

INSIDE R&R

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Many people typically debate whether to spend the year-end holidays in the comfort of their homes or to take advantage of the time off to travel. Now the calculus behind that decision may be changing. Leading hotels are increasingly tailoring their rooms and service to make guests feel at home on the road. Contributor Francesca Di Meglio reports in unveiling our annual ranking of the World's Best Hotels (page 75).

In the markets the growing pressure to maintain returns in a low-yield world is forcing further reductions in equity trading costs, according to our latest survey, conducted for *Institutional Investor* by Elkins/McSherry. Senior Contributing Writer Paul Sweeney has the story, beginning on this page. Meanwhile, Managing Editor Thomas W. Johnson reveals the best of the best—the firms whose equity and fixed-income research wins the most plaudits from investors around the world—in the Top Global Research Firms of 2012 (page 78). —Tom Buerkle

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THE 2012 TRANSACTION COSTS ANALYSIS

THRIFTY TRADERS

As traders do battle in a sobering market environment, investment managers and brokerages cast a cold eye on transaction costs.

BY PAUL SWEENEY

No one would ever accuse Gateway Investment Advisers of swinging for the fences.

The Cincinnati-based investment firm with \$10.38 billion in assets under management shuns a slugging mentality. Instead, it takes the approach of a solid, no-star baseball team that wins games “with singles and doubles while trying to avoid strikeouts,” says Paul Stewart, CIO and co-manager of the firm’s equities fund.

Gateway calls its investment style “hedged equity.” It builds a diversified portfolio of stocks and hedges it in two ways: either by selling index call options (Standard & Poor’s 500 Index options)

written at or near the level of the market or by buying out-of-the-money S&P index put options. When the S&P 500 roars, Gateway’s \$6.7 billion equity fund underperforms, achieving steady but nonetheless “sedate” returns, Stewart says. When the market swoons the fund is protected by the put options. “Long term,” he notes, “we’ve captured 70 percent of S&P returns with 40 percent of the risk.” Short term, though, the fund’s formula lags the market: through November, Gateway’s flagship fund was up only 5.92 percent, versus a 12.6 percent gain for the S&P 500.

One key to making Gateway’s strategy work:

Its trading desk casts a cold eye on expenses. “It’s incumbent on us not to have high costs,” Stewart says. “That would be painful.”

The firm’s vigilance earns it a high ranking in *Institutional Investor*’s most recent Transaction Costs Analysis survey, conducted for the publication by Elkins/McSherry, a division of Boston-based State Street Corp. The survey measures a firm’s trading costs against the average performance of some 1,400 investment managers, relative to the volume-weighted average price. Gateway ranks No. 5 among investment managers in the U.S., with a cost of 20.04 basis points below the Elkins/

Top Agency Arrival Price

Rank	Broker Type	cty	Broker	Total Cost Universe Diff.
1	AGENCY	GBL	ITG	-47.40
2	AGENCY	GBL	Bloomberg Tradebook	-44.92
3	AGENCY	GBL	Instinet	-30.79
4	AGENCY	GBL	Redburn Partners LLP	-25.78
5	AGENCY	GBL	LIQUIDNET INC.	-23.23
6	AGENCY	GBL	Pavilion Global Markets	-20.61
7	AGENCY	GBL	Fidelity Brokerage Services LLC	-13.51
8	AGENCY	GBL	Russell Implementation Services	-12.27

McSherry universe average in the 12 months ended June 30. Only four investment firms deliver stronger performance. AJO Partners comes in first place, with an average cost of 33.87 basis points below the universe average, followed by BlackRock (-20.33 basis points), Brandes Investment Partners (-20.13) and GMO (-20.11).

Among U.S. full-service brokerages, Jefferies & Co. takes first place, beating the overall average by 25.35 basis points. In close pursuit are Oppenheimer & Co. (-24.90 basis points) and Nomura (-23.57). In the ranking of agency brokerages, Instinet leads (-26.36 basis points), followed by ITG (-23.80) and Liquidnet (-23.67). Among bulge-bracket firms, Bank of America Merrill Lynch takes top honors (-23.68 basis points), ahead of UBS (-21.35) and Credit Suisse (-19.46). (Complete global and U.S. transaction cost rankings can be found on our website, institutionalinvestor.com.)

These days, traders do battle in a sobering market environment. Although the U.S. economy has continued to improve since the Great Recession of 2007-'09 and the S&P was up 12.6 percent in 2012 through November, equity trading volume declined 18 percent during that period, according to Raymond Tierney, chief executive of Bloomberg Tradebook. In addition, reports Tierney,

Top Agency Interval VWAP				
Rank	Broker Type	cty	Broker	Total Cost Universe Diff.
1	AGENCY	GBL	Redburn Partners LLP	-49.86
2	AGENCY	GBL	Bloomberg Tradebook	-26.57
3	AGENCY	GBL	ITG	-20.93
4	AGENCY	GBL	Instinet	-20.58
5	AGENCY	GBL	BTIG LLC	-17.55
6	AGENCY	GBL	Pavilion Global Markets	-14.96

U.S. equity options trading skidded by 12 percent and financial futures slumped 10 percent over the same period.

A former global head of equity trading for Morgan Stanley Investment Management, Tierney blames the dispiriting statistics on a "crisis of confidence." Culprits include the risk of wayward technology, such as the rogue algorithm that led to a \$400 million loss at Knight Capital; Nasdaq Stock Market's botched Facebook initial public offering; and the \$5 million fine levied against the New York Stock Exchange for early sharing of information with some high frequency traders.

In addition, say market participants, investors are restive over the regulatory uncertainty surrounding dark pools — unregulated trading systems that match buyers and sellers in a private marketplace — and upcoming implementation of the Volcker Rule, which will bar banks from proprietary trading. Banks are also scrambling to meet the higher capital requirements mandated by the Basel III global accord. A general malaise stemming from the persistent euro zone crisis is further sidelining investors.

Brokerages especially are struggling as competition continues to compress commissions. According to Elkins/McSherry, commissions in the U.S. have declined by 0.47 basis point, to 8.41 basis points, compared with a year ago. In addition, ever more sophisticated technology and low-touch algorithmic trading have set off a shakeout of the brokerage sector. Layoffs are rampant and more firms are closing up shop. Over the past year the fallen have included Ticonderoga Securities and WJB Capital Group. "For the brokerage industry in general, revenues have been down and costs are up," says Niamh Alexander, a financial services industry analyst at Keefe, Bruyette & Woods.

In the hopes of not only surviving but finding new synergies, other brokerages are joining forces: In the past year, Wells Fargo Securities acquired Merlin Securities and Raymond James Financial bought Morgan Keegan & Co. from Regions Financial Corp. Other brokerages are branching into research and offering bespoke investment products. They're hoping to earn extra fees while cementing relationships with invest-

ment firms that are keeping a close eye on trading costs. Douglas Dixon, a principal on the trading desk at \$20 billion AJO Partners, says trading costs "are especially important because we're running a value-oriented quant shop." Like other money managers, AJO benefits from fierce competition among brokerages to win business.

Bob Santella, president of the brokerage group at SunGard's Fox River Execution Solutions, sees a "flight to quality" by some buy-siders seeking "high-performance providers" and "responsive customer service" at a time when many competitors are downsizing. "Our group's trading volumes are up about 50 percent over last year" as the firm has added new clients, he says.

Once a brokerage has been retained by the buy side, it can expect to be constantly monitored, assessed and ranked according to what Joseph Scafidi, director of trading at Brandes, the No. 3 manager in the U.S., describes as "multiple performance metrics." Brandes is loath to select a brokerage only on the basis of its being a low-cost provider; the firm uses traditional full-service, high-touch firms

research & rankings

in concert with execution-only firms. “You get what you pay for,” says Scafidi. “There’s real value to the high-touch business and in human interaction. You can’t hide in the weeds and execute according to the lowest explicit costs.” High-touch traders can help clients steer clear of their “predatory” high frequency counterparts and offer insight into small-cap and emerging-markets names. “Algorithms don’t help you there,” Scafidi says.

Nor are algorithmic trading programs of much use to traders meeting in the increasingly popular dark pools. Rhodri Preece, director of capital markets policy at the CFA Institute, a global investment industry association, reports that over the past three years, “off-exchange trading in undisplayed venues has grown by approximately 50 percent.” Although critics of dark pools argue against their lack of transparency, Preece is a staunch defender as long as “we don’t reach a point where the majority of trading activity takes place away from the ‘lit’ public markets, which is where prices are discovered.”

Backers like dark pools as both a source of liquidity and an end run around high frequency traders that engage in front running, which is both illegal and costly for those left behind. If HFTs get wind that a million shares of a security are being transacted, they may attempt to buy stock ahead

of the block-buyer and sell it back to the institutional investor at a higher price, pocketing the difference. Miranda Mizen, director of equities research at Tabb Group, notes that outfoxing the HFTs is increasingly a high-stakes proposition. Trading in dark pools is “like a sophisticated game of hide-and-seek. And if you want to see without being seen, you have to have sophisticated technology.”

Even so, as margins tighten on the execution front, brokerages are hunting up ways to leverage their positions. Fox River has partnered with financial services firm Robert W. Baird & Co. to add research capability to the diversified algorithmic trading it offers to institutional investors. With more than 100 analysts, Milwaukee-based Baird has a reputation for “providing premier research on small- and midcap stocks,” reports Santella.

Montreal-based Pavilion Global Markets, No. 6 among global agency brokerages, has worked to stay lean. Says Jamieson Ritchie, director of global

markets trading: “We’ve been able to maintain or grow our trading volumes in difficult times. We’ve never overextended ourselves. Some firms have ten investment bankers and a bunch of researchers. With a lot of mouths to feed, those firms are closing down.”

But over the past two years, Pavilion has hired a three-person team of strategists and now offers clients a “global macro strategy research” product. These analysts “focus on all major economies and markets and set strategies on how to invest in equities, bonds, commodities and currencies over the next six to 12 months.” Even though “trading volumes are getting more difficult,” Ritchie adds, “the new product has been a positive catalyst.”

ITG, a leading agency brokerage and financial technology firm, stitched together a research unit, ITG Investment Research, following its acquisition of two regional firms, Majestic Research Corp. and Ross Smith Energy Group. Majestic’s analysts had followed 200 companies in 17

sectors and boasted a loyal following among institutional clients. Ross Smith, a Canadian shop with a 40-person staff, brought along 60 new clients to ITG plus connections to corporations that were the subjects of its analysis. Many of the buy-side firms switched to using ITG for execution of U.S. equity trades, says Ian Domowitz, managing director and head of ITG’s analytics.

Guzman & Co., a boutique brokerage based in South Florida, has tried its hand with research. In the spring of 2000, just before the Nasdaq bubble burst, Guzman hired two analysts to follow cable, media and telecom companies. But in 2007 the firm dropped its research group. As Guzman focuses on its core business, it has expanded into operating a 24-hour international trading desk, adding technology and two new hires, registered to trade in Europe. It also trained its staff to handle global trading duties. “We’ve talked to our clients, and it seems that a lot more of them are investing in emerging markets and

Top Agency Arrival Price

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1	AGENCY	US	Bloomberg Tradebook	-32.47
2	AGENCY	US	Agency Trading Group, Inc.	-31.26
3	AGENCY	US	Telsey Advisory Group	-26.42
4	AGENCY	US	Guzman & Company	-26.13
5	AGENCY	US	Fox River Execution Solutions	-25.24
6	AGENCY	US	ITG	-20.51
7	AGENCY	US	LIQUIDNET INC.	-20.39
8	AGENCY	US	Pavilion Global Markets	-19.12
9	AGENCY	US	BTIG LLC	-15.85
10	AGENCY	US	Instinet	-15.72
11	AGENCY	US	Capital Institutional Services, Inc. (CAPIS)	-13.93

putting less into their U.S. portfolios,” says John Bell, vice president and head of global equity trading.

Few brokerages have diversified as rapidly and aggressively as Bloomberg Tradebook as it moves from what CEO Tierney calls an “execution-only model” to an “execution-everything model.”

“We don’t just provide

electronic execution services anymore,” says Tierney, “we offer cradle-to-grave services.” The firm has morphed into an emporium offering independent research, commission management and execution consulting, along with its customized algorithms. Using transaction cost analysis, the firm will not only customize an

algorithm but keep track of the client’s performance and make whatever changes the product requires to work at optimum levels. In 2011, Bloomberg Tradebook completed more than 65 such projects for 45 clients across equities, options, futures and foreign exchanges.

Even as it rolls out new products and services,

the firm has not neglected stock trading. “We think if we help clients reduce transaction costs, we can turn this expertise into market share growth,” says Tierney. The Bloomberg executive started his career as a Paine Webber trader in 1981, and he knows the abiding value of Wall Street’s bread-and-butter business. ••