Co-sourcing: The Evolution of Trading Operations

Outsourcing, as a tool for managers as they seek to compound returns for investors as efficiently as possible, is at the forefront of the trading operations of firms both large and small. A Greenwich Associates blog post bears this out: 20% of the study's 89 respondents recognize it as the go-to solution for trading. However, 72% still consider it to be the domain of smaller fund managers. In fact, margin pressure, affecting asset managers of every size, has been on the rise for some time, as ETFs and other passive strategies have pummeled managers' bottom line. In 2020, pandemic-driven, global economic gyrations have increased volatility and made liquidity difficult to access, contributing to a mosaic of rising trading costs and the search to find ways to mitigate them.

Asset managers already benefit from using outsourcing as a tool to expand capability and maintain margins. Too often though, outsourced solutions come as a "one size fits all" proposition, putting asset managers in the position of compromising the very efficiencies they were seeking in the first place. Asset managers' needs are as diverse as the number of asset managers that exist. It turns out that one size does not fit all, leaving many managers unable to get where they want to go for lack of a partner that meets them where they are.

In an effort to fill this gap in the solution set for managers, more customer-centric service providers took the concept of outsourced trading and made it more cooperative, becoming more than just another vendor but instead seeking to partner with a manager to craft a trading operation that efficiently executes the manager's trading strategy. What has become known as co-sourced trading is now embraced by asset managers of all sizes, including hedge funds and family offices. We have already discussed what has spawned this growing trend, but what constitutes co-sourced trading? What services can you receive? How can these services enhance your business? How can you evaluate providers? We explore these issues and outline a roadmap to put you on a path forward.

CO-SOURCING: THE EVOLUTION OF A HIGH-END BUSINESS MODEL

The key to understanding co-sourced trading as an evolution of the generic outsourced model is customizability. A co-sourced solution will maximize the value of in-house assets while opening the door to capabilities that may be beyond your reach without significant investment of time, money, and energy. Rather than simply shuttering your trading operation and turning everything, lock, stock and barrel, to an outsourced trading provider, you may choose to retain your in-house trader with their specific skill set and expertise and forego hiring additional staff by relying on your co-sourcing partner's capacity to serve a specific asset class (derivatives or rates) or geography (Asia or Latin America). It really is like moving from a prix fixe model to an à la carte model, or put more bluntly, a transition from a "my way or the highway" model of doing business to a partnership that focuses on ensuring the customer gets what they need as efficiently as possible.

A SPECTRUM OF SOLUTIONS

If we think of outsourced trading as the wholesale transfer of trading operations to a third-party, co-sourced trading is that customizable spectrum of options that exist between keeping everything in-house and the fully outsourced solution. Co-sourced trading solutions allows an asset manager to work with a progressive service provider willing to cooperate in crafting a bespoke trading solution.

Imagine a volume knob that adjusts how much you want to entrust to your provider. A little turn of that knob gives you access to your provider's global trading hours. Turn it up halfway and you add the ability to trade across asset classes that you would never have felt comfortable trading yourself. Turn it up a little more and gain access to markets that are only available to the biggest of managers.

Regardless of where you set the knob, it is always going to be your hand doing the turning, getting exactly what you want out of your provider to help you accomplish your goals.

THE BENEFITS OF THE CO-SOURCED TRADING MODEL

First and foremost in the benefits column is better execution quality. Access to indications of interest (IOIs) and natural flow from the street means you can identify the other side of your trade. A common rule of thumb is that higher AUM results in fewer cost savings, but that truism is being supplanted as even larger funds seek new pathways to efficiency. Outsourcing lets you transform fixed costs to variable costs, based on trading frequency, with greater access to pools of liquidity. These include not only the explicit costs from brokerage fees but also implicit ones, such as the bid-ask spread, market impact, and arrival cost (the delta between the price at which the order originally was placed and that at the time of execution). All of this means you can deliver on your best-execution obligations and at the same time either disclose your position (or maintain anonymity, if that is your preference).

Co-sourced trading lets you share the seniority (and experience level) of senior, experienced, buyside traders to complement your own dealers. Equally valuable is obtaining high-touch services—delivered via your partner's ecosystem of global brokers, bankers, and technology and operations providers. These services give you greater advantages than you can typically reach through your own internal, and possibly less-robust, channels that may not have the breadth and reach your strategy demands.

Another edge during both normal and increasingly turbulent times is 24/7 global connectivity to leverage all geographies, asset classes, and market conditions. Your partner's one-stop proficiency in complex assets, including equities, credit, rates, commodities, swaps, options, futures, fixed income, and FX, augurs well for you when your strategy's success hinges on instant information and first-to-market status. Consider, too, the supplemental services, such as middle- and back-office support, a single point of contact between execution and technology, and an outsourced COO function.

HIDDEN BENEFITS

Every fund manager shudders at the thought of a “black swan” disaster: a hurricane that cripples operations; a devastating global recession; a cyber breach that exposes data on critical portfolio holdings; or a pandemic forcing a global business shutdown with mere days to prepare. Co-sourcing partnerships are a bulwark in maintaining business continuity. Your partner takes the lead by shouldering the burden of conducting a capabilities assessment and performing crucial vendor selection, including cybersecurity. Being prepared for a disaster will be the key to your survival.

An added bonus: Co-sourcing not only supplements existing infrastructure with little material increase in costs, but syncs with the work-from-home (WFH) model that is a reality of today’s business landscape.

Finally, co-sourcing partnerships help ensure compliance, a task that often demands employing a posse of professionals to stay current on the latest regulations and a legal staff to enforce them. By contrast, your partner’s staff routinely deals with compliance and regulatory issues, such as the Market in Financial Instruments Directive (MiFID II) rules for transparency in research and trading costs mandated by the EU. Your partner also oversees an array of commission management, commission sharing rules, and commission sharing agreement aggregation closer to home, thus sparing you the administrative headache that accompanies them.

WHO ARE THE PROVIDERS, AND WHAT SERVICES DO THEY OFFER?

At their core, an outsourced trading partner is a force multiplier. They allow you to add capacity, replicating all the functions and duties of an in-house employee without expending the resources it takes to interview, on-board and train a new human resource and the ongoing costs associated with maintaining that employee — a compensation package, a Bloomberg machine, a career development program, etc.

Providers typically comprise divisions within diversified financial services firms. There are two primary distinctions between outsourcing and co-sourcing providers, 1) the scope of services offered, and 2) the ability to customize an offering to meet the need of the manager. A good co-sourcing partner is going to be able to provide a more flexible solution because of the wider choices available from the menu of services and the willingness to deliver that bespoke package of services.

OUTSOURCED MENU

Execution
- Provide access to global execution venues 24/6
- Deliver best execution
- Find the necessary liquidity
- Minimize market impact
- Trade anonymously or secure attribution, to suit the needs of the manager

CO-SOURCED MENU

Pre-trade
- Screen names for consideration
- Evaluate financing options
- Consider tax implications
- Examine proposed trade in the context of the larger portfolio
- Advise on the suitability of proposed trade for manager's strategy
- View the trade versus overall market conditions
- Assess the viability to trade on swap
- Estimate liquidity
- Offer guidance on entry/exit timing

Post-trade
- Verify all executions are reflected accurately in systems
- Real-time insight into portfolio risk
- Ensure all bookings, commissions, and securities are settled at the appropriate custodians

Support
- Track liquidity and/or correlation risks
- Monitor positions for important moves and upcoming expirations
- Hedge FX risk in the portfolio
- Keep investment team apprised of opportunities on syndicate calendar
- Access to quality information designed to aid in strategy and execution
- Easy access to comprehensive expertise
- Oversee stock loan portfolio
- Develop and advise on financing options

The services offered by providers can be broadly classified into two groups, trading and support. The execution services are pretty standard across providers. It is what happens before and after a trade and the support functions where a good co-sourcing partner is going stand apart from the rest of the outsourced providers.

WHAT TO LOOK FOR IN A CO-SOURCING PARTNER

Co-sourced trading services are intended for professional, institutional asset managers. You are going to want to stop and consider the costs associated with engaging with a partner relative to the costs of building global trading capacity in-house. Make sure your firm's investment strategy is compatible with the use of a co-sourcing partner. Each provider is going to have a unique set of terms for their services, so review the agreement from the providers under consideration to make sure that what they are offering is going to meet your needs.

Depending on your fund's strategy, you have a plethora of wants and 'must haves' on your wish list, but a partner with an experienced team made up of the "best and brightest" is paramount. That team should comprise senior, skilled, buyside traders with experience across geographic regions and asset classes, and who are infused with diverse product knowledge. The team also should have a history of success in forming partnerships with clients like you, while modeling a culture of accountability and confidentiality.

Next on the list should be a record of high-touch competency and senior sell-side connectivity. This includes displaying multi-asset capability, global connectivity, and best execution while furnishing middle- and back-office support. Your partner should be an authorized trader and executing agent, essentially functioning as your in-house trader.

Also vital is your partner's capacity to direct trades using your order management system so that the sell side recognizes your fund as the counterparty and settles against you. You should receive fully transparent attribution from banks, when appropriate, so that no confusion arises as to counterparty relationships.

In addition, you want ample liquidity and best execution, so your partner should have an extensive broker network and liquidity venues to supply these services. Ideally, that network will be global, thus ensuring you have the best access at the lowest cost in whatever geographic area you need it. "We are agnostic on trade execution and send the majority of our orders to other banks and brokerage firms," says Andrew Caplan, Head of Outsourced Trading for StoneX Financial Inc.'s subsidiary, INTL Fillmore.

Your provider's platform should be effective and cost efficient to supplement your process. At a minimum, it should facilitate customized solutions and provide live updates on your portfolio's risk. It also should allow for synchronized communications among team members, reduced friction for booking and settlement of trades, and a multi-custodial risk and enhanced reporting platform.

Additionally, you want meaningful, custom content. This could include market insights in the form of daily calls and emails on portfolio performance, market developments, and market intelligence, plus thought leadership that you can disseminate to clients. You should receive market recaps, research relevant to your strategy, and risk and macro views to give you a competitive edge in managing your fund.

Performance analytics will simplify your decision-making, along with proactive, opportunistic risk metrics, including liquidity, sizing, and factor analysis. You should expect to receive idea generation from your partner that incorporates trade analysis, pricing, and themes.

Finally, you want access to prime brokerage (both self-clearing and introduced) and fully paid securities lending at competitive rates.

CONCLUSION

Co-sourcing extends beyond traditional outsourcing—it is a partnership between you and an experienced team that can deliver untold benefits at competitive prices. You have a choice of providers offering different service models. INTL Fillmore's experienced team of professionals, underpinned by a 200-member broker network and global presence across asset classes, and combined with an enviable record of client success, makes it a top choice. To put INTL Fillmore to work for you, call **+1-415-230-5504**, email **Andrew.Caplan@StoneX.com**, or visit **stonex.inc/cosourcedtrading**.

Carefully consider a fund's investment objectives, risk factors, fees and expenses before investing. This and other information can be found in the fund's prospectus which may be obtained by contacting your broker.