It is a truth universally acknowledged that a basket of shares in need of rebalancing is in want of a good portfolio trader. These are lambent days, as demand for their specialist (and sometimes arcane expertise) is on the rise. But even while portfolio trading grows apace, the sector is itself in transition – facing a new set of opportunities and challenges. Trading strategies, benchmarks and the market structure are set to become even more sophisticated and competitive.

Zachary Tuckwell, global head of portfolio trading at Dresdner Kleinwort Wasserstein (DrKW)

THE UPSIDE OF PORTFOLIO TRADING

AFTER A PERIOD of lacklustre growth throughout the 1990s a noticeable uptick in volumes has occurred during the last four years. Market talk has it that in 2005 portfolio (or program) trading is finally walking tall. Back in 1995 portfolio trading accounted for barely 12% of all trades on the New York Stock Exchange (NYSE). By 2000 this ratio had crept up to just under 20%. According to specialist research house Greenwich Associates, the proportion of portfolio trades in relation to total trades now executed on the exchange rose from 44% in 2003 to 50% last year. That percentage appears to be on the rise again, as in early March the NYSE reported that portfolio trading accounted for 52.8% of its average daily trading volume.

Money managers routinely use portfolio trading to invest cash inflows, implement tactical asset allocations, manager or portfolio transitions and rebalance portfolios. There are myriad reasons why portfolio trading is gaining. Not least is the increased availability of technology, a trend towards quantitative 'top down' portfolio management, a greater focus on transactions costs, and a growing requirement for asset managers to respond quickly to market movements explains Emad Morrar, managing director, Lehman Brothers International (Europe). In that context he says, "portfolio trading is a critical execution method." Portfolio trading also allows asset managers to help control commission payments, the market impact and the opportunity costs associated with their trades. And "put simply, the price of program trading is lower than that of single stock trading," says Stavros Siokos, head of alternative execution sales at Citigroup.

The ability to deliver high quality executions for a large list of stocks is one of the main reasons for its increasing acceptance. Efficiency is a cornerstone of the business and automation of portfolio traders is of particular benefit to asset managers and bankers both. The ability to break down a sizeable (and otherwise market-seismic) block of shares into different combinations (say into specific

countries or sectors) which can be traded more easily, is a plus for asset owners and the market, explains Garth Ritchie, head of European equities trading at Deutsche Bank in London. The algorithms used in automated trading facilitate easier and more liquid orders and also give traders the time needed to structure and effect the trading of more complex baskets, he adds. Automation also helps keep the business efficient – a point noted by the rather tight numbers of traders in portfolio trading operations. However, as important is the fact that customers are sensitive to execution quality and prefer a greater degree of discretion when entering the market, something which automation confers effectively.

One of the benefits of a good portfolio trading desk is to be able to understand and accommodate diverse investment styles and approaches. In some instances, for example, orders from clients have special limitations, such as cash neutrality, sector neutrality, derivative overlays, or volume-controlled execution.

"The flexibility provided by computer-based portfolio trading systems means we can meet our customer's requirements precisely," explains Ritchie. Lehman's Morrar agrees. A key element of using portfolio trading is its ability to handle the complexity that results from intra-day market volatility. "Managing a quantity of futures to trade throughout the day while staying market neutral is a complexity easily handled," he notes. The speed with which a trader can prepare a list and get it to the exchange is considerably faster than if done via block trades, he adds.

Two approaches to execution dominate the business. The first is risk execution, which incorporates a variety of trading strategies specific to benchmarks or specific prices set by the client. It is also quite common for trades to be accompanied by a 'best efforts' mandate. Generally these are referred to as agency trades, where the prices the asset manager gets are the prices the broker achieves on his behalf. "In this case, no particular benchmark is given and execution decisions will be made directly by the portfolio trader on a multitude of factors, including liquidity and expected market direction," explains Andrew Freyre-Sanders, vice president, portfolio trading at JP Morgan Securities Ltd. At DrKW, explains says Zachary Tuckwell, global head of portfolio trading at Dresdner Kleinwort Wasserstein (DrKW), the business is split three ways: "with the bulk being a combination of pure agency, where the client takes the risk, and pure risk, where the bank takes the risk. The remainder is a mix that includes guaranteed close and guaranteed volume weighted average price [VWAP], where the risk is generally split equally between either the bank or the client."

Stavros Siokos, head of alternative execution sales at Citigroup

Like a number of houses, Deutsche Bank and DrKW have aligned the portfolio trading business with cash equities. Ritchie, prior to being promoted to head of European equities trading was in fact head of portfolio trading. "Our focus is for our FPT client base to mirror our cash client base," expands DrKW's Tuckwell, though he points out that this is a relatively recent phenomenon as previously the bank's global portfolio trading operations had been aligned to the bank's derivatives business. "DrKW offers clients an integrated and bespoke approach where our GPT cash equity teams will visit clients together and strategise together, whether it is a transition or agency deal. We listen to a client's objectives and then provide a best fit trading strategy to accommodate their needs."

Leading index providers have steadily moved to free float adjusted indices – a move designed to avoid supply and demand distortion of share prices.

This linkage with cash equities has invariably created opportunities for small, niche players to leverage business, particularly among the rising independent brokerages. Competition is invariably growing and the established historical dominance of houses such as Citigroup, Lehman Brothers, Deutsche Bank, JPMorgan and others in the portfolio trading segment is beginning to come under fire from quarters such as ITG and Instinet. These are not your typical custody firms with natural access to portfolios from either custody or transition management flow. ITG does claim transition management expertise, but Instinet for one sells its portfolio trading services instead" on being a

Emad Morrar, managing director, Lehman Brothers International (Europe)

pure agency broker, with the same sophisticated tools and expertise, but without the conflicts of interest," explains Natan Tiefenbrun, president of Instinet Europe, "we earn our money entirely through commissions and never by competing with clients". It is a pivotal selling point for the specialist broker. Tiefenbrun would have it that some of the investment banks do not, in fact, act in the best interests of clients. He cites the potential for front-running or pre-hedging which, which he says, could compromise the relationship between the client and broker. He explains: "If a portfolio trade is undertaken on a risk basis (where the broker guarantees the price) then how the broker subsequently unwinds the portfolio is his own business. However, in seeking risk bids for a portfolio, the client has already given them the information on the characteristics and constituents of the portfolio, and that can allow them to trade against the client, if they wanted to do so, even before the risk-price has been set. For agency trading, the question is whether you can get a true agency execution from a firm that conducts agency and principal trading side by side – data mining of customers' algorithmic trading to fee a bank's own proprietary trading decisions is commonplace."

Instinet's business model is different, says Tiefenbrun. "The way we pay our staff ensures it is aligned with our customer's best interest. We do not undertake principal trading, we preserve anonymity and confidentiality and an assured code of conduct ensures fair treatment, whether you are a large or small customer," he explains.

The response of most of the houses to the gauntlet of Instinet is phlegmatic. "DrKW offers a comprehensive and high quality GPT service and our risk offering is, as with other houses, very competitive and therefore our client business has been increasing steadily – we do not pre-position trades," says plain speaking Tuckwell, at DrKW, agency, guaranteed VWAP, and exchange for principal, or EFP. "Our risk offering, as with other houses, is very competitive and our business has been increasing steadily. We have no need and are not going to pre-position."

For some, the competitive argument is on a different plane. To compete at a high level in this business investment banks now provide a comprehensive range of execution services including "global agency and risk portfolio trading, hybrids, derivative portfolio strategies with futures and exchange-traded funds (ETFs) quantitative portfolio trades," says Ritchie. Within that the portfolio trader also has to provide liquidity, comprehensive risk management services, cash collateral financing and various analytic tools which can be applied before and after trading. Though Tiefenbrun concedes that there are significant differentials in structure and form and even breadth of total product offering between firms such as Instinet and the global investment banks, he believes that trade for trade Instinet provides the same if not more degree of care and support. Tiefenbrun insists "on an unprecedented level of transparency and we also have the advantage of not undertaking principal trading, which gives our customers comfort."

But there are other competitive considerations. Instinet, just like the investment banks, has a high level proprietary

portfolio trading system, "built up over many years," says Tiefenbrun. He concedes however that new entrants in today's market would require a significant investment in technology, "which would put the business out of the hands of the smaller investment banks wanting to enter the business, for sure."

Perhaps the highest degree of competitive pressure has been felt most in the area of analytics. "A few years ago, for example, very few offered pre-post trade tools. Now, it is a sine qua non," interjects JP Morgan's Freyre-Sanders. Pre trade analysis gives investors "the necessary data to make informed trading decisions at both a macro and micro level and provides the necessary inputs for trading algorithms," explains Adam Toms executive director, global portfolio trading and advisory at Lehman Brothers. "Post trade analysis meanwhile concentrates on cost measurement and the performance of the trading algorithms."

Mounting complexity means few banks can compete at these service levels, suggests Freyre-Sanders, who explains that "the launch of structured portfolio trading involves producing an all-encompassing service, which invariably means high barriers for entry.

Mounting complexity means few banks can compete at these service levels, suggests Freyre-Sanders, who explains that "the launch of structured portfolio trading involves producing an all-encompassing service, which invariably means high barriers for entry." Technology is a particular consideration, he suggests "because our clients have differing technology preferences and security concerns we can deliver our analytics either as a desktop application or through a web-based browser. It helps make us single stop guys. The underlying premise is the search for execution to live on its own."

Given the breadth of service it makes sense that more often than not portfolio trading services are provided in conjunction with global custody business and transition management services and because of that, most investment banks provide a multi-asset execution capability, although portfolio trading is, specifically, an "equities-only business," explains Lehman's Toms. "From that point of view, we note a dealing desk progression," adds Seema Arora, vice president, portfolio trading, JP Morgan Securities in London. "These days most buy side firms will use a centralised dealing desk to manage the execution of trades. However, we are now seeing a different breed of buy side dealer, especially on larger dealing desks, who require a variety of trading tools including: direct access to the market and the use of sell side algorithms for greater control and anonymity." As early as the spring of 2003 Fidelity Capital Markets, the institutional trading arm of Fidelity Investments largely began the direct access trend, utilising the enhanced the quantitative modelling capabilities of its portfolio trading operation as a key selling point of its service.

On the surface that kind of development appears to be every traditional portfolio trader's nightmare. Nevertheless increasing customer sophistication is seen as a benefit rather than a challenge. For one, "at Citigroup portfolio trading allows institutional investors to implement simultaneous investment decisions across a large number of securities throughout the world," maintains Stavros Siokos at Citigroup. "That by itself can not be achieved by direct market access. Asset managers will invariably have to access that global capability through us and houses like us." Like Deutsche Bank, Lehman Brothers, and JP Morgan, Citigroup's portfolio trading group encompasses around key teams situated around the world. "The bank's global market share provides a distinct advantage in our ability to service our clients," says Siokos.

Although Siokos notes "significant direct market access

Adam Toms, executive director, global portfolio trading and advisory at Lehman Brothers.

flow" it is "not as popular as you might expect." To be effective, he points out, you need a big sized trading desk and not every buy side institution can afford ten to fifteen traders to hand, backed by a small quant team. Equally, if something does go wrong you have no broker to help cover your position – so there is the added comfort of transferring those operational risks to the specialist."

There are myriad reasons why portfolio trading is gaining. Not least is the increased availability of technology, a trend towards quantitative 'top down' portfolio management, a greater focus on transactions costs, and a growing requirement for asset managers to respond quickly to market movements.

While portfolio trading remains a high volume, low margin business, it will continue to suffer particular stresses. The downside to the changes in portfolio construction is the transactions costs that investors are subject to in rebalancing portfolios. Combine that with regulatory pressures to understand the costs and fees that are being charged in the industry and the strain builds and builds. Consequently, "there is incessant pressure on margins and margins are being pressed to sub-economic levels," acknowledges Deutsche Bank's Ritchie. "There is always a new entrant to break ranks and come in at a favourable price, to win business," – a point not lost in the market. "It is question of positioning, expands Lehman Brothers' Morrar. We compete on product quality, not price – that is a losing game." DrKW's Tuckwell agrees. "Relationships are an incredibly important consideration, putting a human face on the trade and then trying to add value at every level. Everyone has their particular strength. You can win business just on price, but you can not keep it, if you are not adding value throughout the execution chain."

Natan Tiefenbrun, president of Instinet Europe

It is a complex balance, suggest Lehman Brothers' Toms between "people, systems such as algorithms and the value-added analytics and advisory on a pre and post trade basis and getting the balance right all the time." Morrar expands, saying that portfolio trading cannot be commoditised. "If you do that, there is no need for the quant teams or the analytics. Once you have made the decision to commoditise the business you have lost the game." Utilisation of algorithmic trading strategies alone does not, in fact, guarantee better results. Investors need to specify appropriate macro level strategies and select brokers who can align micro level pricing algorithms with their overall objectives. Ritchie meanwhile takes the pragmatic stance that "at some level market forces will prevail and the buyside will comprehend the level of service they get for the price they pay."

For the time being however portfolio trading volumes are pushing through at a heady rate and volumes are still compensating for the lack of really healthy margins. "We have seen geometric growth," admits Ritchie, acknowledging "portfolio transitions a key customer of the portfolio trading desk." For Deutsche Bank this note has particular resonance as the bank remains one of the top two transition management houses in the world

by volume of portfolio assets transited. "It certainly gives us an edge," he concedes.

The importance of an in-house transition management business however is neither ubiquitous, nor always fundamental to portfolio trading volumes. Siokos, for example, anticipates that only around 20% of portfolio trading undertaken by Citigroup this year will be a direct result of portfolio transitions. "In our firm," he says, "'Chinese walls' exist between the transition management team and portfolio tracing." However, he concedes that "transition management is a particularly strong element this year as a number of major indices have undergone a restructuring. Imagine how many index funds have had to readjust because of this."

Garth Ritchie, head of European equities trading at Deutsche Bank in London

Since 2000, leading index providers have steadily moved to free float adjusted indices – a move designed to avoid supply and demand distortion of share prices. In turn, capitalisation weight has shifted from low free-float companies to high free-float companies, requiring significant change or rebalancing of passive investment portfolios benchmarked against specific indices. Index providers FTSE and MSCI were early movers, moving to free float adjusted indices in stages between 2001 and 2002. Now a broad range of free float calculated indices are available in the market, ranging from the Dow Wilshire Indices to the SENSEX (Malaysia) and TSE (Japan) indices in Asia. Last year Standard & Poor's (S&P) announced it was moving to free float index calculations in two stages: half the float adjustments for each constituent were made in March, with the remainder scheduled for September.

As portfolios are continually rebalanced to compensate for changes, there is no doubt that portfolio traders have benefited and continue to benefit from portfolio transitions. At the top end explains Lehman Brothers' Morrar "with more complex multi-asset business, we would work directly with our transition team, which has separate reporting lines from our portfolio trading business. If it is equity only then it is in practice just a big portfolio trade, unless the client specifically wants a transition management project team around it." It is not an uncommon request, adds Adam Toms, "some clients want the trades undertaken behind Chinese walls. And with the equity markets on something of a rebound we are seeing more equity-only transitions."

The relationship between portfolio trades and portfolio transitions would suggest seasonal peaks and troughs though DrKW's Tuckwell notes that traditional trading patterns are in flux as "many passive managers are working smarter. There are a lot of people, both active and passive, who are looking at index make-up and starting to anticipate which way things will move. Some managers are not waiting for specific announcements and are moving slightly before or after an expected rebalancing of an index. It is changing the pace and tempo of the business."