Liquidity in the Time of Covid

Building New Liquidity Partnerships - The View from the Buy Side

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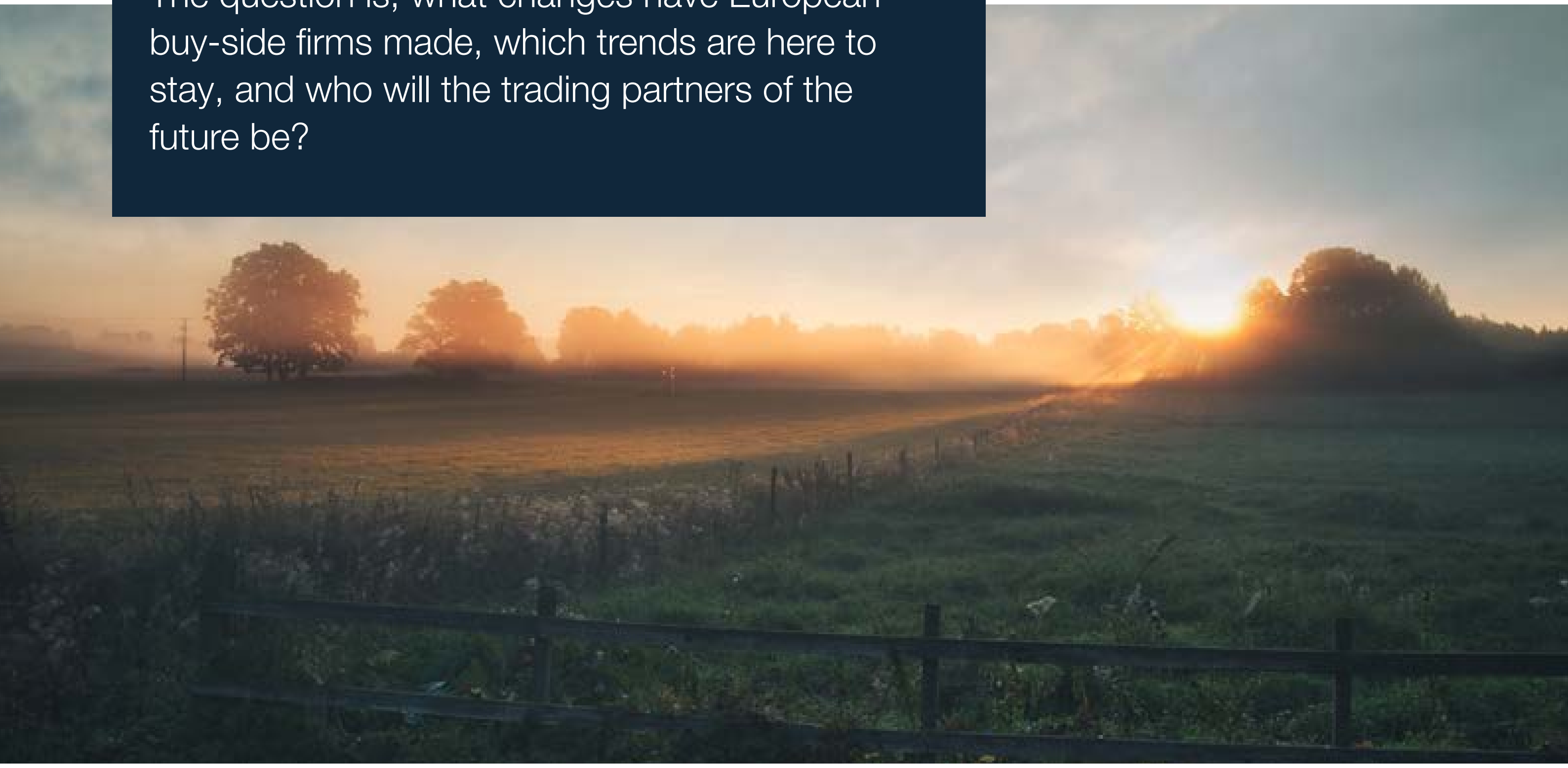
Covid-19 continues to redefine the trading landscape in Europe. **Changes in liquidity formation already in play due to the increased use of automated trading and rise of passive investing were accelerated as traders rushed to make changes to investment strategies due to the pandemic.** Remote working, greater reliance on cloud technology and the high volatility early in the pandemic created new additional challenges which is resulting in the industry rethinking trading partners and access points to liquidity.

The question is, what changes have European buy-side firms made, which trends are here to stay, and who will the trading partners of the future be?

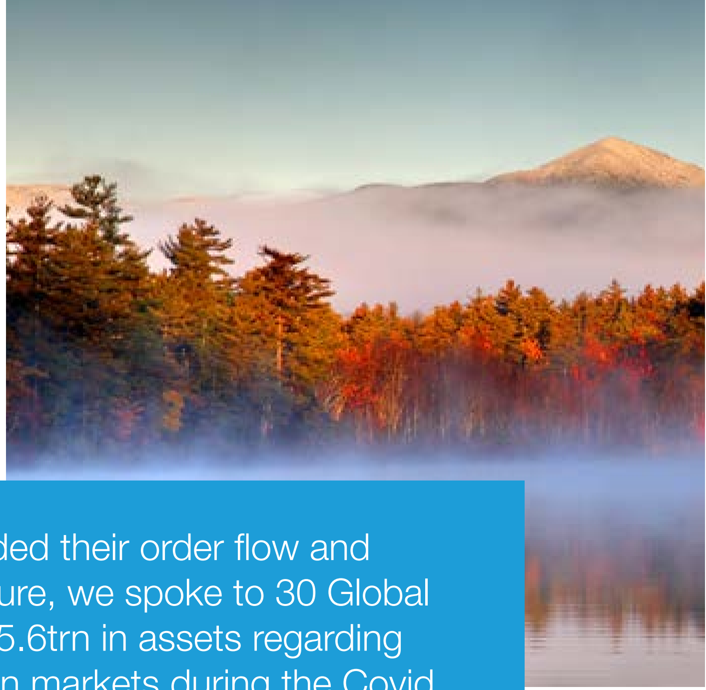


Dealing desks at asset managers in Europe are fast becoming more autonomous, reducing their dependency on traditional means of accessing risk capital and increasing their connection to multiple streams of liquidity. While broker relationships remain pivotal to accessing primary issuances, a wider group of liquidity providers is gaining traction in the European execution space.

Whether accessing a global bank, a regional specialist, an interdealer broker or an electronic liquidity provider (ELP), trading on or off venue, buy-side traders need to understand when and how best to engage with which providers of liquidity and by what means; sometimes directly, sometimes via a third party.

Initial concerns about dealing with alternative counterparties are declining as transparency over new business models, improved routing of order flow and more accurate post-trade data are emerging.

As electronification moves across the asset classes, the post-pandemic markets landscape in Europe creates an opportunity for more diverse actors to become incorporated into the trading process and a chance to change the rules of engagement again. Asset managers are looking to benefit from a wider and more diverse pool of counterparties and create greater optionality in how and where they can execute investment strategies; while liquidity providers have the opportunity to re-position themselves and build new partnerships.



To find out how European buy-side firms traded their order flow and what changes they are considering in the future, we spoke to 30 Global Heads of Trading at asset managers with $35.6trn in assets regarding their experience sourcing liquidity in European markets during the Covid pandemic. Of these 57% were based out of the UK, 43% in Europe. 40% of respondents were based at firms with more than $500bn AUM, a third had assets up to $100bn and 27% were between $100 and $500bn.

Key Facts

91%

91% of respondents noted improved access to automated and diverse sources of liquidity during the March-April 2020 volatility period compared to the crisis of 2008.

77%

77% of respondents increased their means of accessing liquidity electronically and automated trading during the pandemic.

61%

While markets appear to have recovered from the recent volatility, **61%** of respondents see continued liquidity challenges intraday.

47%

While **47%** of respondents concentrated liquidity with traditional relationships with sell-side dealers during the pandemic, providers,

53%

53% took the opportunity to diversify their means of who they trade with to access to liquidity.

70%

The focus for asset managers is now on matching the right flow with the right provider; **70%** of respondents are engaging more with alternative liquidity providers,

37%

although for **37%** this interaction depends on the asset class being traded.

Source: Redlap Consulting

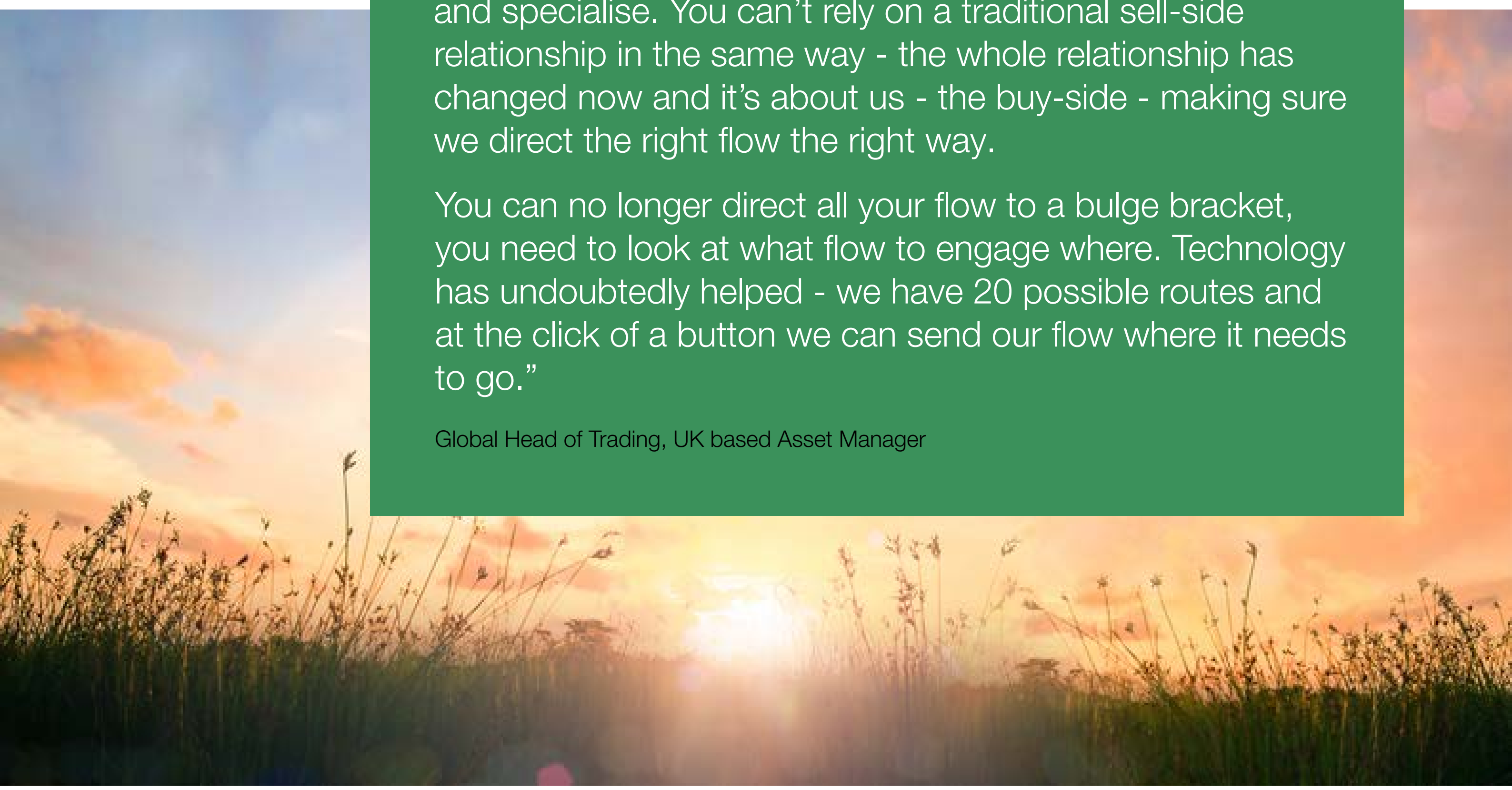
Keeping Markets Moving

At the height of the Covid crisis in March 2020, the extent to which capital markets needed to function away from the confines of traditional finance hubs with physical trading floors accelerated the move to automation (see Exhibit 1). In the initial days of the pandemic, the focus was on maintaining access to the markets and certainty of execution, but as market conditions normalised and volatility reduced, a broader discussion emerged with regard to individual firms' experience of trading during the pandemic and who their future trading partners should be.

For **91%** of respondents, the electronification of equity markets since the implementation of MiFID II in 2018 has delivered a more robust market infrastructure, enabling a high level of self-sufficiency for the buy side compared to the financial crisis of 2008. At that time, buy-side firms were heavily dependent on traditional providers of risk capital.

In 2019-2020 the buy side benefitted from greater use of electronic trading and algorithms with access to more diverse venues. This provided them with the ability to access the liquidity they needed to trade even when the provision of traditional risk capital dried up (see Exhibit 2). Buy-side firms with high levels of automated equity trading could continue to trade almost as usual. Trading strategies were reprogrammed at a flick of a switch to access liquidity that had relocated to lit venues.

March 2020 recorded the highest trading volume since the introduction of MiFID II with an average trading volume of **€81.9bn**[1]. As volatility and volumes declined, trading strategies were adapted again to be more passive. Irrespective of market volumes or volatility, technology ensured continued access to markets by providing not only the means to trade but also accurate information where best to trade.



"What Covid highlighted is the need to look at our flow and specialise. You can't rely on a traditional sell-side relationship in the same way - the whole relationship has changed now and it's about us - the buy-side - making sure we direct the right flow the right way.

You can no longer direct all your flow to a bulge bracket, you need to look at what flow to engage where. Technology has undoubtedly helped - we have 20 possible routes and at the click of a button we can send our flow where it needs to go."

Global Head of Trading, UK based Asset Manager

[1] Qualifying use of data sourced

Keeping Markets Moving

"MiFID II opened up a world of venues and a world of liquidity to us. The difference with 2008 was that historically we were very dependent on high touch."

Head of Trading, EU based Asset Manager

"In 2008 you were relying on bank balance sheet, the very thing that was under pressure. Now there are other liquidity providers in the market using ETFs to offer another way to derisk any exposure so there are more tools at our disposal meaning liquidity is better now than it was then."

Head of Trading, EU based Asset Manager

Exhibits 1 and 2

How did the pandemic affect how you source liquidity? How does this compare with your experience of the Global Financial Crisis of 2008?

Source: Redlap Consulting

Fixed Income Challenges

In contrast, the limited electronification of bond markets created additional execution challenges at the height of the pandemic because institutional traders were all trading the same way. Although the central banks eventually intervened to provide the injection of liquidity that the bond markets needed to continue operating, the buy side's heavy reliance on sell-side balance sheets exposed the still prevalent risk of executing order flow in the bond markets.

While larger fixed income buy-side firms were able to lean on strong high-touch relationships, some mid and smaller managers found themselves cut off from their ability to execute as sell-side firms prioritised their balance sheets. Those relying on automated trading models saw some sell-side firms switching off autoquotes. The opacity in understanding the location of any available liquidity compounded the liquidity drought. As a result, certain buy-side firms found themselves temporarily unable to trade with theirestablished counterparts and rapidly needed to start engaging with alternative providers. In the past, retaining access to primary issuances was an incentive to stay with traditional providers of liquidity; but when some sell-side firms stepped away in the initial stages of the pandemic, buy-side firms had no alternative but to gravitate towards electronic liquidity providers.

The respondents who experienced these liquidity challenges at the height of the crisis are using the stability of current markets to reassess their future access to liquidity. Buy-side firms face internal challenges such as trading staff shortages as they re-organize their dealing desks in a post-Covid world, as well as external challenges as lower yields are resulting in a lack of appetite on the sell-side for taking on risk trades. . All of which is leading to a fundamental rethink about liquidity on two fronts: firstly, what liquidity is available, where it resides, and how to engage with it; and secondly, its sourcing and formation, such as increased automated quoting, portfolio trading flows or even new opportunities in asset correlation.

"The challenges are much more noticeable in Fixed Income where you can see the brokers who had been balance sheet intensive and no longer want to be, but with our execution technology we have access to multiple brokers and we can choose where we want to go."

Head of Trading, EU based Asset Manager

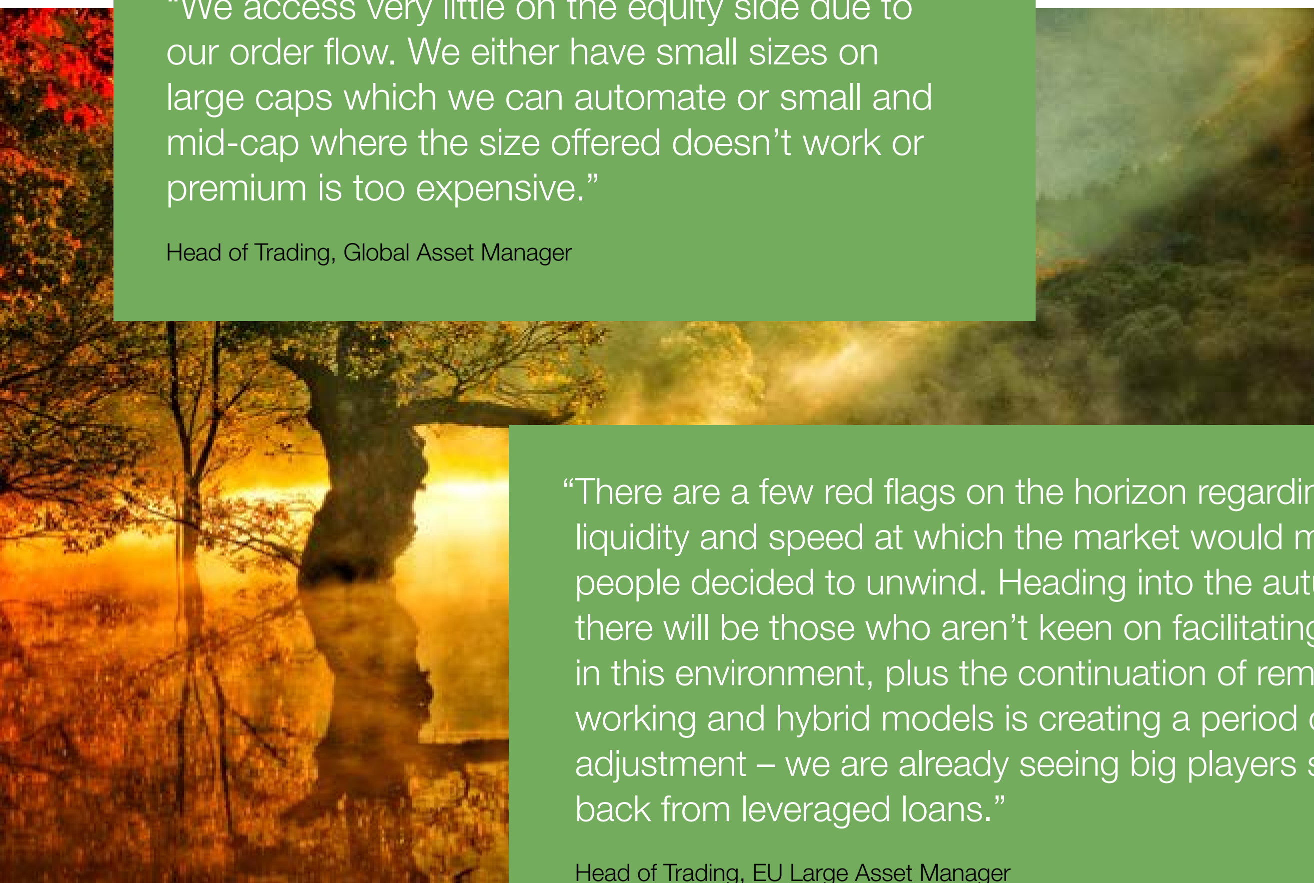
"After the forced concentration of flow at the beginning with high touch counterparties, we are now in a phase of trying to find new ways of working, new players who can provide us with liquidity in other ways and who are better positioned than some historical counterparties."

Head of Trading, EU based Asset Manager

Re-thinking Relationships

While valuable core relationships become tighter at the height of the pandemic for 47% of respondents, 53% noted that they are actively seeking alternative counterparties to guarantee future access to liquidity regardless of trading conditions (see Exhibit 3). These future partnerships will likely be based on technology rather than balance sheets, because only a quarter of respondents now consider themselves to be active users of traditional risk capital (see Exhibit 4). 63% of respondents either do not use risk capital or their usage remains dependent on the type of order flow or asset class they trade. The separation of the provision of execution and research under MiFID II has meant that portfolio managers can now focus purely on the research in isolation, while the same time heads of trading have been more empowered to make execution decisions independent from the soft inducements of yesteryear, resulting in a decline in consumption of consume risk capital in its traditional form.

This move away from trading using traditional risk capital is possible for liquid equity instruments due to the homogeneity of equity instruments which results in deep natural liquidity pools and facilitates a competitive market structure. Firstly, there is a single line of stock issued whereas corporates may have multiple issuances in fixed income which can trade very infrequently, requiring alternative means of transferring liquidity. Secondly, the commission rates of equity trading are nearing zero. Therefore, the appetite to pay up for risk to trade in large size is low if there are alternative means to source liquidity to execute orders, for example via a block crossing network. For fixed income trading, which is far less homogenous and less automated, traditional access to risk remains critical. It just depends on whether access is still available. Most respondents acknowledged that after a year marked by strong episodes of volatility, they cannot afford to miss out on any future liquidity opportunities and need to investigate alternative providers of liquidity and the manner in which they can engage.



"We access very little on the equity side due to our order flow. We either have small sizes on large caps which we can automate or small and mid-cap where the size offered doesn't work or premium is too expensive."

Head of Trading, Global Asset Manager

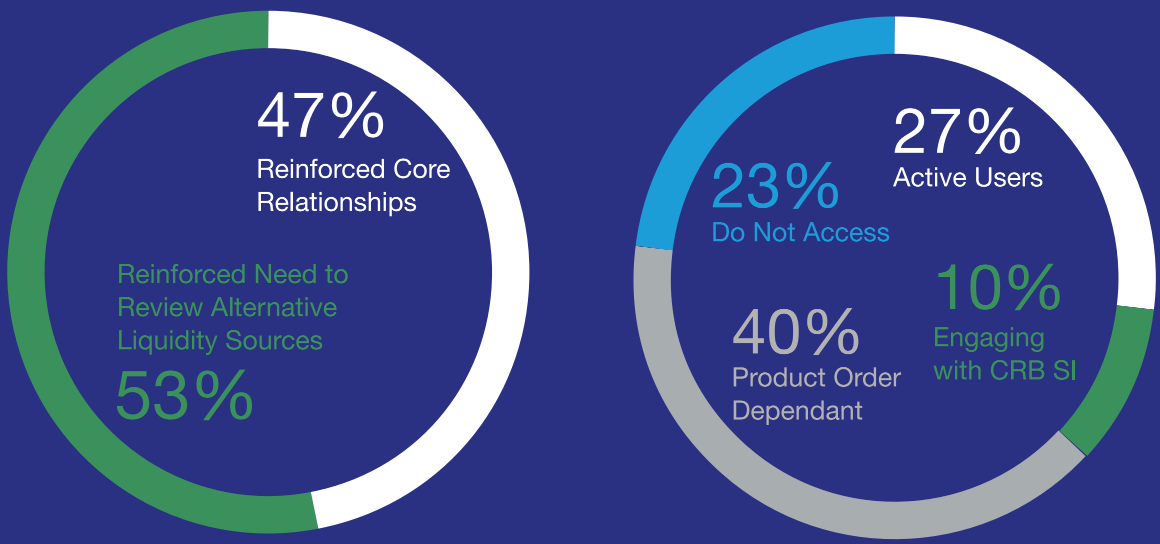
"There are a few red flags on the horizon regarding liquidity and speed at which the market would move if people decided to unwind. Heading into the autumn there will be those who aren't keen on facilitating risk in this environment, plus the continuation of remote working and hybrid models is creating a period of adjustment – we are already seeing big players step back from leveraged loans."

Head of Trading, EU Large Asset Manager

Re-thinking Relationships

Exhibits 3 and 4

How did the pandemic impact who you engaged with to source liquidity?
Under which scenarios are you still able to get access to traditional risk capital?



Source: Redlap Consulting

"For the larger tickets you absolutely still need the bulge to see the axes in Fixed Income, but ELPs have been a growing counterparty of ours for a number of years now. In the equity space, we still rely heavily on specialist brokers due to our small/mid cap focus - its about finding the right panel of liquidity providers for the type of flow you have to trade.

Head of Trading, Mid-sized UK Asset Manager

"Trading at a third of the volume was seen as fairly passive. Now anything greater than 5% is seen as aggressive and likely to have an impact. Intraday liquidity is so constrained that we have to smooth the order over weeks rather than days. We may theoretically be back to pre-pandemic levels, but the construct of liquidity is different."

Head of Trading, Global Asset Manager

New Trading Partnerships

Greater buy-side independence brings greater responsibility. Recent analysis by the independent data analytics provider Big XYT[2] highlighted the significant differences between equity trading venues with the rise in rapid automated trading; 25% of turnover now occurs within 500 microseconds of a prior order book event. Unsurprisingly, for buy trades the most frequent prior event was a lowering of the offer price (and the opposite for a sell trade), representing an opportunity for price improvement. Smaller execution sizes, however, require a change in trading strategy.

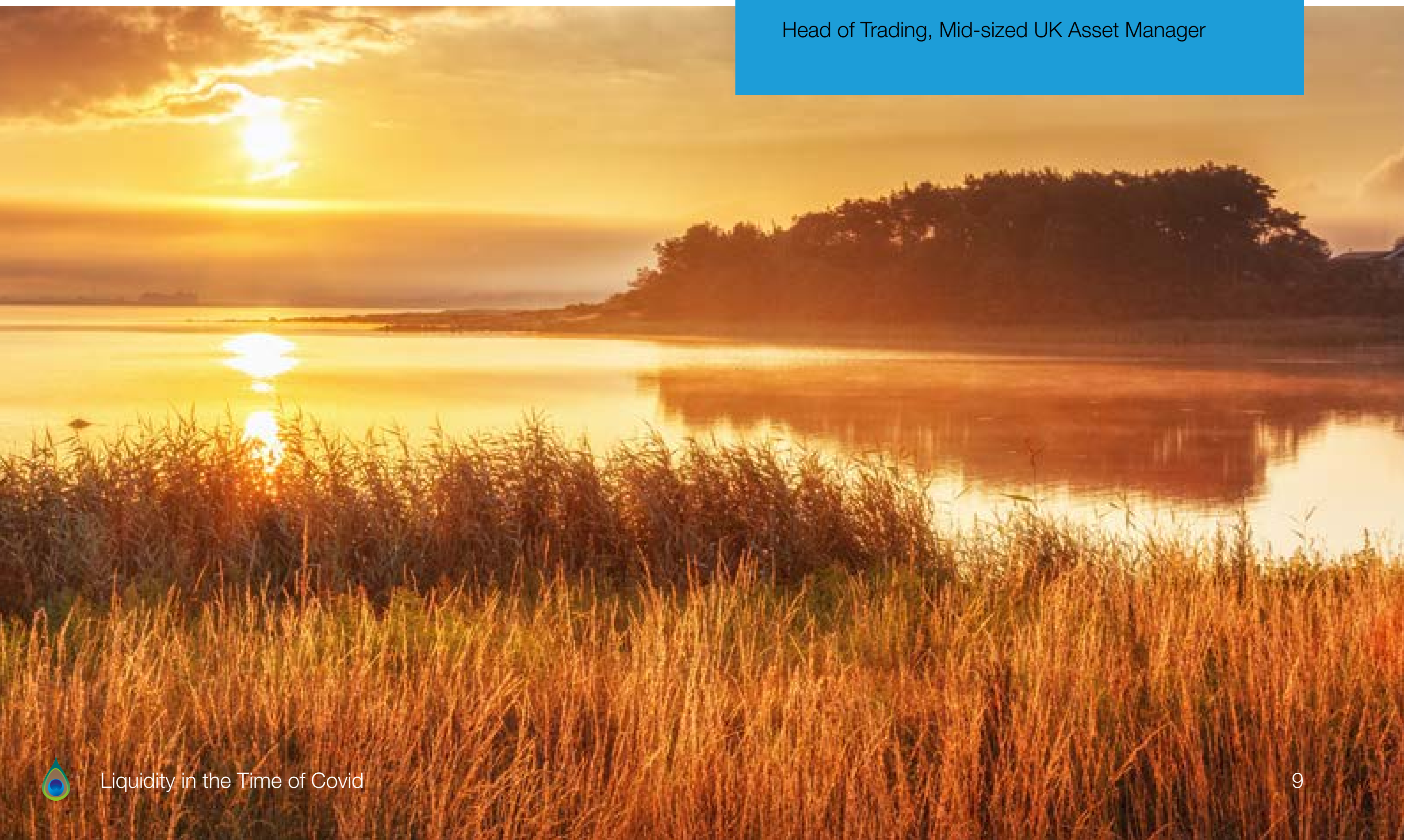
Historically, trading a single stock order at a third of market activity (volume) was deemed sufficiently passive to avoid signalling one's trading intentions. The decline in overall intraday liquidity together with a larger share of automated trading exposes trading intentions far sooner, requiring different ways to protect unexecuted order flow and engage with the market. With tighter spreads returning, every incremental difference matters to the overall execution performance, driving buy-side trading desks to continuously analyse their flow, review and re-assess trading strategies to protect alpha but maximise opportunities to add value to the investment process.

[2] https://big-xyt.com/how-fast-is-the-market/

Although 49% of respondents noted that spreads have normalised after widening considerably at the beginning of the pandemic (see Exhibit 5), the rise of passive asset management over the past years has led to more volume being done at the close. It is quickly becoming a self-fulfilling prophecy as volume attracts more volume, which means that as intra-day liquidity dries up, buy-side traders are more active around three main liquidity events - the EU open, the US open and the EU close. This concentration of activity accentuates the ongoing challenges of trading with a lack of continuous liquidity (see Exhibit 6).

"Our costs of trading are broadly the same at a high level but under the surface, a tremendous amount is changing. The average exchange fill has dropped from $6,000-$7,000 to $4,000, so you've got to change how you access that flow."

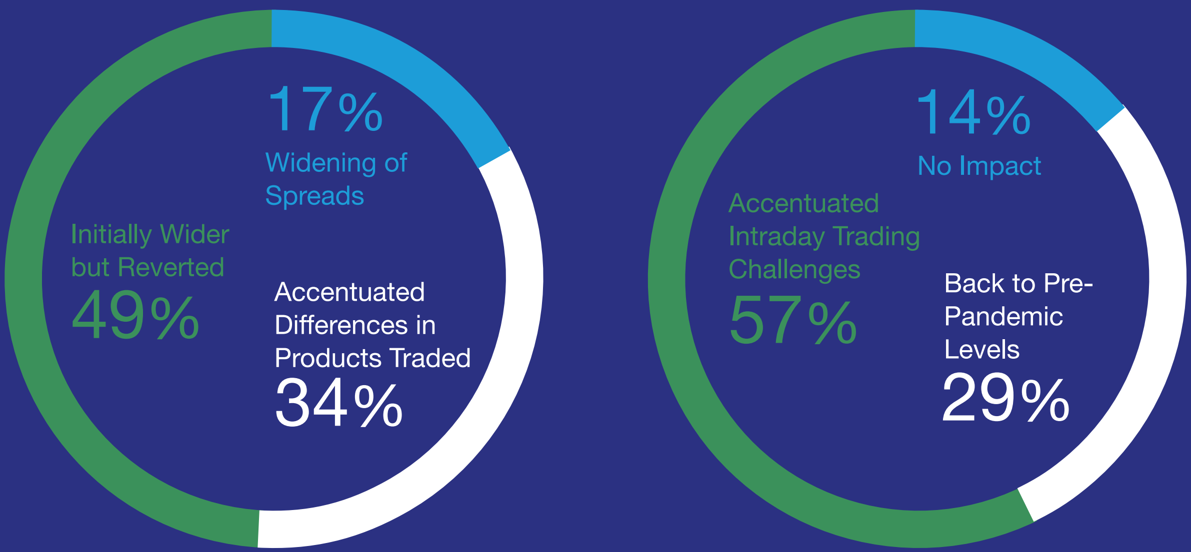
Head of Trading, Mid-sized UK Asset Manager



New Trading Partnerships

Exhibits 5 and 6

What impact have you seen on spreads?
What impact have you seen on liquidity?



Source: Redlap Consulting

"Some ELPs are significant and it's very hard to ignore somebody who has that large a market share. When we ran the data we found that the average fill size is more than double than on the exchange. We're getting fills of 8000, double an exchange fill so that is a useful execution option for us."

Head of Trading, Mid-sized UK Asset Manager

"Trading at a third of the volume was seen as fairly passive. Now anything greater than 5% is seen as aggressive and likely to have an impact. Intraday liquidity is so constrained that we have to smooth the order over weeks rather than days. We may theoretically be back to pre-pandemic levels, but the construct of liquidity is different."

Head of Trading, Global Asset Manager

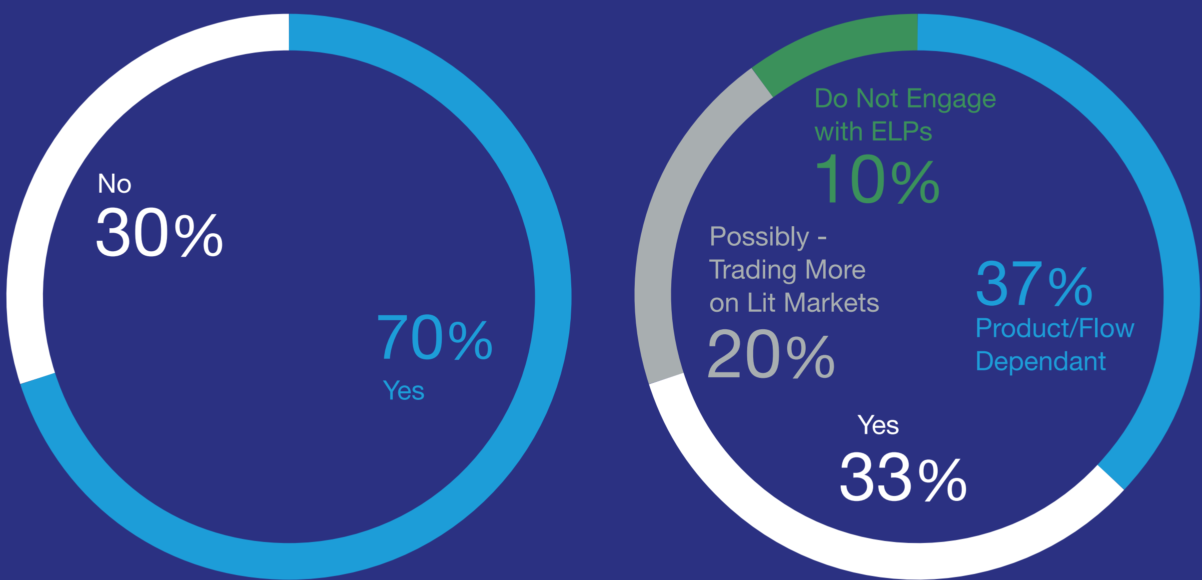
Creating Optionality

The buy side must maintain strong relationships with bulge bracket banks for access to a broad range of services including primary allocation. However, in an environment of chronically constrained liquidity, maintaining greater optionality over how to access liquidity became essential. The pandemic lifted the veil on the role ELPs can play in liquidity formation, with 70% of participants acknowledging they engaged more with non-bank market makers during the volatility (see Exhibit 7), with some emphasising the ELP model as a particularly good match for specific products or fill requirements (see Exhibit 8).

> "We definitely engaged more with ELPs; as bulges stepped back, they stepped up. Agency brokers educated us on how we could engage better with ELPs. Market conditions and our style of flow suited what the ELPs could offer in terms of hedging - we are filled at arrival or better so it worked for everyone. It's all about understanding the ELP's model and figuring out how to engage with it."
>
> Head of Trading, Large Global Asset Manager

Exhibits 7 and 8

Did you engage more with ELPs during the volatility?

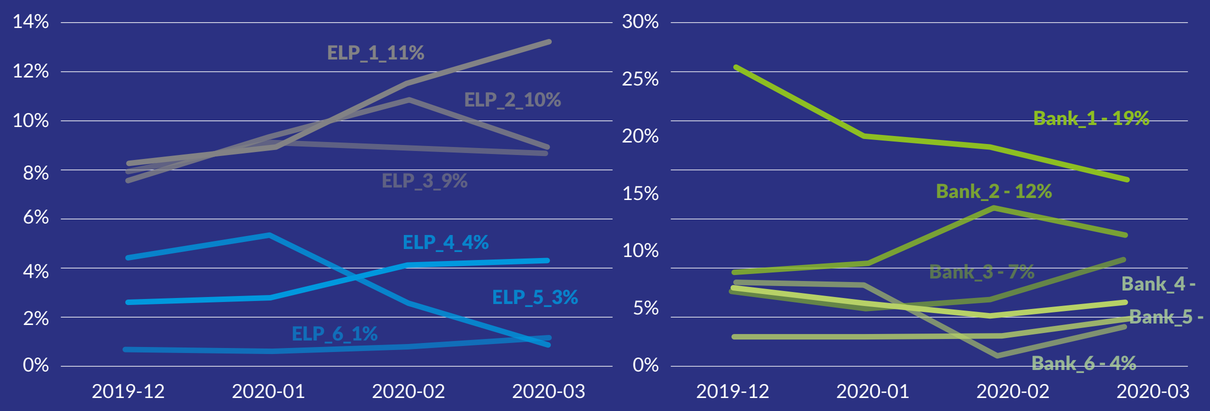


Source: Redlap Consulting

Creating Optionality

Exhibits 9 and 10

SI market share trend during the continuous trading phase,
ELP SI (left) vs Bank SI (right)



Source: RDT-TREM, AMF – for Q1 2020

The ability for ELPs to step up at a time of market volatility and provide liquidity has not gone unnoticed by regulators. The Autorité des marchés financiers (AMF) reported last year on the changing dynamics in March 2020 at the peak of the pandemic[3]; for the French stock market, in terms of volumes traded, activity from the leading ELP systematic internalisers (SI) increased from 8% to 13%, whereas the market share of a leading bank SI was reduced from 26% in December 2019 to 16% in the same period (see Exhibits 9 and 10).

[3] https://www.amf-france.org/sites/default/files/2020-06/202005_etude_internalisateurs_integrale_va.pdf

"Our engagement wasn't meaningful initially, but we discovered that it was the way that the banks were interacting with the ELPs that was the issue. We have now changed the routing logic and we saw an uptick, they were definitely there and the quality of interaction dramatically improved."

Head of Trading, Mid-sized UK Asset Manager

An Unmistakable Trend

In fixed income, some sell-side firms opted to withdraw from trading in certain segments, creating a vacuum which ELPs stepped in to fill. Similarly, ELPs have become very competitive in portfolio trading; their technology expertise and ability to manage short-term risk enable them to provide valuable alternative flow alongside traditional sell-side counterparts.

In ETFs, providers of single instrument liquidity are no longer the default trading desks to go to for portfolio trades now that liquidity is bifurcating between different pools of liquidity. Instead, buy-side traders are opting to tap into ELPs' ETF flows within the equity and fixed income spaces, mixing buying and selling interests, and further broadening their liquidity options.

The buy side is clearly willing to be more creative about access to liquidity as well as how to remunerate counterparties. Some buy-side traders may still be reluctant to engage directly with electronic market makers given the complexity of changing SOR logic or operational issues such as counterparty arrangements, but they also recognise the value of engaging with a broader range of liquidity providers for at least some of their flow.

The recent unprecedented situation and challenges in accessing liquidity has led many buy-side firms to re-think their provider lists. Key criteria include which firms stood firm for them at the peak of the pandemic, the type of order flow they have to trade and how they want to access liquidity in the future. The pandemic is already leading to greater innovation in how to improve access to liquidity, not only in equities and fixed income but also in new asset class such as cryptocurrencies. With more open discussions taking place between the buy and sell-side, and greater transparency and confidence over new operating models, a willingness to build partnerships among a more diverse group of market participants is emerging.

The more that electronic liquidity providers are willing to engage and provide transparency to explain how their models work, their routing logic and how they unwind risk, the more they will gain the buy-side's trust as reliable execution partners. The role of technology will continue to expand to become the core structure of capital markets. The sell side's ability to propose innovative technology solutions to the buy side will continue to transform the execution landscape, particularly in asset classes such as fixed income where the adoption of automated trading has been slower. Providers whose business model revolves around technology integration will have a clear advantage over those whose legacy issues slow down their ability to adapt.

The trend seems unmistakable; the rise of new providers could change the future provision of liquidity, in particular post Brexit. However, the future for liquidity formation in Europe is still uncertain: Will bulge bracket banks and their ability to service clients in multiple areas represent a glass ceiling for ELPs and their growth? With on-exchange intraday liquidity evaporating, what will the future of trading look like? We will look to answer these questions in the second paper in this series.

About Redlap Consulting

Redlap consists of a group of experienced industry professionals who have a deep knowledge of Capital Markets. Using this as the basis of research this enables us to provide detailed and thought-provoking research on the impact of evolving market structure globally.

About the Authors

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Rebecca is a leading industry voice on market structure, regulatory reform, and financial services technology. Writing research since 2011, rebecca has authored a plethora of qualitative reports and commentaries covering the impact of market regulation on all asset classes, the impact of the rise of fintech in capital markets, as well as the impact of the move to esg and sustainability in asset management; focusing on how technology can help address current challenges, improving capital markets both for participants and investors.

Rebecca is the co-chair for FIX EMEA and a member of ESMA's Secondary Markets Standing Committee. In relation to ESG, Rebecca is Co-Chair of the FIX Working Group on ESG; Convenor for the ISO/TC 68 Sustainable Finance Advisory Group; a member of ISO TC 68 Strategic Leadership Group and serves on the ISO Technical Management Board committees of Climate Change Coordination Committee (CCCC) and ISO Positioning and Consultation Responses (CCCC-TG 4).

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About the report

This study has been produced by independent financial services research group Redlap Consulting. It was commissioned by the FIA European Principal Traders Association (FIA EPTA), which represents Europe's leading Principal Trading Firms. Its 30 members are independent market makers and providers of liquidity and risk transfer for end-investors across Europe. It works constructively with policymakers, regulators and other market stakeholders to ensure efficient, resilient, high-quality financial markets. To find out more visit www.fia.org/epta

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