

FX Trading: The Next Generation

FX Trading and Technology Trends in 2010

By Emily Fraser Voigt
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2009 saw an unprecedented push into foreign exchange (FX) trading. In the uncertain economy, investors' appetites for less esoteric products grew, and many FX trading desks outperformed their equities and credit counterparts to make huge profits on the volatile currency markets. Many firms expanded their FX trading desks, and other firms began trading FX that had not done so before.

Although the markets are very different in nature, there is a huge interest as to which technologies and strategies can be transplanted from the equities world to FX. The current boom has drawn the interest of sophisticated high-frequency equities traders who previously did not trade FX. They want to know how they can use their expertise and tools from equities to profit from the lucrative and growing currency markets.

Algorithmic trading is becoming more and more common—in particular event- and time-driven algorithms. However the use of algo trading in FX is still in its early stages, and will continue to evolve over the coming months.

FX Trading and Technology Trends in 2010 Survey

This April, StreamBase carried out an online survey to discover the latest trends and developments in FX trading and technology.

A total of 83 active traders of FX—49% on the buy side, 24% on the sell side—took part in the survey. (See figure 1a). Some 76% were from the Americas and the remaining 24% were from the Europe, Middle East and Africa (EMEA) region. (See figure 1b). The primary FX trading venues according to the survey respondents are CME, Reuters D3 and Currenex, in that order. (See figure 2). The top two were also in pole position during a similar survey conducted by StreamBase last year.

Some 74% of respondents said they trade between one and nine currency pairs, up from 67% in 2009. (See figure 3). The leading currency pairs, EUR/US, GBP/USD, and USD/JPY, remained unchanged year on year.

The survey was followed by a roundtable discussion with a panel of experts from the FX industry.

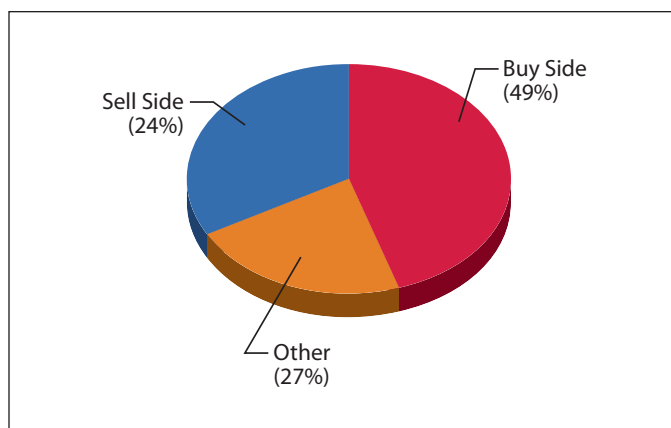


Figure 1a – Type of respondents

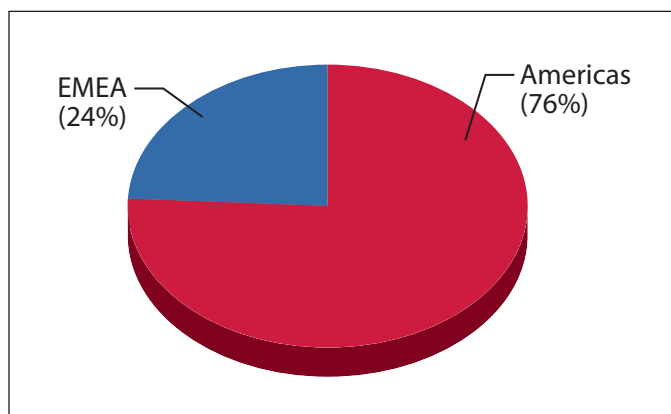


Figure 1b – Location of respondents

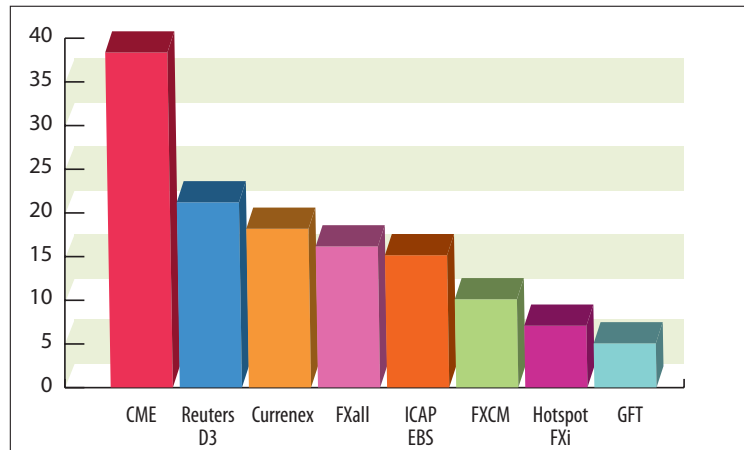


Figure 2 - Primary FX trading venues used

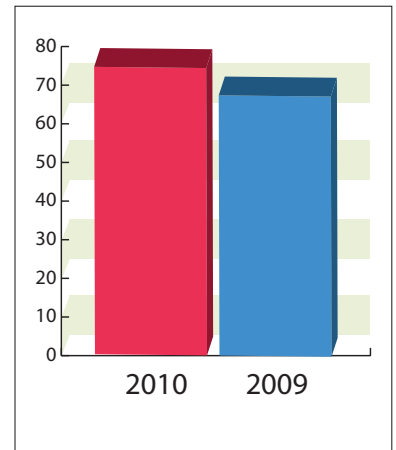


Figure 3 - Percentage of firms trading 1-9 currency pairs

Broker Systems

When it comes to selecting an eFX platform, the most important criteria are liquidity and robust and easy-to-integrate technology. Some 48% of respondents rate their FX system as neutral, while 26% rate it as good and a further 26% say it needs improvement. (See figure 4). According to the survey, Deutsche Bank's broker system was being used by the most number of respondents—the same as in 2009. (See figure 5).

However, there seems to be a shift in terms of how firms are accessing liquidity. More firms are using more than one platform to trade in FX, driven in part by the push towards multi-prime and the sell-side desire to provide more holistic execution and clearing services.

The buy side has seen a shift towards using multiple prime brokers, in part in order to diversify their risk, but also to broaden their options when looking for liquidity, says Erik Lehtis, president, DynamicFX Consulting. Electronic communications networks (ECNs) are supporting multi-prime setups more than before, which makes this easier to do. And brokers are marketing beyond their core customer base—more and more banks are supplying data and execution services, providing

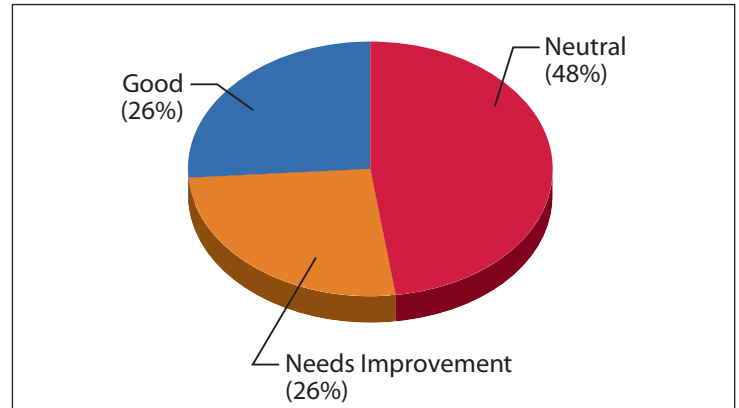


Figure 4 - How traders rate their existing FX systems

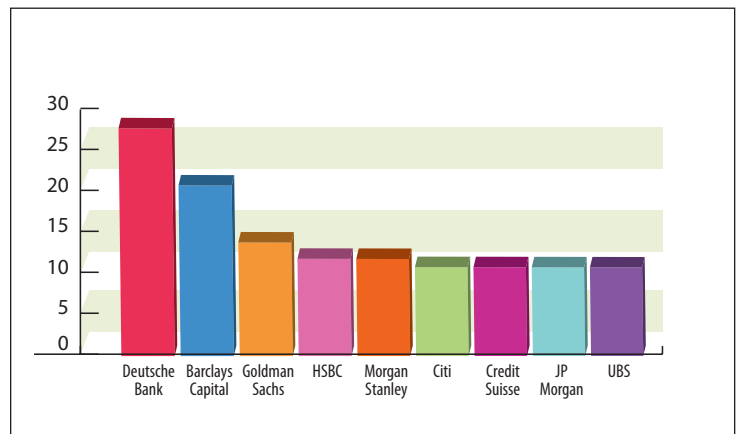


Figure 5 - Primary broker systems used

alternatives to the traditional Reuters and Electronic Broker Services (EBS) platforms. “The endgame for banks is to have customers that are not only trading with them but are using them to clear their trades,” says Lehtis.

A lot of FX platforms were built with institutional customers in mind and most banks are not set up to allow much crossover between retail and institutional silos. The boom in the retail FX market has therefore left many brokerage firms scrambling to provide technology platforms to clients, and many have chosen to white-label products rather than build from scratch. “If you look at some very big sophisticated banks, they’ve chosen to white-label their retail products. That technology is way ahead and you can’t compete or catch up quickly enough now,” says David Poole, COO and principal, ClientKnowledge.

Algo Trading Widespread and Growing

Algorithmic trading is becoming more and more popular for FX trading firms. According to the survey, among firms that actively trade FX, more firms are using algorithmic trading than not. (See figure 6). Execution algorithms are most often event-driven, with the next most common category being time-driven algos. (See figure 7)

However FX algo trading is in its infancy compared with the strategies being deployed in the equities world, leaving much room for growth. “To a large extent we’re in the very early stages of trying to define how to use algos effectively for strategies in FX. Event driven is the latest thing and it’s starting to get some clips, but I do see it moving on. I think it’s got a long way to evolve,” says Poole.

There is an increased demand for anonymous algo execution provided by banks, according to Dave Reid, Director FX Prime Brokerage, Citi. He says many trading firms do not have algorithmic trading capabilities built into their own systems and

instead they are drawn to banks that provide algorithms to execute orders in a specific and anonymous way. “An ability to execute in an invisible manner for our clients in a way that adds value to that execution process I think is becoming ever more attractive,” he says.

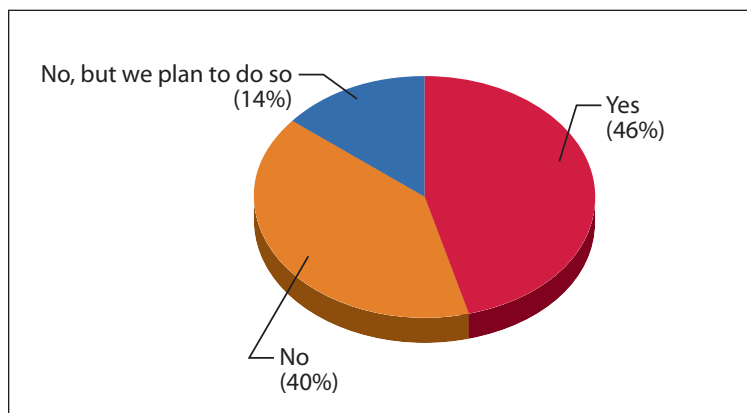


Figure 6 - Percentage of firms using algorithmic trading

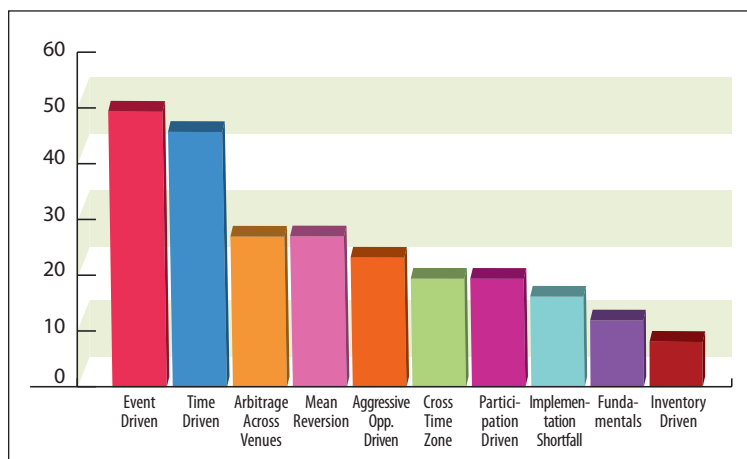


Figure 7 - Most popular execution algorithms used

Integration Trumps Adding New Venues

Roughly a third of the survey respondents said they planned to change or add new electronic FX venues in the coming year. This contrasts somewhat with the 2009 survey, when there appeared to be a larger drive to change or add new venues. (See figure 8).

While there is a lot of technology enabling firms to draw on a broader range of liquidity sources, there are still a number of technology problems to be solved, particularly around integration, says Richard Tibbetts, CTO, StreamBase Systems. “There are challenges on normalization, data analysis, the semantic meaning of quotes, and the interaction styles of different venues. There are all these issues coming to play as firms are going from a single counterparty or execution venue to multiple—those issues are becoming more and more challenging,” he says.

The FX marketplace is very fragmented—traders need to interact with banks, prime brokers, non-bank liquidity providers as well as increasingly large retail liquidity pools. These players—banks in particular—are not very interactive, says Citi’s Reid. In addition, firms such as Citi face enormous inbound and outbound flows of liquidity, which means they have to spend a lot of time and energy aggregating the flow and normalizing the data in a way that makes sense for trading. This makes FX aggregation especially important for automated trading, which was borne out by the survey results.

The survey showed a roughly 50:50 split between those firms that aggregate prices and volumes electronically across venues, and those who do not aggregate, but trade on each platform separately. However, when it comes to automated trading decisions, firms said they prefer to use FX aggregation as the basis for those decisions. (See figure 9).

While many platform providers have improved their integration with other platforms, Tibbetts says there is “an inverse relationship between user integration and market share on the part of the venues.” Logically, the more established venues have to work less hard to provide integration than the newer players looking to onboard new clients. This means there will be a need for some kind of intermediary FX aggregator for some time, he adds.

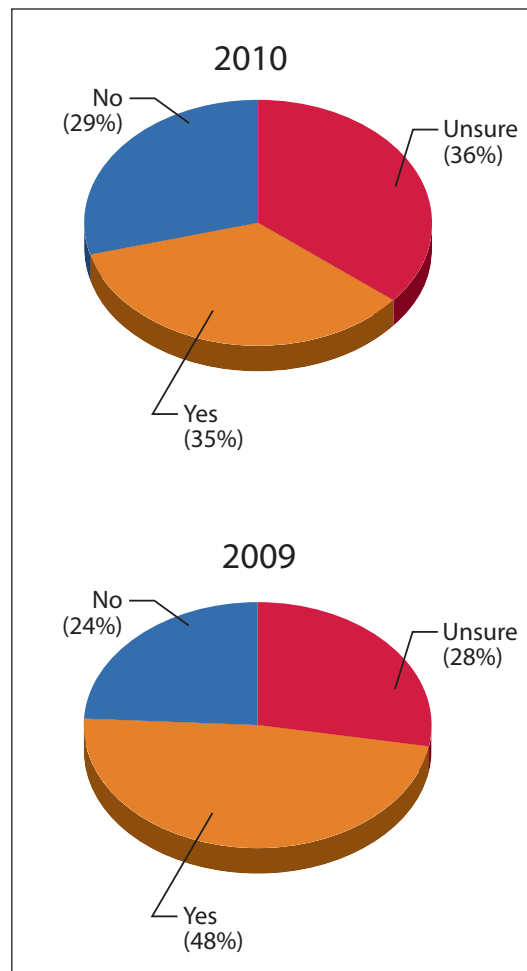


Figure 8 - Firms planning to change or add new eFX venues

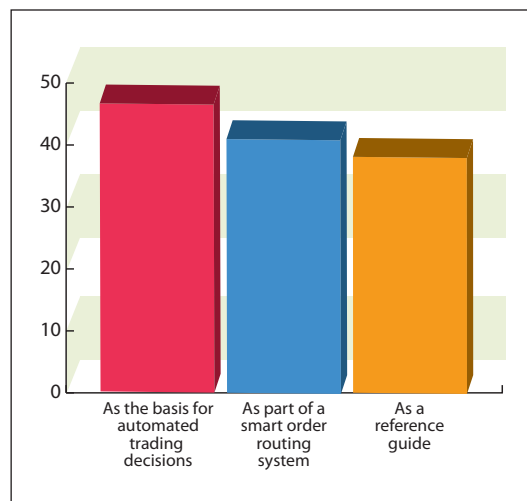


Figure 9 - How firms want to use FX aggregation

Information Beyond Pricing

As more people offer out-of-the-box aggregation services, those who once saw it as their competitive advantage will have to be able to source deeper, broader market information, says Lehtis. In the early days of electronic FX trading, few people were able to intermediate between star pools of liquidity, and traders were “very married to the platforms upon which they traded,” Lehtis says. Now, sophisticated tools like StreamBase are more widely available and many firms that need large amounts of liquidity are able to aggregate for themselves. This takes away some of the ability to arbitrage between platforms and it means that buy-side firms have to do other things to remain relevant.

Reliable pricing will no longer be enough: “Everyone has good prices,” Lehtis says. Instead people will want information about what is actually trading or how a price was reached—where the flows went through, and the size of the flows. Few platforms today provide this information, so people are effectively trading in the dark. “Anyone who does statistical arbitrage of one kind or another, quantitative analysis, wants that information,” especially the hedge funds that are accustomed to it in the equities world, he says.

Lehtis believes complex event processing (CEP) has a role to play in taking FX trading to the next level and providing the more nuanced information in a timely way. “We’ve been trying to do more complex event processing of market data, analyzing microstructures in order to be a bit more directional in our views, and to be more aggressive about risk taking—this can only be done when you have good information,” he says.

CEP seems poised for broad adoption in the FX industry. Despite the widespread use of algorithmic trading, 67% of people who took the survey said they did not use CEP in their trading infrastructure. However, 60% of respondents were keen to learn more about how it can be used.

The main reasons for using CEP in FX, according to survey participants, are identifying trading opportunities, order placement, data aggregation and pricing. (See figure 10)

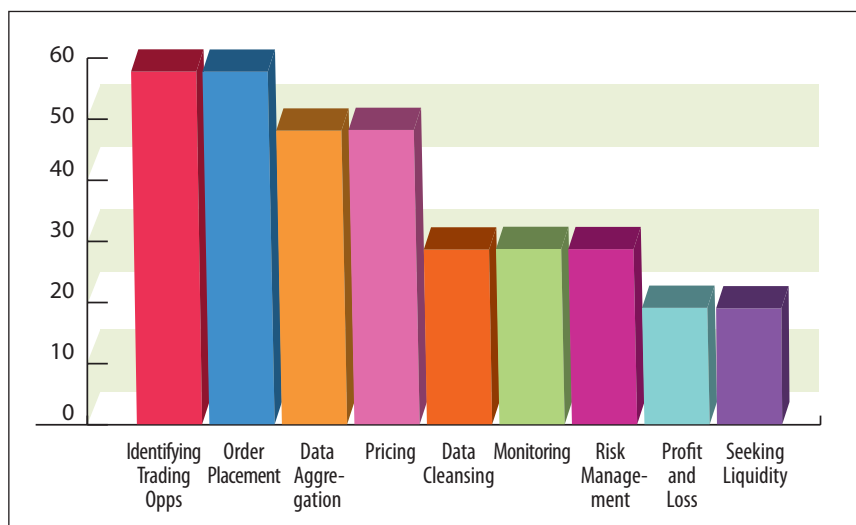


Figure 10 - Primary reasons for using CEP technology in FX

Budgets Mostly Flat

In terms of budgets, most respondents said their trading technology budgets will likely remain the same as in 2009. Around 12% said they will see an increase in spending of more than 25%—however this was down from last year, when 19% saw such a large increase.

The primary area for increased spending remains low-latency technology. There are a number of ways to reduce latency, including taking advantage of colocation offerings, improving software engineering to do more processing in memory, investing in hardware acceleration, and modernizing hardware and software throughout the entire stack. “The reason low latency is getting the biggest spend is because it’s the most expensive thing to do,” says Lehtis.

However not all FX trading firms should be putting all their energy into achieving ultra low latency, says ClientKnowledge’s Poole. “There is a sheer amount of money and investment just to get a very small gain on something like latency. It’s becoming almost disproportionate and only worthwhile for very few people,” he says.

“We inevitably focus on the sharp end of the client business, and sometimes we forget where a lot of the core money is made in foreign exchange,” Poole says. While the high frequency traders with the lowest latency might get the most attention, the core business of a lot of FX trading firms—the corporate and retail customers—is very healthy and growing. He says that many firms would be better off investing in updating their less glamorous back-office systems—which in many cases are between five and 10 years old—to make them more efficient and better able to integrate with their more modern front-office platforms.

Many survey respondents said they were concerned about potential future regulatory changes. As the highly charged political debate over financial regulation unfolds in the US and Europe, trading firms will have to wait and see what new rules and regulations will come down the pike and adjust their systems—and budgets—accordingly.

Conclusion

High-frequency trading is top of mind for many people working in the FX space, and low latency is the area of biggest spending—although not all players will be able to spend enough to profit from the low latency arms race.

As algorithmic trading and aggregation technology becomes more commoditized, and systems and preferred liquidity providers come to be changed more easily and more frequently than today, the current dominant market players will be challenged with maintaining their market share.

In many ways, the development of the FX market—particularly on the high-frequency end—is very similar to that in the equities market, despite key differences in market structure. As the cost of entry is lowered, the market will see higher volumes and smaller average trade sizes, more liquidity and tighter spreads, says Tibbetts.

Over time, and with increased use of sophisticated technology, FX is set to become a more prominent asset class. “From the buy-side point of view the hedging of foreign exchange is still a very inefficient process and very poorly understood and poorly used,” says Poole. FX is still a relative side show compared to other asset classes, but as more sophisticated players get involved in the market that will change, he says.

About Emily Fraser Voigt

Emily Fraser is a freelance journalist specializing in capital markets technology. Her previous roles included news editor and US reporter for Waters magazine, covering technology news and trends in the global capital markets. Samples of her previous work can be found at www.emilyfraservoigt.com.

About StreamBase Systems, Inc.

StreamBase Systems, Inc, a leader in high-performance Complex Event Processing (CEP), provides software for rapidly building systems that analyze and act on real-time streaming data for instantaneous decision-making. The World Economic Forum recently awarded StreamBase the title of 2010 Technology Pioneer.

StreamBase's Event Processing Platform™ combines a rapid application development environment, an ultra low-latency high-throughput event server, and the broadest connectivity to real-time and historical data. Leading investment banks, hedge funds, and government agencies use StreamBase to power mission-critical applications that increase revenue, lower costs, and reduce risk. Applications in Capital Markets include FX Aggregation and Pricing, Smart Order Routing, Market Data Management and Algorithmic Trading.

StreamBase customers include CME Group, SunGard, ConvergEx Group, RBC Capital Markets, CMC Markets, City Index, Gain Capital and BlueCrest Capital Management. The company is headquartered in Lexington, Massachusetts with offices in New York, Washington D.C. and London.

For more information please visit www.streambase.com.

Additional Reading and Resources

Visit www.streambase.com/fx.htm to watch the roundtable discussion on FX Trading and Technology Trends in 2010 and to download additional StreamBase FX trading resources.

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