

# THE HUB MARKET INSIGHTS

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

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## Trading: it's a big deal

### Key Takeaways

- Following MiFID II, institutional investors need to provide higher levels of transparency and reporting on their trading activities than ever before.
- The complexity and sheer range of securities used in share dealing today is forcing many to outsource their dealings to specialist trading providers.
- Small insurers and pension funds, in particular, may not have the trading volumes to justify spending on technology and human resources.
- An outsourced solution that provides access to liquidity and benefits from straight-through-processing can reduce risks significantly – even for larger, more sophisticated institutions.

Is MiFID II a gamechanger for asset managers or had the game already changed?

It's pretty clear that the fragmentation of liquidity occurred many years ago and best execution was already a major issue for investment firms long before MiFID II came into force in January 2018. MiFID II's impact is to ensure that institutional

investors that viewed best execution as "nice-to-have", now regard it as essential. The European Union Directive requires investment firms to take all "sufficient" instead of all "reasonable steps" to obtain, the best possible result for their clients.

Dealing is now so important to investment strategies and so complex that inhouse trading functions are struggling to keep pace. Many investment firms operate with a very slim trading team, which deals securities across multiple asset classes, using multiple data feeds and platforms.

It's really no longer a one-man job. It's probably not even a one-team job any more. This is why more and more institutional investors - including larger ones - are outsourcing their dealing to specialist trading providers which not only understand the wide range of securities used today, but are aware of their idiosyncratic needs.

### Twists and turns in market structure

Market structure has changed beyond recognition from the (relatively recent) days when stocks were traded on a single, local exchange and bonds were traded with a single broker over the telephone.

For equities in particular, liquidity is now fragmented across venues and platforms, and the fragmentation process could



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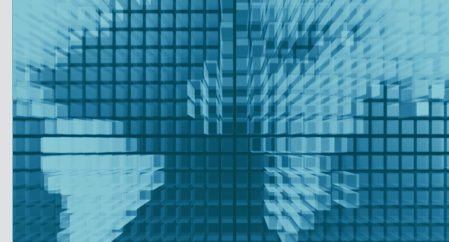
yet continue as technology evolves and specialist providers enter the market. The challenges of finding liquidity have been further exacerbated as banks have shrunk their balance sheets in the wake of the financial crisis.

MiFID II ramps up the pressure still further by demanding that asset managers find the liquidity they need to fill their orders and execute at the best possible price. Institutional investors must also provide higher levels of transparency and reporting on their trading activities than ever before.

In terms of transparency, they must provide pre- and post-trade transparency on equities, bonds and derivatives. In terms of reporting, they must provide post-trade transparency in real time and expand their data reporting with dozens of new data fields.

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In other words, amid already complex infrastructure, institutional investors are being asked to both execute deals better and prove beyond doubt that they have done so. Little wonder that MiFID II kept so many COOs up at night in late 2017 (and still does, in some cases).

It is perhaps in bond trading where the impact of the regulation will be felt the most. With pre- and post-trade transparency now mandatory in fixed income, it is likely that bonds will undergo a similar journey to equities. That is, bonds will increasingly be traded on platforms to generate the data and transparency that regulators require, and this will lead to a proliferation of fixed income technology and platforms. The result: huge potential fragmentation of liquidity in fixed income markets.

## The impact of vanishing liquidity

With the fixed income and equities worlds converging, institutional investors of all types and size are reconsidering how to make the best use of their available skillsets and resources.

There is no one answer to solving the liquidity puzzle, but the key is to be aware of all possibilities and opportunities, and to have connections to all the relevant platforms and technologies.

To do this, trading functions must have sound knowledge of the various markets, deep relationships with counterparties and manage their data efficiently. They must also keep a watchful eye on technology as it emerges and commit to the right systems at the right time.

With profit margins compressed, trade execution and the associated costs become critical to business success. The trouble is that many institutional investors – particularly smaller pension funds and insurers – operate at sub-scale and are unable to capture efficiencies available to larger competitors.

The landscape for dealing is now just too broad and contains too many new features to be navigated successfully.

## Outsourced trading

The solution for an increasing number of institutional investors is to outsource the trading function.

By outsourcing, these investors can benefit from the outsourced provider's established market footprint – broker network, market access, economies of scale – which offers cost efficiencies through reduced infrastructure investments and lower trading costs. It allows investment managers to focus on their core investment mission while trading in an efficient framework that meets institutional clients' growing expectations in the wake of MiFID II.

An outsourced solution should also include a full suite of services along the trade execution chain - liquidity access, best execution and selection, reporting services, research administration, and risk and compliance functions.

## Hi-touch, low-touch world

Only an outsourced provider with deep knowledge of buy-side needs can offer all this and customise it to the needs of individual investment institutions.

"Outsourced solutions should be both tailored and comprehensive," says Olivier Houix, CEO of Natixis Asset Management Finance. "Because it was created (in 2009) with the requirements of Ostrum Asset Management in mind, we're able to respond to the particular needs of the buy-side."

By aggregating the assets and orders of dozens of buy-side clients, the team has access to more data, more venues and more technology than the majority of in-house trading functions. "We offer access to 85 brokers and provide an a la carte service across the value chain," says Laurent Albert, Global Head of Trading. In 2017, the team traded €238bn for clients, across fixed income, equities, forex and money markets.

Its size and reputation mean Natixis Asset Management Finance not only achieves cost efficiencies in secondary markets, but is given preference by

primary dealers, so its institutional investor clients can obtain better access to the issues they look to invest in.

The tailored approach involves recognition that for some deals, investors need plenty of assistance, while other deals can be easily automated. "So rather than segment deals by asset class, and organise its resources purely by market segmentation, we divide the world into hi-touch and low-touch trading," says Albert.

By doing this, Natixis Asset Management Finance puts itself in the institutional investor's shoes rather than adopting the classic broker approach of segregation by asset class. It's a different way of looking at the same issue and, even in a world of ever-greater automation, acknowledges that successful trading requires a human touch. This is particularly valuable for investors such as insurers and pension funds, which go down the liquidity spectrum to less liquid instruments, such as peripheral market bonds or high yield.

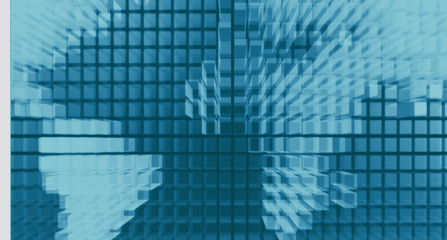
## Primary and secondary market benefits

For institutional investors, the tailored, outsourced solution allows for full compliance with new regulation, including the data analytics needed to perform pre- and post-trading analysis. In fact, this not only enables regulatory compliance, but improves portfolio performance too. "We achieved up to 40bp trade improvement for unconstrained equity trades executed on our platform in 2017," says Houix.

While transaction cost analysis (TCA) is a staple of equity trading, and is well understood by equity-focused clients, fixed income TCA is less well established. However, outsourced providers with broad market connectivity can access and analyse the data necessary to perform TCA on fixed income trades.

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The outsourced solution has tangible benefits for investment institutions in primary markets too. In 2017 the buy-side overall achieved bond issue allocations of about 45% of its orders. The Natixis platform, because it is rated Tier 1 by primary dealers and due to the quality of relationships that have been established, achieved allocations of 61% for its clients. This is very much in line with historical allocation increases that the platform has provided over time.

## Who is outsourcing suitable for?

Not all institutional investors need to outsource their dealing. Some, mainly large, multi-asset, investors have the resources to build their own sophisticated and comprehensive trading desks. For small insurers and pension funds, in particular, the resources are often not available to deal with the complexity and fragmentation in markets. Equally, they may not have the trading volumes to justify the spend on technology and human resources.

Without the requisite resources, the operational risk of dealing rises considerably. Reporting in real-time can be a burden, while risk and compliance teams can become stretched.

An outsourced solution that provides access to liquidity and also benefits from straight-through-processing can reduce risks significantly, even for larger, more sophisticated pension funds and insurers. Having an outsourced trading provider whose systems can adapt to the client's back, middle and front offices is critical to managing risks. For smaller institutions, with monoline businesses, simple web-based tools can also offer seamless connectivity to markets.

"Our three full-time risk officers ensure that operational risk is reduced to a minimum, while our technology experts continuously scour the market for new technologies that offer solutions to access liquidity across a diverse set of pools," says Houix. Technology investments also require frequent upgrades and additional resources dedicated to maintenance and software development.

## Conclusion: future-proofing the dealing function

The liquidity puzzle is becoming increasingly complex to solve and market experience is a critical factor in navigating fragmentation.

A key objective for any institutions is the ability to reduce trading costs across asset classes in the current environment of diminishing liquidity. Flow aggregation and size impact is therefore paramount: a centralised trading operation has the potential to give participants benefits linked to economies of scale.

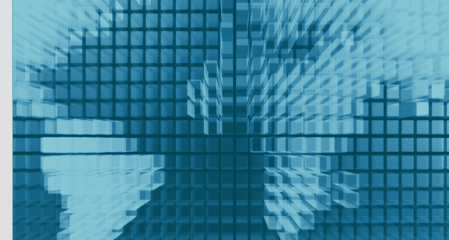
To assess execution costs accurately, it is important to broaden the scope of analysis and use both human and technology resources. An execution platform which combines these resources should not only provide best execution in the current environment, but achieve it when market structure or regulation changes in the future.

Written on 22 August 2018

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