Global Equities

US Equity Hedge Fund Trading 2012:

Disparate and Desperate

Author: Miranda Mizen

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Executive Summary

After the bruising markets of last year, 2012 looks unremarkable on the surface, yet this will be a year of disruption for hedge funds and brokers alike, as market conditions, sell side economics and regulation create a triangle of change. Early optimism that market conditions are improving and markets will catch election fever early may not be played out unless the macro environment and equity volumes improve, and this keeps wallets thin and commission rates steady as hedge funds need to ensure brokers are sufficiently rewarded. Only a few can outperform markets in these doldrums.

This environment highlights the heterogeneity of the hedge funds' trading styles and needs, putting pressure on brokers to narrow products, services and pricing models to target groups and offer variations of transparency and flexibility.

Differentiation in the algorithm world comes in three forms: product performance, operational transparency, and low-touch coverage. While the biggest firms can crunch and compare thousands of executions to measure performance, most find greater differentiation in levels of knowledge, disclosure and support. For brokers, this signals an investment in low-touch service to be able to offer both proactive transparency and deeper levels of technical knowledge on the front line.

As firms have focused on electronic trading, the sales trading desk also struggles to differentiate itself and has become far more technical. Thin overall volumes, a reticence to trade blocks or use risk, and high turnover on the cash desk has changed both relationships and needs. While economics provides the fuel to constantly reassess broker lists, regulation is lighting the match, and the tails of large funds' broker lists are going up in smoke. Limited resources, fewer one-off deals and the burden of connectivity and compliance means brokers must be seen to earn their keep. Meanwhile, the constituent core group of brokers who command the greatest concentration of commissions is steady this year reflecting the constant need for diverse ranges of services.

The top broker may be hard to uproot, but there is a jostling for position amongst the next four. For those hedge funds that do not pay for research or whose trading desks have no ties to prime brokerage or which brokers they trade with, the last trade will determine the next. With limited dollars to play with, deeper relationships, outperforming algorithms and consistent coverage can nudge a broker up a place.

Whether expanding into new alpha territory or putting in place processes for new regulatory compliance, the need for products and services is becoming ever more disparate. Large funds are getting larger, demanding data, innovation and transparency, while smaller funds provide valuable sources of order flow if they can be serviced economically. Leadership with regard to operational transparency, market structure changes, regulatory issues, coverage models and better ways of supporting their needs will be rewarded with order flow and a place on the broker list. For everyone else, the check will be in the mail.

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For this year’s hedge fund trading study, TABB Group spoke with 51 individual US-based hedge fund companies, including many of the largest hedge funds running US equity strategies. The firms participating in this study manage an aggregate $182 billion in assets. Conversations covered the views of head traders on a wide range of topics, including: order flow allocation across high and low-touch trading channels; commission rates and commission wallet trends; broker lists; leading brokers and prime brokers, mid-tier brokers, and coverage differentiation in the high and low touch space.

Table of Contents

Table of Exhibits