

In Times Like These...

VOLATILITY HAS HAMMERED HEDGE FUNDS AND COUNTERPARTIES ALIKE. IN ALPHA'S RANKING OF THE TOP EQUITY TRADING FIRMS, FRIENDS MATTER MORE THAN EVER. By Imogen Rose-Smith

Any doubt that the markets are deeply troubled — and that Wall Street is worried — was swept aside on September 14, when 158-year-old Lehman Brothers Holdings went into a bankruptcy dive and 94-year-old Merrill Lynch & Co. abruptly agreed to be bought by white knight Bank of America Corp.

To say that investment banks are hobbled with balance-sheet problems and are cutting their capital commitments and equity-trading personnel is to understate the magnitude of what is taking place, foreshadowed in none-too-subtle fashion this spring when Bear Stearns Cos. was swallowed by a rival. The government offered little comfort this month as it directed Wall Street bankers, essentially, to work it out among themselves, because federal support of the kind that pushed New York-based Bear Stearns into the arms of JPMorgan Chase & Co. and shored up mortgage giants Fannie Mae and Freddie Mac was unlikely to be offered again.

Clearly, relationships matter more than ever, for Wall Street and for the hedge fund managers who depend on its services. That is borne out by the results of *Alpha's* second annual ranking of the Top Equity Trading Firms, as judged by the hedge funds that use them.

"Funds have become very focused on how they are executing their trades, who they are executing with and what they are getting in return," says Roy Martins, London-based head of international prime services for Credit Suisse, the Swiss banking giant that tops the ranking this

year, moving up one place to dethrone last year's top trading firm, Goldman, Sachs & Co., which falls to No. 5.

No. 2 JPMorgan, which didn't even receive enough votes a year ago to be ranked, benefits from its May acquisition of Bear Stearns, including its well-regarded prime brokerage and hedge fund equity trading franchises. Rounding out the top five are third-ranked Morgan Stanley, up one notch from 2007, and Lehman Brothers, which, despite the problems in its mortgage and real estate businesses that landed the firm in bankruptcy court, jumps three places, to No. 4.

Traders from more than 300 hedge funds voted in this year's survey, which was administered in the spring and early summer (well before the most recent plot twists for Lehman and Merrill). Respondents included representatives from more than one third of the *Alpha* Hedge Fund 100, our ranking of the world's biggest single-manager hedge fund firms. Managers were asked to rate equity-trading partners and to say which of the services these firms provided was most important to them.

The past year has been tough on the industry. Equity hedge funds have struggled, and more than a few have lost money. The equity hedge (total) index, compiled by Chicago-based data provider Hedge Fund Research, lost 6.29 percent in the first half of the year (the Standard & Poor's 500 index was down 12.65 percent). More and more hedge fund investors have begun to ask for their money back. Hard-hit players include East Setauket,

TOP EQUITY TRADING FIRMS

Here are the brokerage firms that hedge funds say provide the best overall trading service, based on their expertise and market knowledge, traditional execution, algorithmic trading and electronic trading services.

RANK		FIRM
2008	2007	
1	2	Credit Suisse
2	5*	JPMorgan Chase & Co.
3	4	Morgan Stanley
4	7	Lehman Brothers
5	1	Goldman, Sachs & Co.
6	6	UBS
7	8	Citi
8	3	Banc of America Securities
9	10	Merrill Lynch
10	9	Deutsche Bank

*Rank in 2007 was for Bear, Stearns & Co., which JPMorgan Chase & Co. acquired in May; JPMorgan did not rank last year.

On the Web Please visit our Web site, www.alphamagazine.com, to find the Top Equity Trading Firms rankings, as well as more features, including the 2008 Hedge Fund 100, *Alpha's* annual list of the biggest single-manager hedge fund firms in the world.

New York-based Renaissance Technologies Corp., whose Renaissance Institutional Equities Fund has seen assets drop from \$22 billion to approximately \$19 billion this year, and two Manhattan-based firms, \$15.3 billion Atticus Capital and \$9 billion Ospraie Management. In this dark climate managers want to know more than ever who their real friends are.

“I have never seen so many people so confused” by the equity markets, says Barry Savitz, co-founder of Stamford, Connecticut-based Greenwich Prime Trading Group, which handles outsourced trading for about 40 hedge funds. Facing enormous pressure to perform — in many cases to find a way to reverse losses — fund managers are increasingly worried about the security of their order flow.

“With hedge funds, anonymity is always important, but that concern has seriously escalated,” says Andrew Silverman, Morgan Stanley’s head of electronic trading distribution in New York.

To claim first place this year, Credit Suisse does well in all four areas of the survey. The Zurich-based bank

is No. 2 in Trading Expertise & Market Knowledge, which hedge fund managers say they value more than anything. It also ranks second in Algorithmic Trading, third in Traditional Execution and fourth in Electronic Trading/Direct Market Access.

New York-based Banc of America Securities, No. 8 overall, quietly scores a coup by finishing first in Algorithmic Trading, improving on its fourth-place finish of one year ago. Its acquisition of Merrill Lynch can only help. Although New York investment bank Jefferies & Co. fails to make the top ten overall because it drew insufficient accolades for Electronic Trading/DMA or Algorithmic Trading, it ranks No. 1 in Traditional Execution and in Trading Expertise & Market Knowledge.

The amount of money to be made from hedge fund-based equity trading is huge. According to a July 2008 report by Greenwich Associates, a Stamford, Connecticut-based research firm, hedge funds were responsible for about 30 percent of the \$26 billion in equity-trading commissions generated by institutional investors in the U.S. during the 12 months ended in

TOP EQUITY TRADING FIRMS BY CATEGORY

The following tables show how the top brokerage firms fare in each of the four major areas of equity trading, based on voting from more than 300 hedge fund firms that use their services.

TRADITIONAL EXECUTION

RANK		FIRM
2008	2007	
1	10	Jefferies & Co.
2	4*	JPMorgan Chase & Co.
3	5	Credit Suisse
4	8	UBS
5	6	Morgan Stanley
6	1	Goldman, Sachs & Co.
7	7	Lehman Brothers
8	2	Citi
9	9	Deutsche Bank
10	—	Merrill Lynch

ALGORITHMIC TRADING

RANK		FIRM
2008	2007	
1	4	Banc of America Securities
2	1	Credit Suisse
3	3	Lehman Brothers
4	5	Morgan Stanley
5	9	UBS
6	2	Goldman, Sachs & Co.
7	6*	JPMorgan Chase & Co.
8	10	Merrill Lynch
9	8	Citi
10	7	Deutsche Bank

ELECTRONIC TRADING/DIRECT MARKET ACCESS

RANK		FIRM
2008	2007	
1	4	Morgan Stanley
2	7	Lehman Brothers
3	1	Goldman, Sachs & Co.
4	3	Credit Suisse
5	6*	JPMorgan Chase & Co.
6	5	UBS
7	9	Citi
8	2	Banc of America Securities
9	10	Merrill Lynch
10	8	Deutsche Bank

TRADING EXPERTISE & MARKET KNOWLEDGE

RANK		FIRM
2008	2007	
1	7	Jefferies & Co.
2	5	Credit Suisse
3	3	Morgan Stanley
4	2**	JPMorgan Chase & Co.
5	9	Lehman Brothers
6	1	Goldman, Sachs & Co.
7	8	Citi
8	4	UBS
9	6	Banc of America Securities
10	—	Deutsche Bank

*Rank in 2007 was for Bear, Stearns & Co., which JPMorgan Chase & Co. acquired in May; JPMorgan did not rank last year.

**Rank in 2007 was for Bear, Stearns & Co.; JPMorgan Chase & Co. was No. 10 last year.

February. Stamford-based SAC Capital Advisors alone spends as much as \$400 million a year on equity-trading commissions (SAC has \$16 billion in assets under management). To cash-strapped banks hurt by the credit crunch, such potential profits are obviously attractive.

“The Street is anxious to get that business,” says Barry Colvin, vice chairman of Balyasny Asset Management, a \$2.5 billion Chicago-based multistrategy hedge fund firm that specializes in high-volume equity trades.

Big funds are increasingly picky about who they do business with, however. “Every hedge fund wants lower commission costs and lower financing,” Colvin says. “But more and more you need people. Hedge funds need a fuller relationship.”

Counterparties are also more selective than they used to be. “The banks are becoming much more focused on which clients they want to deliver their resources to,” says Credit Suisse’s Martins.

Rather than accepting any client who walks through the door, banks are increasingly keen to work only with funds that provide lots of revenue. They do so at the expense of the smaller end of the hedge fund market.

Not surprisingly, funds of all sizes are paying more attention to relationship-building. A report published in May by Westborough, Massachusetts, research and consulting firm Tabb Group found hedge funds becoming increasingly choosy in how they allocate commissions. In a sign of how seriously big firms are taking such relationships, D.E. Shaw & Co., a \$39 billion New York-based hedge fund firm, in July hired Thomas Levy, who previously worked in Morgan Stanley’s prime brokerage unit, to oversee its counterparty relationships. In January, Renaissance hired James Rowen, SAC’s former CFO, who was previously head of Deutsche Bank’s prime brokerage business, to play a similar role as chief operating officer.

Technology remains a huge factor in hedge funds’ judgment of the best equity-trading firms. Electronic connectivity, direct market access and algorithmic trading all continue to play important roles in shaping the competitive landscape. Goldman Sachs, No. 3 in Electronic Trading/DMA, has leveraged its RediPlus technology platform to maintain its strong market position in equity trading among hedge funds. RediPlus, which Goldman acquired through its 2000 purchase of market-making firm Spear, Leeds & Kellogg, is used by about half the traders on Wall Street.

Credit Suisse’s ascent to the top of this year’s survey is fueled by its algorithmic trading. The Swiss bank was early to develop a robust electronic trading platform and has been especially effective at building algorithms that are efficient at finding liquidity in dark pools. Still, Credit Suisse finishes second to Banc of America in Algorithmic Trading.

Unlike the first generation of execution algorithms, which were typically unable to cope with volatility, BofA’s current offerings have performed well in the

Compiling the Ranking

Alpha compiled its second annual ranking of the Top Equity Trading Firms based on voting in the spring and early summer by more than 300 hedge fund firms. Brokerage quality was broken down into four broad functional areas — Algorithmic Trading, Electronic Trading/Direct Market Access, Traditional Execution and Trading Expertise & Market Knowledge — each of which included a series of specific points of service on which hedge fund managers evaluated their brokerages. Respondents also rated the importance of each broad functional category, the result of which was then used to calculate the overall winner, rewarding firms that do well in the tasks hedge funds prize most. In the accompanying tables we rank only those firms for which we received a minimum number of responses.

Alpha’s 2008 Top Equity Trading Firms survey was conducted by Research Specialist Timothy Roberts with Associate Editor Julia Leikin, under the guidance of Assistant Managing Editor Sathya Rajavelu and Senior Editor Jane B. Kenney.

choppy markets. “Algorithms have worked, and they are on the rise,” says New York-based Ciaran O’Kelly, head of global equities at BofA.

But even in the realm of electronic trading, people are playing a bigger role. “There is a lot more dialogue and a lot more partnership between asset managers and sell-side traders, particularly on the larger portfolios,” O’Kelly says. “The role of the trader is more consultative now than it ever has been — there is an intersection of the traditional trading desks and algo trading.”

Though hedge funds remain eager to tap electronic trading to help cut costs, they still need the services that come with a more expensive, high-touch approach. The Tabb report found that although the hedge fund migration toward electronic execution persists, it is “slowing to a crawl.” The report estimates that by 2010 one quarter of all hedge fund deals will still be conducted through traditional trading desks.

Savitz, the Greenwich Prime co-founder, is among those who argue that electronic trading has actually hurt the marketplace. “People are fooling themselves if they think the machines have made trading cheaper,” he says. The market, Savitz insists, is less liquid than ever, and orders are harder to execute. “The system is broken right now,” he says.

The preference among many managers for a hands-on relationship helps explain why Jefferies, which began to develop electronic trading capabilities after most competitors did, makes such a strong showing this year. Traditionally a provider to small and midsize hedge fund firms, Jefferies is going after bigger fish these days. To increase its global reach, the firm this month hired 25 former Bear Stearns equity professionals for its London office.

“Customers are looking for idea flow,” says Jason Griffith, head of global equities at New York-based Jefferies. “They’re looking for people they can trust with large orders.”