Q2 2018

# Beyond Liquidity: Optimizing Product Selection

GREENWICH ASSOCIATES

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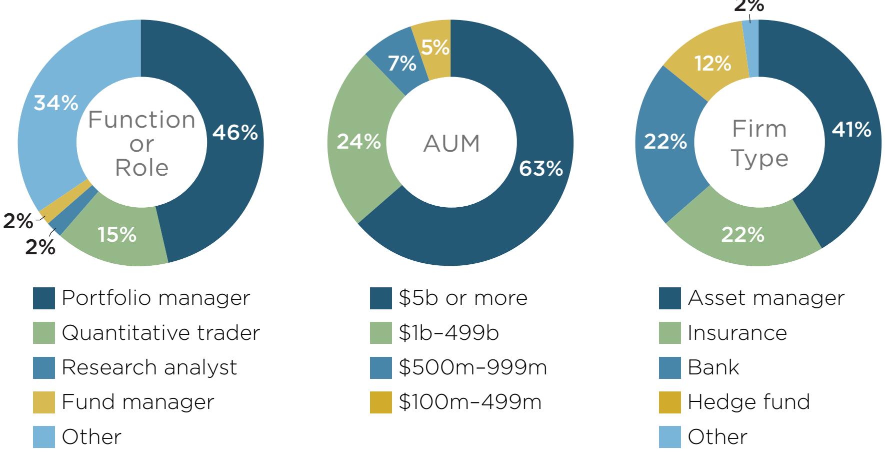
**95%** OF MONEY MANAGERS TAKE A MANUAL APPROACH TO INSTRUMENT SELECTION

ONLY **15%** OF BUY-SIDE FIRMS HAVE THE ABILITY TO COMPARE INSTRUMENTS INTRADAY—AN OPPORTUNITY FOR ANYONE CAPABLE OF FILLING THAT HOLE

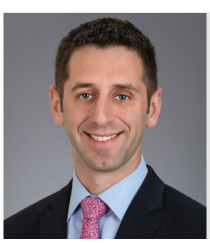
## METHODOLOGY

From November 2017 to February 2018, Greenwich Associates interviewed 41 institutional investors in the United States and Europe to understand current practices relating to product selection and relative value analysis. Our participants included asset managers, insurance companies, banks and hedge funds. Almost two-thirds were firms with assets under management of $5 billion or more.

### DEMOGRAPHICS




Note: May not total 100% due to rounding. Based on 41 respondents.
Source: Greenwich Associates 2018 Relative Value Analysis Study



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# Executive Summary

*From equities to fixed income, the number of financial products available to portfolio managers is impressive. While the financial crisis all but dried up the market for complex structured products, the following 10 years brought a host of new, more straightforward instruments that have, in some cases, enhanced liquidity and eased access to the underlying markets. Many of these benefits continue to go underutilized, however, as the analysis to determine the most effective instrument choice for the given situation is non-trivial.*

*Portfolio managers and their trading desks primarily choose instruments based on past experience rather than through an analytical process. While the accumulated knowledge of an experienced portfolio manager should not be undervalued, a move toward more systematic instrument selection would ultimately enhance fund returns by capturing alpha invisible to the naked eye. Should you buy a bond or use an exchange-traded fund (ETF) or credit default swap (CDS) to gain that exposure instead? Now more than ever, analyzing that not-so-simple question on demand throughout the day could have an outsized impact not only on the portfolio but on the market as a whole.*

*For instance, 90% of U.S.-based corporate bond investors[1] say that a lack of liquidity has impacted their ability to implement their investment strategy, and volatility in the roll process is adding additional costs to derivatives-heavy portfolios. At the same time, 89% of FX dealers[2] believe that uncleared margin requirements have negatively impacted their cost of trading.*

*While these structural challenges impact each fund differently, waiting for the market structure to change in your favor rather than employing a smarter approach to instrument selection is a losing proposition.*

**A move toward more systematic instrument selection would ultimately enhance fund returns by capturing alpha invisible to the naked eye.**

1 https://www.greenwich.com/fixed-income-fx-cmds/credit-investing-beyond-bond-market
2 https://www.greenwich.com/fixed-income-fx-cmds/bright-future-fx-futures

# Finding Exposure

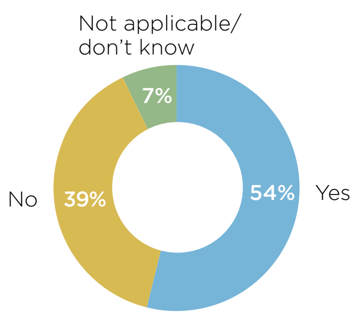
Investment managers need to count every single basis point these days. Management fees are shrinking as market competition heats up, low-interest rates continue to limit opportunities, and institutional clients are more informed than ever, asking questions about everything from technology used to trade execution strategies, keeping portfolio managers and traders on their toes.

While challenging for the buy side, whose trading desks spent nearly $7 billion on technology[1] over the past year, institutional investors are the beneficiaries of a more streamlined investment process than ever before. For example, measuring and working to improve best execution via transaction cost analysis (TCA) is nearly ubiquitous on equity trading desks and is growing rapidly with fixed-income and FX traders. This means investors no longer need to take a portfolio manager's word that they're achieving the best possible outcome—the proof is in the numbers.

> **"Decisions we make are only as good as the quality of the information available to us."**
> *~Central bank*

However, for half of asset managers, that analysis of execution quality only examines how well the trader did with the exact order as given. If the portfolio manager told the trader to buy $10 million in 5-year GE bonds, the trader's success is based on the degree of improvement over the desired outcome for that exact bond—whether that be price, timeliness or lack of market impact. What remains underweighted in that analysis is whether or not buying that GE bond was, in fact, the most efficient way to get the exposure the portfolio manager was looking for.

### INSTRUMENT SELECTION IS PART OF THE BEST EXECUTION REVIEW PROCESS




Note: Based on 41 respondents.
Source: Greenwich Associates 2018 Relative Value Analysis Study

Instrument choices today are numerous yet nuanced. There are many sources of credit exposure, for instance, all with their own benefits and drawbacks. As discussed in previous Greenwich Associates research, credit traders now have access to total return swaps, credit default swaps, credit futures, and ETFs. While some products have explicit fees that must be taken into account, for instance, others have less clear implicit costs that are critical to the analysis. Further, while the derivatives provide

1 https://www.greenwich.com/equities/investor-spending-reaches-equilibrium



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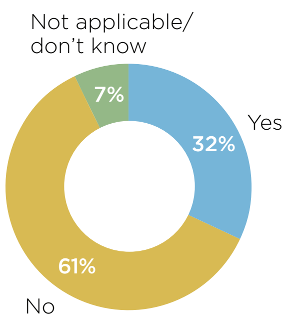
leverage, top credit-focused ETFs are liquid and track more closely the indices followed by bond investors. The ETF create-redeem mechanism has also proven to be a valuable source of liquidity, allowing bond portfolios as a whole to be traded much more efficiently. Nevertheless, making these choices on the fly is no easy task for the buy side.

> **"We expect to move in this direction where instrument selection will be part of best execution process."**
>
> *~Large asset manager*

An influx of fixed-income market data has finally made such analysis possible and actionable. Very few are leveraging this data via TCA and similar tools, however—less than one-third of our study participants. And for those that are, the platforms and the value of the analysis they produce are perceived as in their infancy. Between corporate bond liquidity issues and a long list of product alternatives for gaining interest rate, credit, and equity exposure, only examining prices from a few counterparties or exchanges for a single instrument means investors are frequently leaving money on the table.

### BUY-SIDE USE OF PRE-TRADE TCA




Note: Based on 41 respondents.
Source: Greenwich Associates 2018 Relative Value Analysis Study

# Who's in Charge

Buy-side trading desks exist to execute the portfolio managers' market thesis, and do so in a way that limits market impact, slippage and other unnecessary or undesired costs. A decade or more ago, depending on the market, this function was completely outsourced to the sell side. Even in cases where that asset manager had traders, their primary role was to know which dealer counterparty to outsource that execution to.

Today, tremendous technological innovation has seen the buy side take much of the execution risk upon itself. The sell side still plays a major role in trading, of course, whether acting as principal, agent or market-color provider. But the determination of what to trade and how to trade falls largely on the investment manager.

When it comes to instrument selection, the portfolio manager makes the decision at 75% of buy-side firms and is the sole decision-maker for half. Not all investment managers have traders, as some, both small and large, have PMs do their own trading. But for those that do, not leveraging the knowledge of the trader is a mistake.



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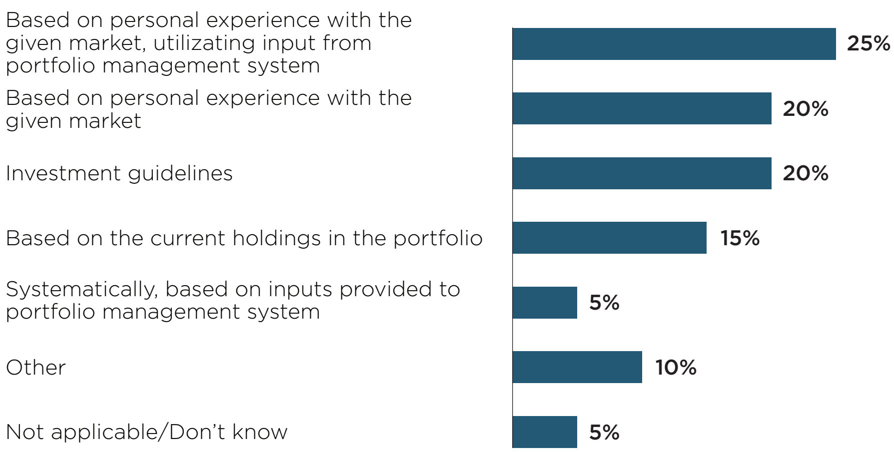
## INSTRUMENT SELECTION DECISION-MAKER


Note: Based on 41 respondents.
Source: Greenwich Associates 2018 Relative Value Analysis Study

Taking that thought one step further, 95% of money managers in our study take a manual approach to instrument selection. Nearly half say decisions are largely based on the experience of the portfolio manager, with only some input from the portfolio management system. Trader input into instrument selection is also minimal. While our sample in this instance is somewhat limited, only 5% report getting frequent instrument input from the trading desk, with half reporting no trader involvement at all. Whether this is due to defined roles at the given firm or a lack of incentive to do so, input from the trading desks about liquidity, fees and other market microstructure issues could have a huge impact on the ultimate execution.

## HOW INSTRUMENT CHOICES ARE MADE




Note: Based on 40 respondents.
Source: Greenwich Associates 2018 Relative Value Analysis Study



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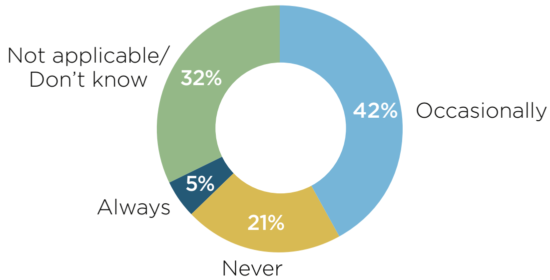
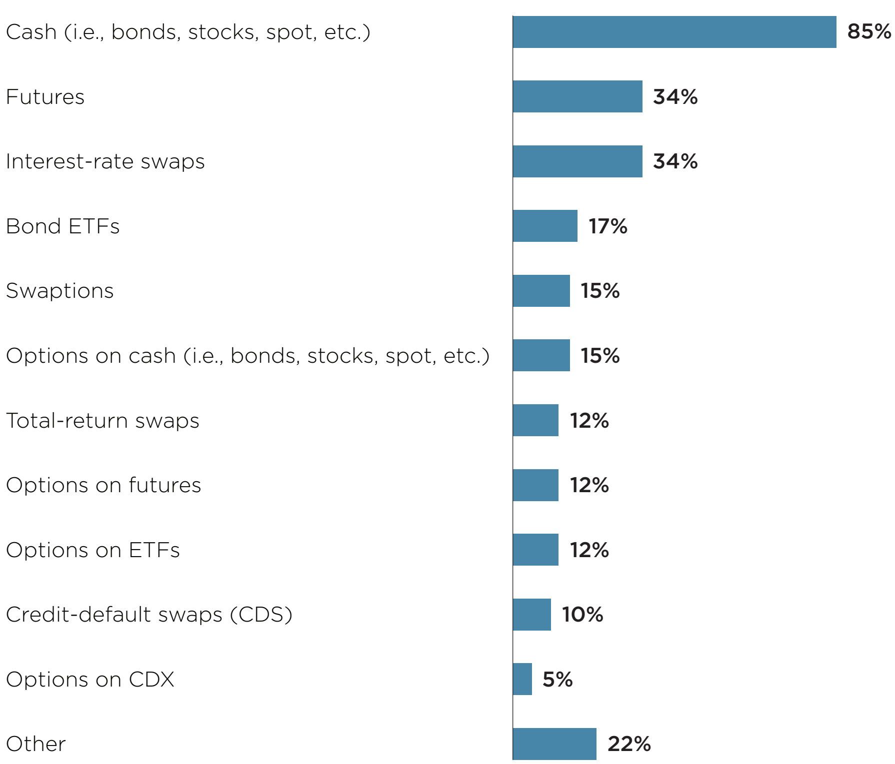
## FREQUENCY TRADER RECOMMENDATIONS DIFFER FROM INSTRUMENT ORIGINALLY REQUESTED




Note: Based on 19 respondents.
Source: Greenwich Associates 2018 Relative Value Analysis Study

While we by no means want to minimize the value of a top-tier portfolio manager, they are human and will tend to utilize the instruments with which they have the most experience. Those most familiar with bonds, ETFs, swaps, futures, or options will gravitate toward those products first, potentially missing a less-known but more effective approach. While 85% of the buy-siders we spoke with say they trade cash instruments, percentages dropped precipitously from there, with futures and interest-rate swaps coming in a distant second.

## PRODUCTS IN PRIMARY ASSET CLASS TRADED IN PAST SIX MONTHS

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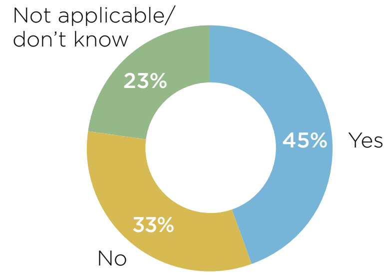
For some, the issue is instrument access—which may be due to technology, operational or compliance reasons. But almost half tell us that's not the case. Greenwich Associates research shows that 90% of the buy side now utilizes an OMS, and nearly all of those systems, including Bloomberg, Charles River, EZE Software, and BlackRock's Aladdin, provide robust multi-asset capabilities. As such, most have access to instruments that they don't use: ETFs and swaps, predominantly.

While these results could, at some level, be impacted by the focus of the investment managers in our study, we believe they still point to a more systemic issue: Portfolio managers as a whole are underutilizing the instruments to which they have access. The comfort zone isn't always the right place to be.

### TECHNOLOGY AND OPERATIONAL ABILITY TO SELECT DIFFERENT INSTRUMENTS TO TRADE

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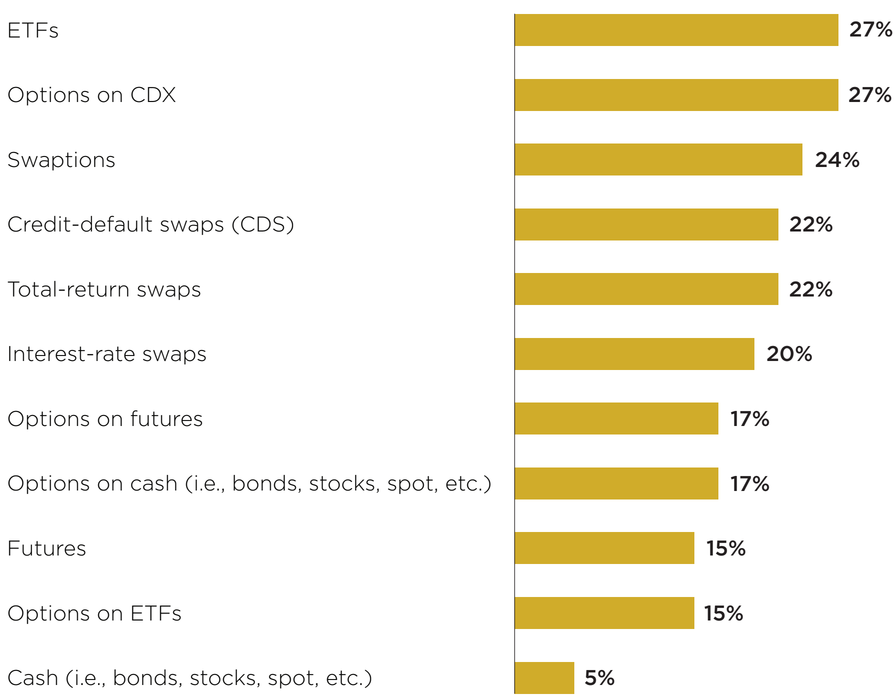
Source: Greenwich Associates 2018 Relative Value Analysis Study

### AVAILABLE PRODUCTS NOT TRADED IN PAST SIX MONTHS




Note: Based on 41 respondents.
Source: Greenwich Associates 2018 Relative Value Analysis Study

# Dealers Should Do Their Part

The best service providers, regardless of industry or expertise, are those that will not only solve the problem they've been asked to solve, but when appropriate, will suggest a better alternative based on their experience. While the sell side plays this role in general, it does not play it in a meaningful way when it comes to instrument selection. Nearly half



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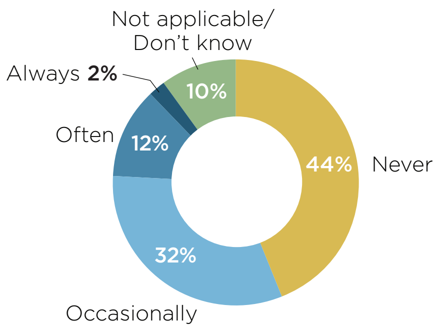
of our study participants said they never—not occasionally, but never—receive recommendations from their dealers to trade an instrument other than the one they initially asked to trade.

### FREQUENCY BROKER-DEALER RECOMMENDS TRADING DIFFERENT INSTRUMENT THAN REQUESTED




Note: Based on 41 respondents.
Source: Greenwich Associates 2018 Relative Value Analysis Study

If the buy side were proactively doing their instrument-selection homework on a large scale, the sell side might rightly feel their sole role here is to execute the request as received. This is clearly not the case, and this gap can present a huge opportunity for those willing and able to take it.

Equipping the sell-side sales desk with technology that can quickly make those recommendations is an obvious roadblock. That technology does exist at some firms, however, and is in the works with various top-tier technology providers. The bigger barrier to change lies in the siloed nature of many of the largest broker-dealers. Bond traders trade bonds, swaps traders trade swaps, futures traders trade futures, and all are compensated as such. That means little incentive exists for one trader to trade another trader's product—and for increasingly lucrative products, there is no reason for one trader to give up that execution to another.

A more concrete example lies in the credit market, given the growing use of corporate bond index-tracking ETFs. For some asset managers, these ETFs have taken the place of CDS as a good hedge or cash management product while the bonds needed are found. However, ETFs trade in equity markets and are, more often than not, available through the equity desk—not via the credit traders those credit investors have built relationships with. Those equity traders don't want to give up the growing commission pool they've helped to build, yet credit ETFs track activity in the credit market and so, more logically, should sit with the credit desk. Some of the more forward-thinking broker-dealers have moved in this direction, but a wholesale move is still some way off.

**"Products are assessed to ensure they conform to our strategy, targeted asset allocation exposure and cost expectations—for example, the cost to execute an ETF versus futures."**

*~Large asset manager*

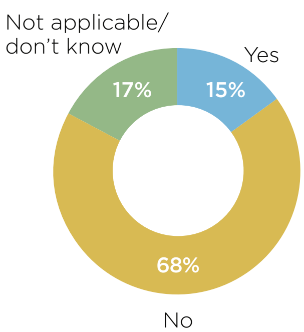
# Product-Agnostic Investing

The experience of the portfolio manager, buy-side trader and sell-side sales desk remain critical elements to the investing process. However, providing each with tools that allow for real-time instrument scenario analysis would ultimately add basis points to the fund's performance. Only 15% of buy-side firms have the ability to systematically compare instruments intraday—an opportunity for anyone capable of filling that hole.

**"We use a lot of mathematical models to determine relative value between two instruments."**

*~Mid-tier asset manager*

### ABLE TO SYSTEMATICALLY COMPARE INSTRUMENTS INTRADAY

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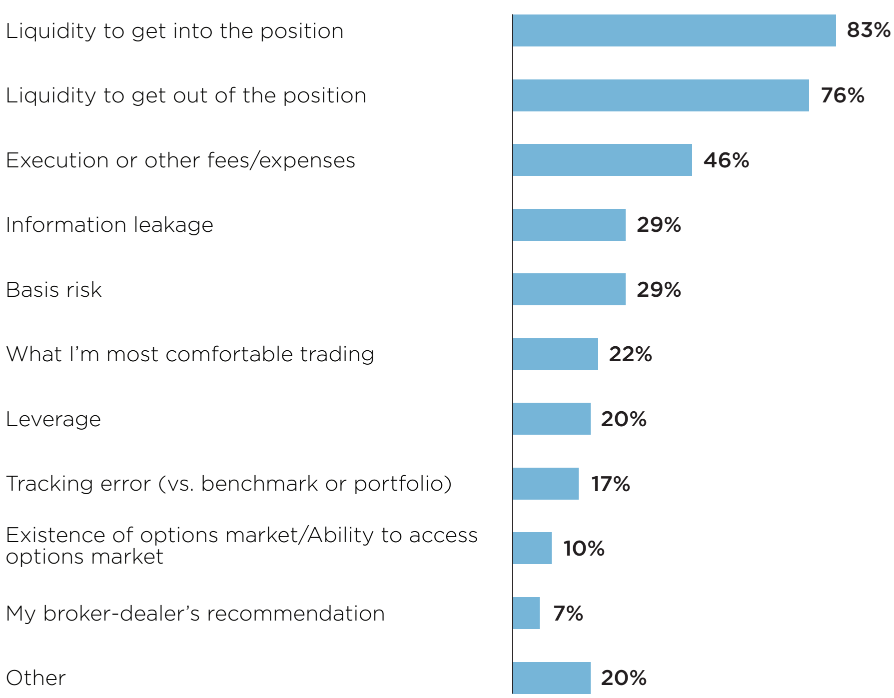
### FACTORS CONSIDERED IN INSTRUMENT SELECTION PROCESS




Note: Based on 41 respondents.
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The complexities of each market structure and the sheer number of choices mean this isn't possible without technology. Liquidity, execution fees, potential basis risk, information leakage, leverage, and several other factors all must be tracked and calculated on-demand to create actionable outputs that can be applied before the market opportunity is gone. For example, some asset managers that systemically compare instruments point to their use of pre-trade TCA, which examines these and other factors that can ultimately inform the best path forward for the given situation.

> **"We create a liquidity score and value anything we trade based on liquidity."**
> *~Mid-tier asset manager*

While listed markets are a more manageable challenge, given the transparency into fees and publically reported data, OTC markets including bonds and swaps require much more art alongside the science. And since the decision process often involves using a listed product in place of an OTC product or vice versa, solving both problems is a must. Ultimately, making a suboptimal choice that did not take into account both explicit and implicit costs could, over time, have a major impact on fund performance.

# Conclusion

To date, the instrument selection story has been one largely focused on liquidity, particularly for corporate bonds. Looking ahead, however, making such decisions intraday in a data-driven way will ultimately lead to better fund performance. Execution fees, collateral costs, market impact, and other implied costs can often be reduced by looking beyond the obvious choice.

We are not minimizing the complexities of changing the mindset of investors and deploying technology to make that mindset change possible—both are easier said than done. However, solutions are starting to emerge, and some forward-thinking asset managers and dealers have already reshaped their approaches to their benefit. May the best product for each unique situation win.

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