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tourmaline partners

From foe to friend-

Dispelling the notion that outsourced trading is a threat to the dealing desk

Introduction

The term 'outsourced trading' can be viewed as taboo on some buy side trading desks. As execution has evolved post-MiFID II and onward throughout the global COVID pandemic, trading desks have increasingly sought to demonstrate how they add value and protect / generate alpha. At the same time, we have seen a rise in the use of outsourced trading desks. What was once an overly simplified discussion around costs, has become a debate surrounding performance and edge. Some trading heads see outsource trading desks as a threat to the role of an internal desk, and others have questions over how an outsourced trading firm operates - the controls and systems they have in place to navigate equity markets.

To better understand how outsourced trading can work in collaboration with a traditional dealing desk, acting as an extension to a trader's arsenal and not a replacement, The Finance Hive and 11 buy side heads sat down with Tourmaline Partners to discuss how these two functions can support each other in modern markets.

How can a modern outsourced offering act as a compliment to the centralised desk?

"Execution was once seen as the end of a process. We see it as a key component to enhancing the performance of any ongoing investment activity. By partnering with the right platform you can only increase the potential for achieving this edge."

Andrew Walton, Head of European Business, Tourmaline Partners

Dispelling misconceptions of outsourced trading

Commencing the session, Tourmaline Partners were swift to address the elephant in the room – that, in Europe especially, there is a tendency for buy side dealers to see outsourced trading as a threat to their own existence. The subject of outsourced trading is a very emotive one and Tourmaline expressed frustration with the seemingly incessant commentary in the trade press that does little to discuss the enormous differentials and capabilities within the space. The narrative has been opaque, and the sheer number of articles have been so generic in nature, in turn allowing misconceptions to entrench themselves within the buy side community. Adding to the potential friction between outsourced trading firms and buy side dealers is that conversations between outsource trading and buy side firms are often had with the C-suite, away from the trading desk. Tourmaline were keen to engage dialogue directly with buy side dealers believing that this is where discussion should start – reinforcing the notion that this is a conversation about enhancing execution outcomes and not solely focusing on explicit costs.

Tourmaline would like to see outsourced trading firms recognised for what their motives are and what capability they have. There are many players claiming to be in the outsourced trading space all with wildly different operating models, capabilities and reputations. Tourmaline would like to see outsource firms assessed by what they can offer and what they are truly capable of. Tourmaline defines 'outsource trading' in a very explicit manner that is derived from a position of extreme independence, free from conflict and many of the stereotypes associated to the space. Fair to say they see themselves as 'different' and do not wish to be bucketed with the other players in this space.

Three categories broadly define the different types of outsourced trading model on offer. These are: (i) sell side (or "agency broking"), (ii) custodian ("hybrid") and (iii) institutional grade buy side. A heat map displaying where most offerings sit would see the sell side 'agency' model with by far the highest concentration. Tourmaline sit in very limited company at the opposite end of this scale - offering a global buy side service akin to the structure of a centralised or internal desk. They see themselves as a trading solutions firm that can be deployed as a complete solution for managers with no dealing desk, or as a customised extension of the incumbent desk. It is often assumed, incorrectly, that the term "outsourcing" means 'all or nothing' when discussing execution, which in turn enables misconception. The truth is that certain offerings are far more nuanced than that. The levels of service vary from 100% solutions, to supplementary and ad-hoc trading arrangements (which can include a multitude of examples from providing anonymity, accessing wider geographies, information and liquidity pools to simply covering for holiday or absence). The area of "supplementary trading" generated the most interest from the buy side participants and was the main topic of conversation. Also of interest was discussion surrounding conflicts of interest, particularly with the sell side and hybrid models – where this type of platform puts them directly at odds with liquidity providers. This is something that does not apply to an institutional grade buy side service such as Tourmaline Partners, where they are seen as a significant 'aggregated' client by the street and execute business in exactly the same way as an internal desk.

> *"The key difference is in structure and capability. If you are seeking to generate and preserve alpha throughout the investment process Tourmaline's unique position can deliver pathways to ensuring this. Not all outsource providers can offer this."*
>
> ***Andrew Walton, Head of European Business, Tourmaline Partners***

Optimising Execution Quality With The Right Partners

Supplementary trading was discussed with the example of international coverage, i.e. trading 'out of hours' in different geographies / time zones, with Asia the case study. This could have formed the basis of a whole discussion session in its own right – especially given debate around established practices with local brokers. One of the major benefits of an institutional buy side outsourced offering is the ability to mirror the preferred practices (or "playbook") of the incumbent desk across all geographies whilst offering access to much wider channels of liquidity and information. This is critical when assessing the advantages of offering an extension of the internal trading desk, as opposed to merely acting as their agent. Whether it is to extend across geographies where the manager does not have a trading presence, or whether it is in the prime jurisdiction, there is an edge to be gained. The key to understanding this dynamic is for the buy side to see the institutional grade outsource offering as a peer that can augment and enhance workflows, as opposed to an agent or broker with limited tools that are completely inferior to their own.

Areas outsourced trading can act as an extension of a centralised trading desk

- ✓ Anonymity
- ✓ Execution quality
- ✓ Access to extended broker list
- ✓ Liquidity aggregation and greater access
- ✓ Access to broader information
- ✓ Geographical reach
- ✓ Disaster recovery
- ✓ Out of hours trading

Leaning on a supplementary provider can produce exceptional results when dealing in illiquid, 'hard to trade' small / midcap cap names that pose a tricky liquidity profile. Access to any available liquidity becomes imperative under any best execution protocol. Having access to an almost limitless high-touch broker network via one point of contact not only enhances the chances of optimising best execution, but it also enables a reduction in operational risk. It is these sorts of nuances that go a long way to dispelling the very logical cynicism that members of the buy side community may have about outsourced trading and emphasises the difference in capability between providers – it is evident that not all outsource providers are equal.

This allowed the discussion to move towards how internal desks forge relationships with their PMs. The notion that a certain type of external provider could somehow cultivate a similar affinity with individual portfolio managers suddenly became very plausible to the skeptics – not least when you overlay the experiences of the last 16 months of global crisis. Tourmaline have over 400 clients and explained how each client / PM has a customised 'playbook'. They went on to describe tailored solutions that deliver on explicit parameters outlined by PM's for their required workflows. This ranged from specific tolerances around order handling to how communication and interaction is preferred and delivered. Tourmaline added that they welcomed the skepticism that was evident from the conversation and confidently assuaged any concerns raised.

Tourmaline were keen to point out they never shop flow to the market. They do not advertise business and are classically buy side in the way they consume information and liquidity on behalf of their clients. With a network of >400 high-touch brokers and 50 electronic venues, they are as unconflicted as they are agnostic. They do not compete with the sell side in any area of their business and will always trade where they can achieve the optimal outcome for each and every order. The buy side were keen to explore how Tourmaline are received by the sell side and whether anything may be lost by using them versus trading direct. It was made clear that not all outsourced trading firms should be seen as the same, which ties back to the model and motive of the outsourced provider. As Tourmaline are not competing with the sell side they are viewed as a large commission paying aggregated client by the street. The fact they have access to and such a strong reputation with extensive broker network that they have built can only be good for a buy side partner. This underscored the sentiment that Tourmaline are seen as very much a peer to an internal desk.

Some buy side members in the session raised the question about the number of incidents of crossing between clients and aggregation of orders. The buy side often hear the crossing ability of outsourced trading firms as a benefit and helps find liquidity in a less toxic way. Interestingly, it was pointed out that the number of times two clients sent contra orders around the same time was incredibly rare – though the discussion around how such instances would be navigated and how other hypothesised permutations would evolve was welcomed and described in detail.

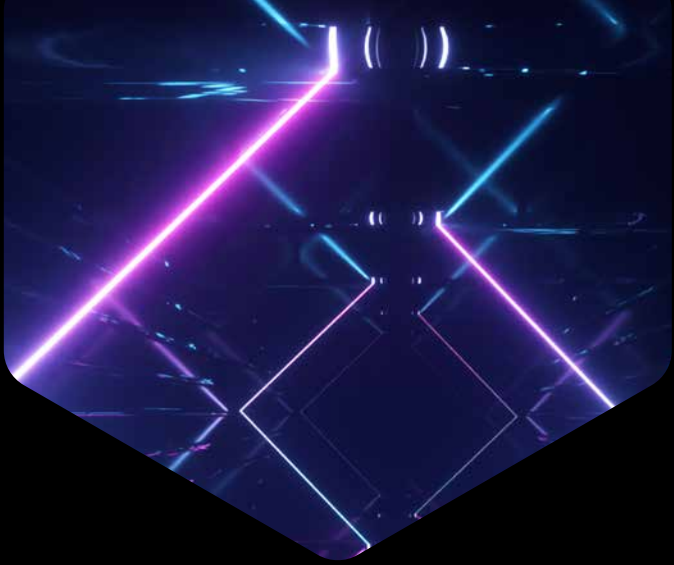
Buy side dealing desks are investing heavily into technology to give them an edge in trading outcomes, which is a constant challenge given the scrutiny around internal costs and management fees. This is an area where an institutional outsourced desk can add significant value, with their own investment in cutting edge innovation. Tourmaline were asked if they were doing the same and whether that meant they were a competitor to those centralised dealing desks. Given the lengthy and diverse number of clients that Tourmaline act for, there is an opportunity to harvest data that could be utilised to improve performance further. Feedback loops and positive analysis of past outcomes will drive future optimisation. Tourmaline are invested in seeking ways to capture this information. In terms of competition with an internal desk – Tourmaline's structure allies them as a partner, with the investments in technology designed to help buy side clients and not replace them.

> *"There has been a lot of noise around outsourcing post MiFID II and the global pandemic. A number of providers have entered the space, but this only seems to have fuelled misunderstanding and confusion around services. There has been very little granular debate about what these providers are actually able to offer and what benefits are derived other than cost reduction."*
>
> ***Andrew Walton, Head of European Business, Tourmaline Partners***

Tourmaline were determined to dispel the notion that outsourced trading is purely about a cost cutting that has potentially negative impacts on execution quality. They clearly explained about the spectrum of services they provide which makes their version of outsourcing anything but binary, which is a huge differentiator versus the various types of firms that populate the space. Tourmaline showed that their business has thrived on quality of service and implicit execution performance and not merely on the level of explicit trading costs which is how some firms operate.

Europe is clearly behind the US and Asia with its engagement with outsource trading. However, interest has undoubtedly grown since the introduction of MiFID II. The global pandemic has provided a real-life working example as to how established centralised dealing desks at some of the biggest investment managers in the world can utilise certain providers to optimise and enhance their existing workflows. The next step for outsourced trading in Europe, will be to encourage further open dialogue. They are determined that be seen not only as friend and not a foe, but also a peer that operates much in the same way as the buy side themselves.

> *"Regardless of strategy, size and scope, institutional grade or 'pure play' outsourced buy side trading services offer a wealth of opportunity and resource tailored to each and every type of investment manager. The outsource platform becomes a tool that can be levered as little or as much as the manager sees fit. It is this autonomy and its potential to augment and enhance workflows towards better execution outcomes that will fuel the growth in the industry."*
>
> ***Andrew Walton, Head of European Business, Tourmaline Partners***



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