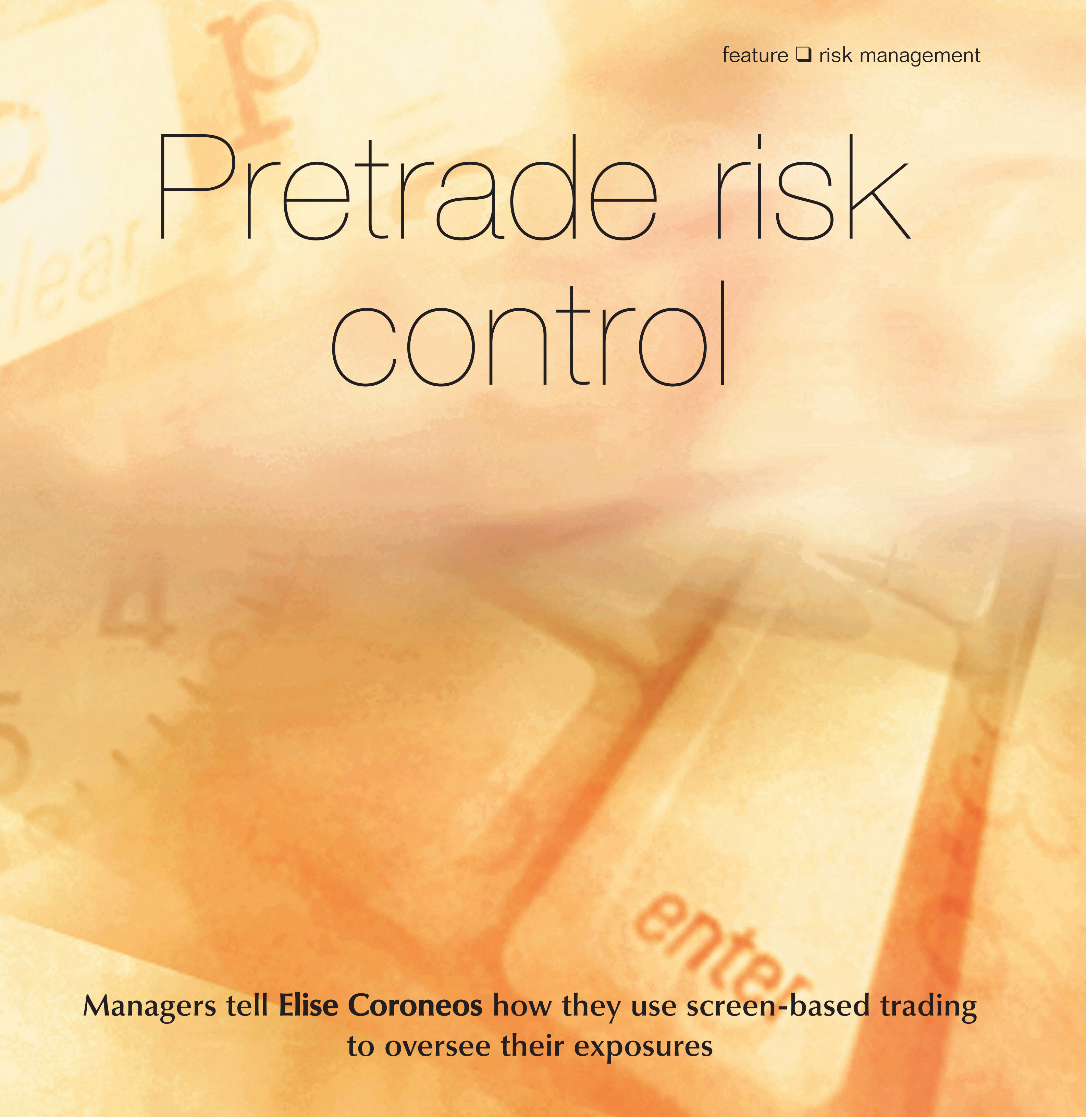

Pretrade risk control

Managers tell Elise Coroneos how they use screen-based trading to oversee their exposures

High volume traders have known for some time that they can save a lot of time and money by using screen-based trading. Many of their lower volume counterparts in the alternative investment space, for whom such savings are less crucial, still call a broker to order a trade. But these fogies, too, may soon disconnect the phone and boot up the computer when they begin to understand the benefits of screen-based trading for risk management. Certainly this is the expectation of some technology developers.

Consider City Fund Management's experience. A prominent managed futures operation in London, CFM has adopted screen-based trading to execute its trades in short sterling and bond options as well as DAX, FTSE and EuroSTOXX futures.

CFM's trading platform features applications that have generally been ignored by alternative asset managers–until now. It allows traders to see markets on a screen and, more important, scan for risk prior to a trade's taking place. CFM uses GNI Touch, a trading system supplied by GNI, which itself was acquired by CFM's clearer, Man Financial, in November last year.

"As far as we understand, we are one of the few alternative managers that use screen-based trading platforms for direct access to particular futures markets," says

CFM's founder John Jackson. "It is very efficient, and from our point of view, the risk control it gives us is phenomenal."

Singling out risk

CFM has harnessed greater control of its day-to-day risk exposure across the board. Just as Man Financial puts a limit on CFM's level of exposure, CFM in turn uses the platform to manage the exposures of its individual in-house traders.

As an active day trader, CFM trades hundreds of times a day, and anything up to 300,000 lots in various markets a month. "We can refine the process of managing exposures, which means we can effectively drill down on a macro risk limit and allocate individual limits which are different depending on the trader, the market and the contract," says Jackson.

The open position limit of an individual trader in a particular market can be changed on a real-time basis according to moves in the P&L statements made known to the marketplace, which are also real time. Furthermore, the presence of this in-house technology allows CFM's management not only to oversee the activity of its traders and manipulate their exposure limits, but also to stop a trade going through the system with just the press of a button.

This much higher level of control is a unique advantage over existing middle-office technology or the broker/dealer network. As such, Jackson believes that in the future, risk management will be more aptly titled "risk control."

Proactive risk control

Risk management systems for hedge funds and managed futures programs are generally reactive, says Bob McGregor, the chief technology officer at CFM. "Most risk management systems that are nonelectronic will pick up the position and run various risk analyses maybe a half hour after the trade has worked its way through the system," says McGregor. "That is a reactive process."

"The difference is that we can see what working orders our people have in the marketplace and manage their associated risk. For the others, when a trade is done, it already has risk attached to it that they may not be totally aware of," says McGregor.

So far, CFM management has never completely stopped a trade from being

executed; however, it could use this function in situations characterized by fast markets or when positions go radically offside. "When you are doing several hundred trades a day," says Jackson, "one of the factors in keeping your arms around the business is to have risk controls around the traders and their risk positions. Electronic trading gives you the mechanism to do that, which is a great comfort to us as risk managers and to our clients."

Ron Carmichael, director of Arcturus, a London-based hedge fund consulting firm, predicts that hedge funds will be among the next users of technology capable of generating pretrade risk analysis. Arcturus is currently working with AKJ in Norway to create an electronic trading platform that provides direct access to equity markets, with its prime target user being hedge funds.

At present, the technology is being soft-tested with an as-yet-unnamed large global hedge fund firm that trades at a moderate to high level of frequency. It is anticipated that the ASP modeled trading system will aggregate order flow and facilitate the use of multiple prime brokers.

"As hedge funds look to gain ground in the institutional marketplace, this technology will be one of the ways they can make institutions more comfortable," says Carmichael. "It could be viewed as one way hedge funds can show investors they are serious about controlling the level of risk in their portfolios."

Behind the eight ball?

The concept of pretrade risk control is somewhat uncharted territory in the hedge fund universe, according to Louise Yarnold of Man Financial, which provides CFM with its electronic trading system. "Right now, a surprisingly small number of hedge funds actually trade themselves electronically, a lot of them still prefer to use phone brokers," she says.

Hedge funds that do use electronic trading tend to use black box technology, whereby they program the front-end of their trading system to order a trigger to buy or sell depending on the price in a certain market or contract. "They take emotions out of the equation by having a trading system by which, say, they will always buy bunds when they reach a certain price," says Yarnold.

Such a system, however, does not provide for pretrade risk control or an overview of exposures to certain markets and contracts on an intraday basis. "Once you have electronic trading, the information is there and available on screen, so you may as well use it," says Yarnold, who adds that Man considers hedge funds to be next on the list of those that can benefit from screen-based trading.

On top of the risk control benefits, the influx of electronic access to markets will drive down costs across the industry, ultimately to the benefit of the end user, says Jackson at CFM. "Our clients are getting better returns because of a continuing reduction in costs," he says. "And when you are a high volume trader, clearly modest reductions have quite an effect on your returns." ❑