BLOG

The pandemic-induced shift towards outsourced trading and its implications for capital market solution providers

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Outsourced trading refers to transferring the trade-execution function from an in-house trading desk to a third-party with a similar or higher set of trading capabilities. The outsourcing models adopted by asset management firms may differ, as some may outsource the entire trading desk, while others only look to maintain a buffer capacity. Outsourced trading is typically adopted by companies that do not have sufficient scale or expertise to deliver on desired client outcomes or those unable to create a comprehensive set of internal controls and oversight models. Therefore, it was leveraged primarily by small asset management firms; however, it is now witnessing increased demand as asset managers face cost-cutting pressures amid a difficult macroeconomic environment.

A 2020 survey of 300 heads of investment operations from global asset management firms shows a clear shift in operating models; 85% of the respondents stated that they had already adopted outsourced trading or were interested in doing so.

Advantages/drivers

There are multiple drivers triggering the adoption of outsourced trading services:

Reduce costs: Maintaining an in-house trading desk is expensive, as firms need to spend on employees (traders), Bloomberg terminals, software, and data feeds. For example, the total annual cost of establishing and maintaining a three-person trading desk and the requisite tech infrastructure could reach GBP1.5m. Outsourcing the trading function enables investment managers to convert a host of fixed costs into variable ones, and manage them on a pay-as-you-go basis. Outsourced trading offers cost savings of up to 25%.

This focus on costs is because asset managers have been facing the double whammy of rising costs and fewer actively managed assets. The shift towards passive funds is responsible for lower revenue and profitability: active management revenue of North American asset managers is expected to fall by 35% by 2023; their annual cost inflation is 5%. Therefore, to survive, small to mid-size firms have no alternative but to adopt outsourced trading.

Achieve compliance: Outsourced trading enables asset managers to better manage compliance with the MiFID II regulation related to strict controls on best execution and the separation of research costs from other fees/commissions. Outsourced trading providers can offer the best execution because they can get the best rates owing to their vast networks. Adherence to best execution mandates in-house is expensive and requires a lot of planning and effort, which can be eliminated through outsourcing.

Other benefits include anonymity, increased capacity, liquidity and access to niche markets. Ability to trade anonymously through outsourced trading helps asset managers reduce information leakage and minimize market impact. Furthermore, as outsourced traders work for multiple clients, they can tap into a larger pool of liquidity providers than individual asset managers can. Additionally, in the search for alpha, investment managers are looking at a wider set of markets located in multiple time zones. Outsourced trading providers, with their wide network of offices, are able to handle multinational trading in such instances. Outsourced trading also helps when investing in niche markets for the short term, which would not justify employing staff full-time.

Impact on capital market solution providers

Capital market solution providers such as order management system (OMS) vendors may lose out on the order flow they currently receive from each client, as most outsourced providers do not employ multiple OMS platforms. Moreover, if an OMS licence mentions a per-message fee, a reduction in message volume will mean less revenue. On the positive side, OMS vendors that service the outsourced trader will see a sharp jump in their message volume. Whether it will be enough to compensate for the loss of messages from individual asset managers is yet to be seen. One of the concerns for OMS vendors would be the greater bargaining power of outsourced trading providers resulting from an increase in their trading traffic.

But all is not lost for capital market solution providers. This is because many firms will try to refrain from adopting outsourced trading due to multiple concerns, such as the loss of strategically important information flow between the trader and the market, questions around the reliability of outsourced trading providers and the risk of trades being deprioritised over those of competitors. But to remain competitive in the market, such firms will look for alternatives to adopting outsourced trading, which come in the form of either (1) providing technology support to traders in the form of automation tools or (2) comprehensive OMS platforms.

Integrating automation technologies with the trading solution offers timely and accurate decision-making support to traders. This enables them to improve execution performance. Additionally, it eliminates the need to scale a trading desk in order to achieve scale performance, and thus helps contain costs. One of the uses of automation tools provided by capital market solution providers is the ability to route orders based on certain criteria involving a broad range of data points and calculations, for example, auto-routing orders based on either instructions of a portfolio manager or bond ratings or market-capitalisation thresholds. Integrating these tools with in-house or third-party algorithms for better trading strategies yields cost improvements.

Another method of embracing the rise in outsourced trading would be the launching of comprehensive platforms by OMS vendors. These platforms can have in-built data measurement, surveillance, risk management, and other features and offer the ability to scale on demand. This scalability would enable smaller firms to co-exist with large-scale outsourced trading providers. Smaller asset management firms would be able to tap into the vast computing resources and functionalities offered by OMS vendors to generate alpha and compete on it, rather than competing on cost by outsourcing their trading function.

Impact of COVID-19

The pandemic has intensified the challenges facing asset managers, as it has led to a loss of revenue and substantial margin pressure. Furthermore, higher redemption volumes and resiliency issues have rendered many asset managers unable to maintain normal operations, pushing them towards outsourced trading.

The pandemic has also questioned the basic assumption of a portfolio manager's proximity to the dealing desk. It has forced firms to outsource their trading functions to remote-working trade setups, and the effectiveness of this process has debunked the assumption. This has opened the way for third-party outsourcing and, thus, is likely to drive growth in outsourced trading. As a result, major custodian banks such as Northern Trust, State Street and BNP Paribas have reported an acceleration in demand for outsourced trading services.

This should boost demand for highly efficient electronic trading platforms that can be used by outsourced trading providers to gain from optimum cost efficiency that can be passed on to their clients. Demand would rise for solutions able to capture a wide range of data to conduct trade cost analysis, and for a rebalancing tool to control broker distribution of trades to yield best execution.

However, sales of OMS and other trading-related solutions to small- to mid-size asset management firms are likely to fall. Even the existing licences may face renewal pressure.

The way forward

Before the onset of the COVID-19 pandemic, it was estimated that one-fifth of investment managers with USD50bn or more in AUM were likely to adopt outsourced trading by 2022. The pandemic is likely to further boost outsourced trading.

Going a step further, investment managers are now considering outsourcing all post-investment decision functions to a single (hyper-scale) professional services provider. In such a scenario, once an investment manager shares a trading idea electronically, all downstream functions – trade execution, matching, settlement, fund accounting, investment book of record (IBOR), reconciliations and reporting – will be carried out by a single provider of such services. Thus, the emergence of whole-office or platform solution outsourcing seems a possible evolution of outsourced trading. This could create further challenges for capital market solution providers.

How Acuity Knowledge Partners can help

Technology firms have benefited from the COVID-19 pandemic because of rapid digital adoption. This presents a host of new opportunities that could significantly alter their growth paths. Acuity Knowledge Partners (Acuity) has been assisting technology players in charting their 2020/21 and long-term strategies.

The technology practice within Acuity's Private Equity and Consulting Group offers a range of strategy support services to technology players. We work with Fortune 500 fintech players and capital market solution providers to offer insights on areas such as the technology landscape, competitors' moves, growth opportunities, M&A and deal insights, and the regulatory landscape. Our subject-matter experts provide customised, time-bound solutions to help you swiftly map your strategic objectives and execution plan.

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Acuity Knowledge Partners is a leading provider of high-value research, analytics and business intelligence to the financial services sector. The company supports over 350+ financial institutions and consulting companies through a team of over 3,000+ subject matter experts who work as an extension of the clients' teams based out of various global delivery centres.

We empower our clients to drive revenues higher. We innovate using our proprietary technology and automation solutions. We enable our clients to transform their operating model and cost base.

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