Engaging the market with more intelligent FX orders

Order management has become an important area of focus for buy-side firms and, consequently, an area that any bank offering an FX trading platform is keen to develop. Nicholas Pratt examines the many ways that the buy-side can work their orders to improve the way they engage with the FX marketplace and how their needs may differ between different client segments – from the more casually trading corporates simply looking to hedge an exposure to the high frequency and high intensity FX traders looking to generate alpha.

The availability of order management algorithms has been hugely beneficial to buy-side firms in enabling them to minimise market impact and to achieve better execution results. And banks have been investing significantly to ensure that their e-commerce platforms can meet the new demands of the buy-side for more sophisticated order management and to keep pace with the accelerated evolution of the electronic FX marketplace.

Engaging the marketplace

There are essentially two ways for buy-side firms to electronically engage the marketplace, says Yaacov Heidingsfeld, founder and chief executive of US-based TraderTools which provides trading services to sell-side banks in the FX market. They could decide that they want to show a complete order to a particular vendor or they could decide that they would prefer to work that order within their own technology and only send it for execution once specific execution conditions have been met. "If you have a sophisticated order management system, which many more buy-side firms have now either created or purchased, you do not have to show your entire order to a particular market participant," says Heidingsfeld. "You can instead work the order internally by taking streaming executable prices into your system and only send an execution request to specific market

participants when pre-determined market conditions are reached."

The order management requirements will vary between different market participants. "At one end, the average corporate trading FX will be more business-sensitive rather than specifically execution-sensitive. Of course everyone wants the best price but a corporate may have a different approach to price discovery and the number of counterparties they go to in order to source that best price. At the other end of the buy-side spectrum lies the alpha-seeking hedge funds that are only interested in one simple question – did the order execute or not?"

Given that there is such a wide spectrum of buy-side clients, can a sell-side bank reasonably expect to be able to offer order management services to suit both the corporates and the alpha-seeking hedge funds? "If you're on the sell-side, it is important that you have the ability to accept as many different order types as possible and this requires banks to have the right technology," says Heidingsfeld.

"However, very few sell-side banks have the breadth, flexibility and sophistication of offering needed to be able to service all aspects of the marketplace, except for the handful of banks that occupy the higher echelons of the industry. For many other sell-side banks, they have made a conscious decision to serve one specific segment within the market."

Use of algorithms

Algorithms are being more commonly adopted among the buy-side says Heidingsfeld. "It is a developing trend, although it is still a far cry from being the standard practice. We are getting lots more inbound calls from buy-side firms – particularly hedge funds and alpha players that are looking to become market-makers – wanting to incorporate algorithms into their order management systems. So although it is not the market standard practice, I expect the adoption of algorithms and related technology such as complex event processing to increase during 2011."

So is it simply a matter of time before algorithms and CEP do indeed become the standard market practice and are adopted by all participants or will the technology always remain unsuitable for some? "The technology will be more prevalent than ever but the market will continue to splinter," says Heidingsfeld. "The corporates that are more service-focused than price-focused and the hedge funds taking a long term position are not going to need a high level of sophistication. But any firm looking to do high frequency trading or advanced market making will need to be using this technology if they are to beat the competition."

In terms of future development Heidingsfeld expects to concentrate on providing greater

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functionality for his existing client-base as opposed to rolling out the same technology to a greater range of clients and a larger number of first-time users. "We have had to extend our API to meet the growing demands of our customers (the sell-side banks) who are in turn looking to provide more functionality to their buy-side clients."

The aftermath of the financial crisis has led to a slight readjustment in the marketplace in the last 18 months. "Customers are returning to smaller banks, their more traditional counterparties, due to the lack of availability of free prime broking and similar mirage-like promotional offers from the top banks. The challenge for the smaller banks is to provide these returning clients with same level of functionality they enjoyed when working with the big banks," says Heidingsfeld.

This functionality includes offering a greater range of order types and also the ability to offer certainty of execution as the order types become ever more complex," says Heidingsfeld. "For example, banks must be able to provide their clients with the ability to engage in a sophisticated synthetic cross but also offer them a facility whereby they can be sure that both legs of the cross have matched and then only execute or cross the trade when both sides are suitably priced."

Above all Heidingsfeld sees the market evolving rather than changing. "I think the market will continue to grow at pace through the improvement of existing technology. Speed to execution will continue to fall, availability will increase and additional order types will be made available electronically."

Changing client demands

Many of Heidingsfeld' sentiments are shared by the numerous sell-side banks that have spent time and money investing in their FX trading platforms and have noticed the changing behaviour and demands of clients over the last decade, particularly when it comes to the management of their orders. "Every single client trades for different reasons and depending on the scale of the assets they manage has to execute in a range of styles of pairs," says James Dalton, director of FX algorithmic execution at Citi. "There is no one-size-fits-all answer to the best way to trade orders. We like to work with clients to find out what is driving their execution and offer them the appropriate range of execution services. For some clients, leaving an order with the desk is the right thing to do and for others, putting an order on an electronic platform is more appropriate. And for others, the best option is to use execution algorithms. It all depends on the market conditions, the currency pairs and the trading objectives of the client."

It is a far cry from the days when the only FX execution many buy-side firms were engaged in was on the back of equities or fixed income trades or an overlay account. But there is now a range from macro models to systematic currency portfolios that have emerged, all with their own execution timeframes and objectives. Furthermore, Dalton says that recent research carried out by Citi as part of its latest development efforts suggest that individual clients and not just client segments are looking to mix up their order types based on the market conditions. "They are looking for logic that allows them to automatically switch to an electronic execution or even an algorithmic execution in more extreme conditions."

If a bank is looking to improve the way they execute orders, they need to look at the flow they generate and consider the platform they are using, says Dalton, and this is leading many banks to turn to the single dealer platforms.