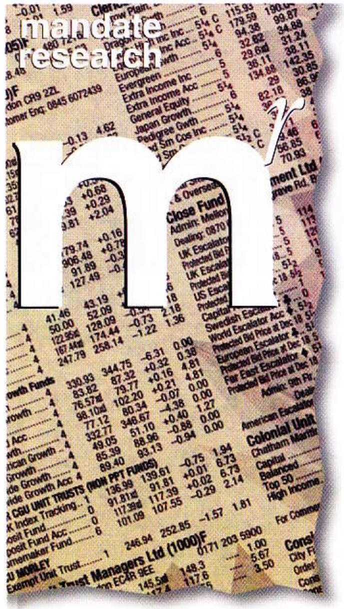
portfolio trading conflict-free services



Investors demand transparency, rules and conflict-free services

Technology is enabling asset managers to take more control over the execution process while also bringing clearer information flows to the industry. Banks must stay ahead of developments to succeed. **Karin Russell** reports

The market environment around portfolio trading has been changing radically. There are increased demands for greater transparency and improved regulatory controls, along with a desire for conflict-free services.

These are driven by the ongoing evolution of technology, coupled with the increased sophistication of both asset owners and asset managers.

Key themes in the financial press and events such as the recent Trade Tech 2004 conference in Paris are focusing on the future of the financial services industry. In particular, much attention has been given to addressing the growing importance of conflict-free services as well as how to provide the desired transparency.

Asset owners are looking for greater clarity on how their assets are managed, including the processes involved in the investment decision-making initiatives and the subsequent handling and placing of transactions in the market. Asset owners want to know what services they are paying for while having the comfort and trust that the assets are managed in their best interests.

The requirement for transparency, combined with a move towards unbundled execution and research, has put the onus on asset managers and brokers to adjust their legacy business models.

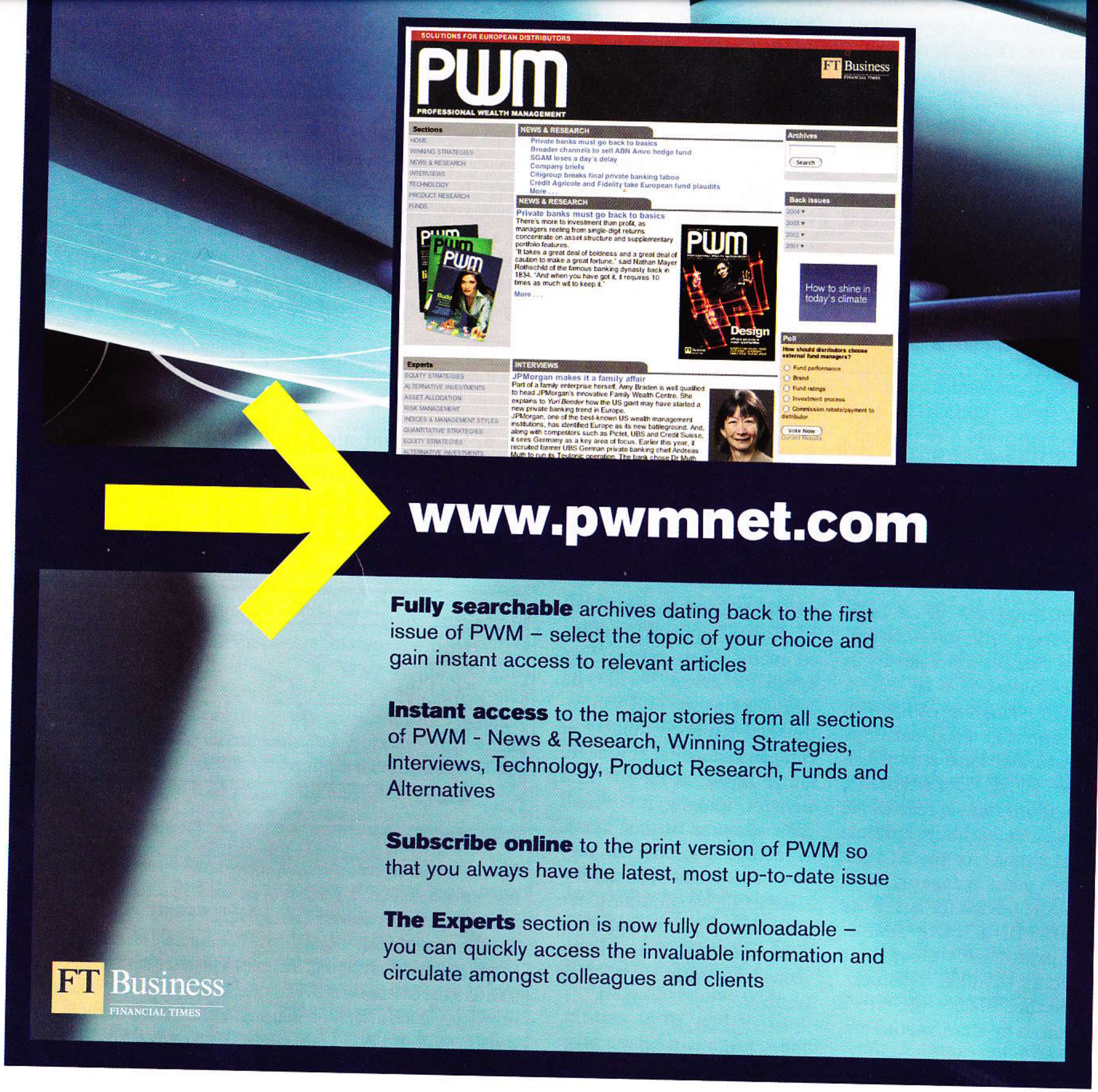
However, this development

firms. If the decision is taken to use independent research providers, the only question remaining is what execution venue to adopt?

One possibility is for the investor to do the trading themselves via tools provided by their broker, or they can select an agency-only execution broker. In this scenario the investor will be comforted by knowing that transactions are dealt with only in his/her interests, and they do not conflict with proprietary trading activities.

By using different providers for these two distinct services, with each one paid separately, one can ensure transparent, conflict-free service and best execution management of the investors' business.

Asset owners



it a revolution where all asset owners begin to manage their assets internally. Outsourcing components of asset management will continue because most asset owners have neither the economies of scale nor the necessary tools for the complex risk management and risk control requirements.

This development, however, will lead to more rigorous manager selection processes by the asset owner, and more rigorous broker and research service selection processes by the asset manager. Ultimately, there will be little room for the unsuspecting yet trusting client to be exploited.

One way to address the issue of conflict-free execution and research services is to choose investment advice from third-party research providers, who are free from any potentially conflicting businesses.

The increasing importance of independent research is demonstrated by the growing number of international full service broker dealers choosing independent research distribution products.

Many of these broker dealers are responding to the recent regulatory settlement in the United States where regulators felt that investment banking interests had too much influence on securities research at brokerage

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When dealing with full-service brokers it is impossible to quantify how much of the commission goes towards paying for the clearance, settlement and execution of a transaction, and how much is applied for the investment advice (as illustrated opposite in the graph on the anatomy of a commission).

Nowadays, asset managers are no longer compelled to purchase one product or service as a condition to receiving another.

Investors can also utilise global portfolio agency brokerage divisions. As part of their commitment to the notion of conflict-free trading, global portfolio agencies offer investors a choice of execution platforms on which to direct their trading flow on an agency-only basis.

As an agency broker, there

Russell: companies that adapt to technology will thrive in future

is no incentive other than obtaining the best price reasonably available on behalf of the client. The client pays for this service with a fully disclosed commission, therefore meeting the transparency requirements demanded from investors and regulators.

Portfolio trading has always been an execution-only product and is ideally positioned in a transparent environment with an agency-only broker it fulfils the requirement for a conflict-free service. Clients place their orders at the industry's most competitive commission rates, secure in the knowledge that the commission is exclusively used to pay for their execution.

in any format a client requires, assisting them in managing the booking process within their environment with little manual intervention.

Last but not least, these developments progressively provide asset managers with transparency and additional flexibility to extend the responsibilities of their internal trading desks to executing their order flow directly in the market via trading tools provided by their brokers.

Within the financial services industry and the portfolio trading houses, there has always been evolution, and with it comes the onset of higher quality products and new value-added services from new market entrants as well as the established payers. The market and industry is constantly changing and moving forward providing a more efficient, clearer and safer investing environment.

A constant and important differentiator for all is the flexibility to adapt to these market changes and remain innovative. While technology is a big expense, providers must realise that to compete they must stay abreast of the latest developments.

But many providers have struggled with reluctance to adopt new technology.

THE ANATOMY OF A COMMISSION

15 basis points commission

Bundled brokerage arrangements	
Access to management	?
Access to IPO market	?
Access to research analysts	?
Capital commitment	?
Fund placement, marketing & distribution	?
Execution, clearing, settlement & administration	?
Total	**€50,000**

15 basis points commission

Independent research arrangements	
Asian strategist (Research works)	€14,000
Technical research (Stockcube research)	€8000
Global strategist (Independent strategy)	€6500
Analytic systems (Bloomberg)	€4833
Execution, clearing, settlement & administration	€16,667
Total	**€50,000**

Source: BNY

made use of portfo-lio trading, whereas today, active managers and hedge funds are increasingly using portfolio trading as a way to efficiently manage cash flows and top-down asset allocation shifts.

Another factor contributing to the strong growth in portfolio trading was the Myners report on institutional investment in the UK, which put trading costs and the subject of transparency into the foreground. Indeed, it led to the Financial Services Authority's CP176 legislation on unbundling which is designed to improve customer transparency, lower costs and remove potential conflicts of interest.

Superior technology is one of the most important success factors differentiating portfolio trading service providers. Technology has enabled execution tools to be developed that analyse transaction performance in real-time, while processing and executing hundreds of transactions across multiple markets simultaneously in a transparent fashion.

These execution tools enable brokers to access exchanges and liquidity channels easily from anywhere in the world and achieve quality executions with tight benchmark performance.

Technology also allows the creation of execution reports with performance analytics not the determining factor for success, rather the ability to be flexible plus a willingness to change and react to clients' demands and needs.

If in the future, the industry remains committed to providing a transparent and conflict-free investing environment, relationships with clients will involve not just supplying generic financial services, but also ensuring that a long-term partnership exists, with mutual understanding between clients, brokers and asset managers.

This creates a level playing field where all parties are involved in achieving common objectives while staying committed to their own individual interests. In this future environment, clients will pay a commission commensurate to the service they receive and should be happier in doing so.

Technology already is, and will continue to be, an important factor in making the communication more efficient and transparent.

The successful businesses of tomorrow will not necessarily just be the established firms of today, but those that are flexible enough to respond to the demands of their clients, relate to them and deliver customised and innovative solutions.

Karin Russell, managing director, The Bank of New York