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Reducing market impact to improve returns

Introduction

Over the past decade, there have been fundamental changes in the way FX markets function, with an abundance of new technology, service and liquidity providers emerging. This has meant that even veterans of the FX industry have been questioning how the market is impacted by new ways of trading and how to understand it. Of particular importance, is how best to reduce market footprint and improve returns.

To address these developments, The Finance Hive and 360T hosted a digital boardroom for a select group of Heads of Trading from global hedge funds to discuss how they are looking to reduce market footprint and improve their returns. This report summarises the key lessons and advice shared from the session, focusing on the 3 core areas:

1. How firms are measuring and understanding market impact and arrival prices
2. What steps can you take to mitigate and minimising market impact
3. Beyond Spot- reducing market impact for non-deliverable forwards and swaps

Reducing market impact to improve returns

Measuring and understanding market impact and arrival prices

There are multiple considerations to bear in mind for hedge funds when it comes to measuring market impact and arrival price. During the discussion, our buy side members emphasised the importance of utilising venues who assist them in developing a clear understanding of their market impact when executing specific FX trades. The core purpose of this is to enable traders to effectively evaluate the different counterparties they are interacting with by determining which ones contribute the most to market impact around the point of execution.

However, it was noted that there is no standardised benchmark or metrics for conducting this analysis, with each hedge fund instead using their own methodologies internally to evaluate their counterparties. As a consequence, it seems that funds are increasingly looking towards platform providers, who are able to amass an array of data from across their execution venue, to help them in this endeavour. In particular, the importance of pro-active liquidity management services from the platform provider was highlighted.

The consensus amongst our buy side members around broker performance was that you must consider their overall performance and services as a whole, as opposed to just focusing purely on the execution of your trades. It was noted that it's likely to be more profitable to start trading with a selection of trusted, proven liquidity providers (LPs) and then add more over time rather than beginning with a large range of banks and slowly filtering out the ones which don't perform over time.

It was stressed though that LP selection is only one element which determines the level of market impact that occurs when trading. The funds present also pointed out that factors such as the size of the trade, the time of day and the currency pairs being traded can significantly affect how much market impact there is around FX execution, leading to follow-up questions about how to effectively analyse the role these play too.

Mitigating and minimising market impact

Buy side members identified three key areas they were using to mitigate and minimise market impact:

1. Hone in on providers -- whether disclosed or anonymous
2. Ensure you understand how LPs are evaluating orders and counterparties
3. Create bespoke pools for specific order types to match with limited providers

The hedge funds agreed that one way to minimize market impact is to trade with a non-directional buy side counterparty, but it was pointed out that some ECNs lack the diversity of participants to enable this. On the flipside, it was commented that trading with agency brokers holding themselves out to ECNs as a market maker can often result in much higher market impact.

The buy side must bear in mind that banks need to remain profitable when servicing them as liquidity providers while simultaneously trying to bring down the noise from their trades. It's important to select brokers intelligently, leveraging the insights and outsourced liquidity management services that certain platform providers are able to offer. Clear communication with banking partners and maintaining a good relationship is essential as this helps the banks stay happy and keeps business profitable for both parties.

Non-deliverable forwards

While the more established swaps market ($3.6 trillion a day) and spot ($2 trillion) are leading the way, NDFs are growing rapidly, and BIS numbers show that notional volumes have jumped tremendously in recent years.

Similarly to the spot FX market, the majority of NDF liquidity is provided by a handful of large, global banks. However, there are many regional specialists in the NDF market which hedge funds can benefit significantly from trading against. This is particularly true in Latin America, where local banks with expertise and natural flows in their domestic currencies are particularly active when it comes to NDF trading. However, it can be difficult to access this liquidity unless hedge funds utilise a trading platform which is connected to all of these regional players.

Algorithms

Algorithmic trading has become more of a staple for the FX industry over the previous three years. When looking at algorithms buy side members put forward that while necessary to look at both the strategy and the underlying liquidity of the LP, the liquidity is ultimately far more important than the behaviour of the algorithm being used.

That is why there is a growing trend towards deploying execution algorithms across multidealer venues, as this enables them to interact with the broadest possible swathe of liquidity available. Hedge funds increasingly want to control the liquidity pool that their algos are interacting with, unlocking a whole new world of liquidity management possibilities.

Swaps

Buy side members also talked about methods for reducing market impact when trading FX swaps. Many are still trading these products over the phone, but putting swaps into an efficient EMS platform; where you can execute, automate, and net trades together based on direction and risk has proven to be a very effective means of minimising impact.

More sophisticated players are now executing their FX swaps using rules-based automated trading tools. As well as giving them complete customisation with regards to how and when these trades should execute, if these tools are powered by accurate, high-quality data then they can also enable funds to set a tolerance limit to the market midpoint, ensuring that trades never occur further than a pre-defined distance from this midpoint. Firms who have done this are showing remarkable cost savings and spread improvement.

Conclusion and Key Takeaways

From the discussion, it is clear to see that buy side firms are facing the same challenges when it comes to reducing market impact from FX trading and improving their returns. The participants shared their key takeaways which are summarised below.

- Continue to evaluate market impact as much as possible
- Search for niche counterparties that might improve upon the core set of liquidity providers
- Automated trading tools combined with high-quality data feeds can help improve FX Swaps execution
- Having a diverse group of participants with different natural interests within a liquidity pool is crucial to minimising market impact
- The liquidity an algo interacts with will determine whether the execution outcome is positive more than the design of the algo itself
- Anonymous trading platforms can be a useful execution option for funds looking to reduce information leakage and market impact
- Outsourced liquidity management services offered by trading platforms can prove very beneficial
- Customised liquidity pools on multidealer trading platforms can help funds gain the benefits of segmented flows
- Be careful when choosing LPs and doing research on market impact - but don't go overboard. It's a fine balance between drilling into data and using common sense