

# Multi-Asset Masters

## How Mellon Capital's Lynn Challenger effectively manages a desk trading stocks, bonds, currencies and derivatives

Traders Magazine, September 2013

Mary Schroeder

For Lynn Challenger, the last seven years have been one big project: transforming a far-flung order processing operation into a centralized, multi-asset trading hub where the traders take responsibility for each and every order.



Mellon Capital Management's managing director of global trading oversees nine traders trading equities, futures, currencies, fixed income securities and swaps from the quantitative money manager's base in San Francisco. All told, group turnover is about \$1.2 trillion annually.

Before joining the storied money manager in 2006, Challenger spent 16 years on the sellside, mostly as an options trader. While he says his broker-dealer background was not a factor in his hiring, he does expect his group to think and act like sellside traders.

"I strive to bring the sellside mentality to the buy-side," Challenger told Traders Magazine. "The way technology has moved, it's really empowering the buy-side to make their own trading decisions and choices and manage their own risk. They're not just order processors that rely on sales traders to manage their orders. What we've been building on for the last six years is a true trading desk."

Mellon Capital Management is one of 16 subsidiaries of \$1.4 trillion asset manager BNY Mellon that includes such well-regarded money managers as Boston Company, Standish Mellon and Dreyfus Corp. It manages \$327 billion of its own, mostly in indexed equity funds. In that game, Mellon is ranked among the Top 5 passive U.S. index managers, a list that includes BlackRock, State Street, Northern Trust, and Vanguard Group, according to Pensions & Investments newspaper.

The firm was co-founded in 1983 by now-chairman emeritus Bill Fouse, widely recognized as the "Father of Indexing" and the creator of the first index fund. That was in 1971, for Samsonite Corp.'s pension fund. With that move, Fouse introduced quantitative investing to the pension fund world, although it would be many more years before passive indexing became accepted. The practice has since exploded, with assets in U.S. index mutual funds and exchange-traded funds accounting for 34 percent of equity and 18 percent of fixed income funds as of year end 2012, according to Morningstar. At \$252 billion, more than three quarters of MCM's assets under management are in indexed equities. The investment category became enormously popular in the years immediately following the financial crisis of 2008 as investors shunned individual stocks.

The flight to index funds has propelled much of MCM's growth. Since Challenger joined the firm in 2006, MCM's assets have grown from \$175 billion to \$327 billion. At the same time, the number of MCM's investment strategies has also grown, rising from 105 at the end of 2010 to 145 at the end of June.

### **SPRAWLING OPERATION**

Challenger has spent most of his time grappling with the expansion of the firm and reining in its sprawling trading operation.

He has overseen the consolidation of the equity trading desks of three former Mellon and BNY units into MCM, and took over fixed income trading as well.

When he arrived at MCM, the fixed income portfolio managers did their own trading, while the trading desk handled equities, futures, FX and some swaps. Over time, Challenger's group gradually took over trading of all fixed income products, consolidating it in San Francisco.

Meanwhile, four separate asset management entities have been rolled up into MCM during Challenger's tenure, with their trading also centralized in San Francisco.

On the equity side, after the Bank of New York and Mellon Financial merged in 2007, Mellon Capital Management took over the quant units of each bank.

In January 2008, Pittsburgh's Mellon Equity Associates was merged into MCM, adding \$21.3 billion in equity index and active quantitative assets, according to P&I in 2006.

In February 2008, the Quantitative Equity Management Group unit of the Bank of New York was merged into MCM.

A year later, Boston's Franklin Portfolio Associates was merged into MCM, adding \$32.4 billion in indexed equity assets, according to P&I in 2006.

While portfolio management is still done in Pittsburgh and Boston, equity trading was consolidated in San Francisco in the years that followed. In a major reorganization of the equity trading team late last year, Challenger shuttered MCM's three-person

Pittsburgh trading desk. John Keller, originally with Mellon Equity Associates, ran that desk for a number of years. He is no longer with the firm.

MCM chose San Francisco over Pittsburgh because that's where the firm's decision makers are based.

"Given the global multi-asset nature of our firm, I believe it's very important that the traders that are dealing with real-time issues are talking in real time and sharing in real time," Challenger said. "Getting them to communicate, work as a team and share information is very difficult when people are in different physical locations."

Before last year's merger, there were three traders in Pittsburgh and seven in San Francisco. There are now nine in San Francisco. On the equities side, three traders handle a mix of programs and single stock trades. Given its index bias, MCM uses portfolio trading system FlexTrade to manage its equity orders. The firm also uses FlexTrade for FX and futures and is working with the vendor to add fixed income as well.

In dollar notional terms, the firm trades about \$1.2 trillion in securities a year. Of that, \$100 billion is equities, \$450 billion is futures, \$400 billion is foreign exchange and \$150 billion is fixed income.

MCM rotates its junior traders through every asset class. As the markets have become interconnected, it's important for, for instance, a U.S. domestic equity trader to understand what's happening in European credit, for example, Challenger believes.

A really good trader understands trading across markets. "So if someone really understands fixed income, and you move them over to equities, it takes them a little while to get up to speed, but once they do, they really understand both sides of the market-electronic agency versus principal dealer," he said.

## **TECHNOLOGY MAVEN**

Technology has played a critical role in Challenger's management of MCM's growth. Since coming to MCM, "it's just been constant growth, and one of my main challenges is: How do I absorb that growth without really hitting the bottom-line expense? So that's why we focus so much on technology and really empowering the trader."

When Challenger joined the firm, MCM had different trading systems for each asset class. The firm finished installing the Charles River order management system about two years ago, which can be accessed by portfolio managers in San Francisco, Pittsburgh and Boston. Next, the firm rolled out the FlexTrade execution management system for equities, futures and foreign exchange.

"Given the growth trajectory we were on, we decided it was best to really focus on putting all the orders through one order management system, standardizing everything

so that traders could really move freely from asset class to asset class, so if I need help in futures trading, my equity trader can move over quickly and trade futures," he said.

Having a single trading system for multiple asset classes allows Challenger's crew to both accommodate the investment needs of clients and to better manage their own risk. For example, an investor with a futures position that has the characteristics of an equity investment might want to switch to the underlying cash equity.

"I can bring both of those trades into my system and manage the risk accordingly, Challenger explained. "You've got to be able to see the risk and act on it. With disparate systems, you really can't manage it appropriately."

While Mellon does invest in overseas securities, the majority of its fx trading is for an active currency management strategy. To support that business, the firm custom built an order management system that allows it to look at currencies on an individual basis, according to Challenger. Mellon Capital Management's managing director of global trading. "Fx is a unique product that is by its very nature two currencies being traded as a pair," Challenger explained. "EUR/USD is really EUR traded against the dollar. So what we do is break the pairs into single securities and view the risk at an aggregate level so we can combine trades into more liquid pairs." MCM connects to all of the single-dealer platforms in the market, streams their prices directly into an aggregator, and has created its own mini exchange.

"So we can in real time trade at the top of the book and the price ends up being 10 times tighter than it would be if we went direct," Challenger said.

Technology has also helped Challenger keep down his head count, which stands unchanged since 2008. "We've really been able to take on this growth through productivity enhancements, putting everyone on the same desk and keeping them together," he said.

Challenger added: "We really are focusing on getting all the information a trader needs on a blotter in front of him, so he can focus on markets and trading. And then when trading is slow, we try and encourage them to integrate and communicate with portfolio managers and research, et cetera.

"One of the things we really want our traders to do is to trade," said Challenger. "So where we can, we are trying to eliminate having them follow up on trade breaks or have them do anything manually, or any administrative work or fill out forms. We really are focusing on getting all the information a trader needs on a blotter in front of him, so he can focus on markets and trading."

### **'FEARLESS VISIONARY'**

At least one observer believes Challenger is "a fearless visionary." Challenger has "the ability to envision, articulate and execute change," said Jamie Benincasa, senior vice president at FlexTrade.

"From a multi-asset perspective, Mellon Capital Management is implementing very forward-thinking work-flow procedures that benefit not only traders' productivity but also their performance," Benincasa said.

For instance, "the way the firm deals with its FX exposure, handles futures trading and implements large global rebalances all have placed significant focus on the traders themselves, rather than outsourcing a lot of that to other counterparties," Benincasa said. The trader has the whole picture and knows what the objective is from the portfolio manager to compliance, he said.

Challenger gets the final word. "Our philosophy is that we own our trading," he said. "Our traders control every aspect of their orders, ensuring the execution is in line with their objectives."

(c) 2013 Traders Magazine and SourceMedia, Inc. All Rights Reserved.