg: I would say one of the approaches that the investment banks are now taking is to look, as we discussed earlier, more holistically across a client's activity. So something that's definitely become more apparent over the past couple of years is we are having more key account manager meetings where we're looking at all facets of what a client's activity is. So as particular areas of business get squeezed in terms of the spread they might have been able to charge, or trade, or commission. Reduction is a constant factor, as obviously people look to reduce their execution costs.

It is making the banks look more at what the client is worth, and how much of their overall wallet the bank can work towards obtaining, as opposed to having this side-out view where someone might turn around and say, “Well, they don't pay me any money in FX, so I'm not going to do any business with them”.

But actually, they pay a lot of money in equities. Or they pay a lot of money in another asset class. So it's actually worthwhile doing business in an asset class that was previously considered unprofitable, because it enhances the overall wallet share.

And this is one of the key factors in being able to provide a homogenous service, whether it's through Prime Brokerage, whether it’s through electronic trading — these are the things that can enhance the wallet share that the bank gets from a client, because we want to be able to provide that sort of service. And if the bank can't provide that service, the client will go to another bank that can.

Candyce: Now are you seeing similar things with your clients, Harry? That they're finding opportunities to expand wallet share by offering these services, and by being able to get a more holistic view of a client's activity?

Harry: Yes, at smartTrade we are really involved in the execution, architecturing, or reorganization of the trading architecture. But I agree that the CRM, in some ways, aspect, is also a domain where a lot of value is lying. Trying to analyze the profitability of a client which has potentially tens of access points into the bank, on multiple assets, through different groups is a nightmare to solve, and requires a lot of probably organization and changes. But overall, what probably everybody's going through, even making a fraction of the debt crisis, of the collapse of the equity stock prices recently, is that probably the overall cake of revenues that are available in the investment banking world is probably not growing any more, if not declining, because clients are not willing to pay more margins. They're also trying to enhance their profitability. So, where the banks are working, whether it’s by trying to find more value from a client, or whether it is on controlling the risk they take, or trying to normalize the way they trade multiple assets is in fact going the direction of deep structural change on the way; the cost and the organizations are built, and in fact it goes very deep.

It used to be that every crisis we used to say, "OK by getting rid of a few traders, shrinking a bit more the number of clients the banks were talking to. We could up suddenly because of the growth of the market suddenly.

Find again, acceptable return levels, profitability where everybody was happy here. If the cake is not growing, the only way to make money — with everybody competing into its sector — so ECNs competing with banks, buy-side competing with ECNs, banks competing with an agency broker. So the only direction is diving under water. And impose structural changes in the way the entire business is done, but much deeper than anything that has been seen before.

And that's probably where again, the challenge is something that probably lies at the board level, of even raising the question of should we continue being an investment banking activity or not, in three to five years from now, because there are so many challenges that must rely on history, of being involved in technology, to measure profitability of a client.

So wallet sharing is something that requires a lot of systems, in risk management, in the having teams of people which are not inflating constantly. So by having to reduce cost teams, risk, latency, etc., going everywhere on the shrinking mode is a very, very big task that will make a selection of who can pass and who cannot pass.

In other words, by industrializing the process we see that everybody's going into a more rationalization because of much lower expenditures overall in the bank. And there is not one source. It is not only one asset class or one group of traders, or just by changing a risk system that the problem would be solved.

It's tackling everything at once, and rebuilding the way the industry is built. And regulators are pushing in this direction. They would be happier to have everybody aligned on the same model, to understand, track, everything that is done. Not to have explosions of collapsing institutions every three years for reasons that they do not control.

Everybody, including now the politicians would be happy to say, "Stay quiet for some time". So that's I think interesting because it's almost a rebirth in some ways of the banking industry, where everybody has to go his own way.

And we see it because as we have multiple Tier One clients, we see that everybody's going his own way in trying to reorganize his activities. And it's like a chess game: everybody has to play his game a certain way.

And again, if we take banks, the banks now do not have to face competition against other banks. I wouldn't say that Google will compete with banks, it's too far. But definitely today, ECNs, brokers, or exchanges or buy-side firms, hedge funds, are all potentially competitive also. It's interesting, at least it's interesting.

Candyce: Yeah, definitely.

Candyce: So, there you have it. Thanks again to my guests Harry Gozlan and Greg Wood. If you'd like to contact Harry, you can email him at hgozlan [at] smart-trade [dot] net. To contact Greg, you can email him at greg.wood [at] credit-suisse [dot] com.

I'm Candyce Edelen, CEO of PropelGrowth, and I look forward to joining you again next time on TrendSpotters. Have a great day.