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Trading's evolutionary *EPOCH*

Two styles, two traders: Jimmy McKnight is getting a run for his money as math wizards like Rizwan Awan accelerate trades using complex algorithms

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Rizwan Awan is the new face of Bay Street: a programmer-broker at BMO Capital Markets. Mr. Awan's edge is his ability to execute sophisticated automatic-trading strategies using mathematical models.

Down the street, Jimmy McKnight of Jennings Capital Inc. still relies heavily on his old-style charm: A hearty laugh, a firm handshake and a trustworthy manner make him a long-time favourite with institutional clients.

Two traders. Two styles. Forty-two years separate them in age. It's a spread that represents an evolutionary epoch in the trading world. While Mr. Awan writes software code, Mr. McKnight embodies the unwritten code of relationships and reputation. The old-school style endures, but it is less and less the norm.

The Canadian trading world is undergoing seismic changes. Although the Toronto Stock Exchange has been fully automated for a decade, the popularity of electronic trading platforms and companion algorithmic trading tools on the buy-side is reshaping the capital-market landscape. Today, 36% of all trades originating in Canada use some form of algorithm execution, according to Forefactor, a Toronto based research and consulting firm.

The first algo-models were crude: "set and forget" programs in which block orders were processed according to the stock's historical trading pattern in one-hour intervals. No longer. Today's programs not only "source liquidity" across different exchanges, but perform statistical arbitrage pirouettes within split-seconds. "Algo quality, variety and accessibility are replacing trader judgment and connections as competitive factors in many cases," says Chris Guthrie of Hillsdale Investment Management Inc., which manages several hedge funds. It's making the business "less personal," he adds. When he shops for traders today, he looks for math and physics degrees, not salesmanship.

When Mr. McKnight quit high school and started working the floor of the TSE in 1954, he was a "post boy" who marked up the board with quotes. Over the years, he worked himself up the ladder trading on contacts. When the stock market exchange became fully automated, he adapted, sending his orders through the electronic pipelines. But he's never going to be a "propeller head." "I don't do program trading," he says. The days of client lunches are over. "You have to cover your butt when you are out there because [the trades] happen so fast now," he says.

The early adopters of the new electronic trading tools were the large pension and mutual fund managers who

were seeking anonymity through the electronic highways.

As the average size of deals on the stock market decreased in the late 1990s, it became increasingly difficult for big funds to hide gigantic trades. Parcelling out buys over a period of time is risky.

If brokers catch wind of their strategies, the prices move against them. Loose lips sink profits.

"The Canadian market is so small that everyone knows everyone else," says Aldo Sunseri, chief equity trader at CI Funds. By allowing managers to break up their orders and feed them directly to the market via their own electronic platforms, the gossip pipeline was quelled. "If the stock doesn't move and we can do a size piece, then we are successful," he says. "I get paid by saving pennies."

Mr. Sunseri got a taste of the capabilities of electronic trading while working with U.S. companies. Not only could these firms help CI Funds better manage block trades within their portfolios using algo-trading tools, it also gave them access to U.S. alternative trading systems (ATS) that allow companies to anonymously troll for matching liquidity in electronic "dark pools."

These dark pools of liquidity mirror the "upstairs" markets, in which institutions or brokers barter better deals outside the public exchanges. Mr. Sunseri recalls trading one month worth of stock in one hour on an ATS. "The stock didn't move a penny," he says.

So four years ago, Mr. Sunseri pushed all his Canadian brokers to invest more actively in their electronic capabilities. The traders kicked and screamed — it costs money to upgrade — but he persisted. One of the companies to facilitate the technological revolution among traders was ITG Canada.

When ITG Canada first arrived in late 2000, it operated both as a portfolio-trading and electronic brokerage, executing trades using transaction cost-analysis tools that helped measure efficiency and best execution. Eventually, Nick Thadane, then head of sales and now chief executive, realized they could leverage their business by installing their "Triton" desktop platform on the desks of the buy-side clients like CI Funds, and offer them a direct market-access system and a suite of algo-trading tools that could be customized.

"It was like a virtuous circle," says Mr. Thadane. "The more we helped clients learn, the more they traded; the more they realized they were getting a good result, the more they traded."

Today, ITG Canada is the leader in trades executed by buy-side traders using algorithms (otherwise referred to as direct market access or DMA), and is the seventh-largest brokerage firm with a 4½% of the market.

His aggressive strategy — to literally share his productivity tools with his customers — had a domino effect in the industry. ITG's move meant that "clients were taking more control over their trading process while leveraging their access to information," says Mr. Thadane. "It was a cultural change."

Even late adopters like Martin Hubbes, executive vicepresident and chief investment officer of AGF

Funds Inc., who believes "machines are nice, but can't replace the human brain," has installed an electronic trading platform. "We've gone through a pretty heavy upgrade cycle over the past two years," he says. "We've put in the plumbing to hook into anything."

Empowering the buy-side clients with algo-tools forced the sell-siders to better equip themselves as well. Not only were they forced to develop more exotic algo-strategies, but also to service DMA orders from buyers as well. (The TSX insists on a broker number attached to any order, so buy-side executions still have to pass through a broker's electronic pipeline. It's akin to renting a phone line, but the brokers get paid a smaller commission for executing this kind of trade.) More than 41% of all trades on the TSX today are via DMA.

This shift to buy-side control has affected the industry on many levels. Traders like Mr. Sunseri say their execution is better, more efficient. The good news is that the increased efficiency by portfolio managers has led to an increase in the volume of trades on the TSX from 7.3 billion in 1992 to 82 billion in 2006. But there is a downside: Commissions to brokers have dropped significantly as fewer trades are fully serviced. Not surprisingly, brokers have put a lot of pressure on the TSX to reduce their prices. In 2000, the TSX charged brokers \$3.81 per transaction; today it charges only \$1.15.

"There's a fantastic pressure on all people, all participants along the value chain," says Thomas Kalafatis, director of sales and trading at the TSX Group Inc. "The buy-side needs to squeeze more basis points out of the equation; the sell-side must compete to service the buy-side," he says. Now it's reached the tipping point, he adds. "This segment of the financial sector is looking more and more like a technology-services industry where you are required to constantly innovate to stay competitive."

The impact of technology on jobs is undetermined.

In the United States, the number of traders has dropped from more than 7,000 in 2001 to 5,200 in 2007 because of technology, according to the Security Traders Association. Membership at the Institutional Equities Traders Association has actually increased 43% since 1995. But that growth may change if volume of trades trails off and more fund managers research in house rather than rely on broker reports — a move that will further squeeze commissions.

One thing is certain: The profile of the trader is changing. "Algo-trading is the buzz word that's gained momentum since 2001 as the use of computers to automate trading took off," says Mr. Awan of BMO. "I got in at the ground floor."

"The rise of machines has meant traders can focus on the big picture and let machines do the micro-management of orders, which greatly increased capacity — how many orders a trader can monitor," he says.

Mr. McKnight doesn't think his style of trading will ever become extinct. "I still think we serve a purpose," he says. "Some people want plain common sense about what the market is doing."