

# Facing Economic Headwinds, the Buy Side Turns to Outsourcing

As asset managers and hedge funds weigh the cost and complexity of running an internal dealing desk, many on the buy side have shifted to an outsourced trading desk.

The trend has been growing over the last decade, but it accelerated during the pandemic when the surge in volatility put stress on asset managers. "Cost savings, operational efficiencies and access to trading expertise have pushed investors to outsourced trading," reported [Reuters](#) in January. With traders working from home, the pandemic also proved they didn't have to physically sit next to each other on an internal trading desk to communicate, reported Reuters.

Meanwhile, sell-side firms, agency brokers, and independents have set up outsourced trading desk offerings to service the needs of asset managers and hedge funds.

Companies such as Jones Trading, Sanford Bernstein, Cowen, and independents like Tourmaline Partners have built out their own outsourced trading capabilities. In March, money manager Axa Investment Management opened an outsourced trading desk to serve smaller asset managers, reported [The Trade](#). Recently, UBS became the biggest major new entrant to launch a global outsourced trading desk known as UBS Execution Hub in the U.S. to help the buy side manage their growing workloads, reported [The Trade](#) in May.

With the demand for increased efficiency and fee pressure from low-cost passive index strategies, in recent years, outsourced trading desks have gained traction with small and mid-sized asset managers.

"There is the drive from the buy side to reduce costs in general, so some smaller trading desks are feeling the pressure," observed Andy Mahoney, managing director of FlexTrade in London. "If the implementation of a trade doesn't generate alpha, then the operational overhead of having an internal trading desk, with the logistics of backup and technology may not make sense", said Mahoney.

Among the benefits are the economies-of-scale that can be achieved because the capability is set up to act as an inhouse execution desk for multiple buy sides, said Mahoney. While the outsourced desk is not providing exchange connectivity or traditional services like a prime broker, such as financing or securities lending, it's acting like an insourced execution desk.

But there are pros and cons to outsourcing the trading function. On the one hand, the buy-side firm can get access to a wider network of banks and brokers. In fact, "the outsourced dealing desk can provide access to liquidity, analytic tools, algorithms, or the know-how to trade markets in other regions, that smaller buy-side firms may not be able to achieve alone,"

said Mahoney. Potentially, the outsourced trading desk may have preferential commission rates with brokers because it can operate at scale, he added.

On the other hand, the asset manager is still responsible for best execution on their client orders, though they are giving up control to a third-party. "You can't outsource the best execution obligation," said Mahoney. "It requires a mutual understanding across all of the buy-side outsourced dealing desk clients as to their definition of best execution, and what is their approach to accessing liquidity," said Mahoney. While best execution is usually defined as best price, there are other factors such as timeliness of execution which need to align, he said. Though most outsourced desks offer detailed analytic reports, "the buy side needs to ensure this matches their best execution principles," urges Mahoney.

While some buy-siders may look at outsourcing their total trading capability, others are taking a hybrid approach. In Australia, small-and-medium-size asset managers often keep two inhouse traders covering the core business of Australian equities during local trading hours while choosing to outsource trading for their global fund, said Dan Enstedt, Director of Sales and Business Development EMEA at FlexTrade.

"An outsourced trading desk comes in handy when you don't have a global trading desk, so the orders running overseas are being executed in different markets and time zones – where you don't have the liquidity access, capacity or the economics to set up your own trading desk," said Enstedt.

### **Addressing "Suboptimal Trading Practices"**

Outsourced trading is also a response to other headwinds that the buy side is facing in terms of sub-optimal trading practices and internal inefficiencies that result in "economic waste," according to recent research by Quinlan & Associates.

When evaluating efficiency of the trading desk, the buy side must consider both explicit and implicit cost factors, notes the research report "[Optimization, Outsourcing, and the Reinvention of the Buy Side Trading Desk.](#)"

It's expensive to support the trading desk – there are explicit costs for traders' salaries, Bloomberg terminals, market data, order-and-execution-management systems, PCs, and subscriptions to analytics, news, and consulting fees. But what's having a more significant impact are the implicit (opportunity) costs of lost performance due to maintaining "sub-optimal trading operations," according to the research report.

Inefficient trading practices are causing buy-side trading desks globally to lose about 1.2-2.7% in fund performance for their end asset owner clients, estimates the report. This is due to a lack of technological proficiency, poor choice of execution method, and the widespread absence of internal/external partnerships.

For example, not using electronic communication networks (ECNs) for equities trading, or not using request for quote (RFQ) for fixed-income, or block desks for illiquid or block crossing, may result in 200-300 bps per account worth of implicit opportunity cost, estimates the report.

Selecting an inappropriate algo or deploying a strategy in a less liquid equity or algo that relies on "consistent participation" rather than applying a more intelligent strategy that reacts to available liquidity, can alone cost 30-50 bps per account in aggregate, unobtained fund performance in a typical year, said the report. Another way to miss out on fund performance is failing to use "systemized workflows for liquid/semi-illiquid execution."

### **Automation & STP: Sell-Side OMS**

As sell-side firms set up their outsourced trading desks, they are focusing on automation, throughput, and open architecture to handle the order flow routed by multiple buy-side clients. "Outsourced desks are looking for automation at a couple of levels," said Rajiv Kedia, Principal and Associate Founder and Global Head of Sell-Side Trading Solutions at FlexTrade. "From a process perspective, they want to add new clients in a seamless manner, without being taxed and to achieve straight through processing (STP) to the extent possible," said Kedia. From the inception of the order, the execution should flow into clearing and custody. "The more it's automated, the easier it is to process, and the more cost effective it becomes," said Kedia.

When onboarding new clients, the outsourced desk provider shouldn't need to redesign the processes or do extensive work to accommodate the nuances of a new relationship, advised Kedia. They are also seeking flexibility in how their technology can accommodate customization with configuration changes, rather than design-level changes, he said.

In terms of order-routing, outsourced trading desks want to reduce the amount of manual intervention for client orders. They also want to auto-route as much as possible to avoid growing the number of traders on the desk linearly with increasing order flow.

"We have seen low-touch/no-touch volumes rise steadily over the last few years across all broker-dealers," said Kedia. Outsourced trading desks can leverage newer technology and analytical tools, (such as our Algo Wheel), allowing them to make more complex decisions on the execution and handle more difficult illiquid names through automated processes and give real-time feedback," he said.

Providers of outsourced trading don't want to expand their own technology overhead either, said Kedia. "They want to receive order flow from any system the client has, mainly FIX. Some are exploring the idea of providing a light-weight front-end application to their clients," he said. A standard front-end would make all client flows look the same and make it easier for middle-office and back-office processing, said Kedia, noting that a single front-end is also "stickier" for clients.

In July, UBS said it [partnered](#) with FlexTrade to integrate the OMS into its outsourced trading desk. FlexTrade's open technology stack will be integrated with the global UBS Execution Hub's

own proprietary automaton technology to provide an improved execution service by routing orders to the best liquidity providers, reported [The Trade](#).

“By combining our own market-leading technology alongside FlexTrade’s track record with buy-side trading desks, we can deploy our cross-asset service on a global scale. The technology partnership allows the UBS Execution Hub team to focus our technical and quant resources on delivering the algorithms that differentiate us on execution quality,” commented Chris Blackburn, COO at UBS Execution Hub.

### **UBS Execution Hub**

Given its significant resources, scale, and trading capabilities, UBS Execution Hub will differentiate its offering from other outsourced trading businesses.

“As the first outsourced execution offering from a top tier investment bank, we are able to deliver our clients the geographic reach, product breadth and technology edge which they would expect from a provider such as UBS. In addition to combining these capabilities with experienced buy-side trading teams, we are focused on bringing developments in machine learning algorithms, which we have been deploying across our other businesses, to the outsourced execution space. This allows us to create a data-driven approach that optimizes execution decisions and enables us to scale our capabilities and people during busy times,” said Blackburn.

With the interest in outsourced trading continuing to evolve, UBS Execution Hub has plans underway to expand globally, within specific regions and client segments.

“This year we will be launching for clients in the US, EU and Switzerland and plan to launch in the UK and APAC next year. As a result, we are talking to clients of all sizes, segments, and locations about their needs in outsourced execution. As expected, we see strong demand in the US where this type of solution is already well established, particularly amongst US hedge funds. However, what has surprised us since we went public has been the level of interest coming from other regions and larger clients,” said Blackburn.

### **CF Global**

As more fund managers look for best-execution solutions, outsourced trading desks are expanding into multiple asset classes and rounding out their expertise with senior hires from the buy side. CF Global, a brokerage firm providing outsourced desk services to asset managers globally, hired Dominic Howlett, as European Head of Fixed Income Trading in June of 2020. Howlett joined from Newton Investment Management, the London-based investment management subsidiary of BNY Mellon, where during his 20-year career there he built an extensive execution network covering fixed income and foreign exchange products. “Outsourced execution by a non-conflicted independent partner is a logical next step for fixed income,” said Howlett, in the firm’s [announcement](#). The addition of buy -side veterans in trading and operations has enabled CF Global to expand into new asset classes so it can offer

a comprehensive 24/6 solution for global equities, bonds, and listed options, said CEO Scott Chace.

## **Outlook**

With demand for outsourced trading desks on the upswing, experts expect other large brokers to throw their hats into the ring, making it difficult for small and mid-size outsourced desks to compete.

Custodian banks are said to be eyeing the outsourced trading space as well. "They want to provide their clients with an end-to-end solution, from trading through custody and all of it at one price to capture the client's business," said Rajiv Kedia. "Outsourced desks may do the execution at a low cost or no cost, but then make up the fees on the custodian side," said Kedia. "The thinking is to bundle so many services in one package that it's difficult for the client to go elsewhere with any piece of revenue."

On the flip side, outsourcing may not be the answer for everyone. "For an asset manager handling a high volume of orders, or a complex set of scenarios to execute on, with a huge amount of alpha available in the order execution, there is always value in having a knowledgeable, inhouse execution team," said Mahoney. Portfolio managers value the relationship with an inhouse trader who provides market-color on names the firm is trading. PMs can also have a confidential conversation with the inhouse trader, who tells them what's going on in a stock and how the liquidity is in a name.

Despite all the talk about the outsourced trading desk, some asset managers prefer to focus on optimizing internal trading technologies and workflows, notes the Quinlan & Associates report. "Outsourcing and/or optimizing of trading operations can deliver significant benefits to an asset manager, both in terms of reducing cost wastage and enhancing fund performance," the report advises.

In the meantime, many of the outsourced providers are making senior buy-side and sell-side hires to convey "they understand both sides of the puzzle," said Enstedt. While sell-side traders are very good at executing orders, outsourced desks have made very senior hires on the buy side as well. What is key to their success? "Great customer service, scale, technology, liquidity access, and the know-how from buy side and sell side," he said. "It's a big push," said Enstedt.