



Reader ROI

- Spurred by the need for increased automation and organizational efficiency, hedge fund firms are exploring order management systems options. Industry-leading product suppliers are tailoring individualized solutions to satisfy this growing demand.
- Organizational size, investment strategy complexity, security type coverage, derivatives processing, and liquidity needs are key considerations for hedge fund firms looking to implement OMS.
- Hedge fund firms need to understand their own unique trading and processing requirements, and the challenges associated with those requirements, in selecting an OMS vendor and an OMS implementation strategy.
- Hedge funds are driving several key advancements in OMS, including increased security type coverage, more robust currency capabilities, faster trade execution and transparency for liquidity, and improved abilities to process higher trade volumes supporting more complex investment strategies.

Customizing Order Management Systems for Hedge Funds

Execution management systems (EMS) and order management systems (OMS) have historically been competitors on a hedge fund trader's desktop. EMS solutions have focused on accessing brokers' direct market capabilities and algorithms to execute electronic trading strategies, providing multiple trade routing choices through major exchanges, ECN, crossing networks, and other execution options.

OMS solutions initially focused on providing firms with an electronic trading capability, essentially a trade blotter with an FIX engine. Increasingly, OMS has extended both forward into the EMS space for order execution capabilities and interfaces, and backward into the portfolio management space with rebalancing and what-if analysis capabilities. OMS solutions may provide a host of other broad functions including transaction cost analysis, pre- and post-trade compliance, integration of realtime data, interfaces with market analytics, etc.

At the margins, some functionality between these two types of systems will likely converge. Smaller hedge funds may continue to depend on prime broker tools and EMS due to an emphasis on speed of execution and the lack of need for a more extensive OMS product.

Many hedge funds, however, have more complex needs and want to use more proprietary trading strategies; they will begin to move away from prime broker-supported functionality to a more robust OMS offering. These firms will likely employ multiple EMS options for liquidity and other purposes. Implementing an OMS with multiple EMS links and proprietary and non-proprietary trading algorithms introduces additional complexities for configuration, testing, and implementation.

Order management systems benefits

OMS solutions have been deployed widely in traditional institutional investment environments where large volumes of equity and fixed-income trading have driven the need for automation. Over the past few years, increasing numbers of hedge fund firms are taking advantage of the technology. Several business and technology drivers are behind this move to OMS:

- **Efficiency Gains:** An automated order management system shortens trade execution time. This enhances operational efficiency, promotes liquidity, and provides improved transparency for trade execution metrics.
- **Demands from Institutional Investors:** Many institutional investors, seeking to diversify their investment portfolio by investing in hedge fund products, require an OMS because it provides a better audit trail and transparency to the trading process.
- **Direct Access to Electronic Liquidity Sources:** Using electronic trading services enables hedge funds to reduce time to market and manage transaction costs. An OMS usually provides hedge funds with direct access to various electronic liquidity source (electronic brokers) or execution services.
- **Regulatory Compliance Reporting:** An OMS can help hedge funds satisfy regulatory reporting requirements [e.g., order audit trail system (OATS) and order tracking system (OTS)]
- **Linkage with Prime Broker and Outsourced Trading Desks:** OMS provides electronic linkage with prime broker and outsourced trading desks, so start-of-day positions and execution detail can be communicated among multiple parties without manual intervention.
- **Availability of Realtime Market Data and Realtime Gain/Loss Reporting:** The availability of realtime market data and analytics gives the hedge fund manager the ability to see gain/loss on a realtime basis. This is a critical workflow component for hedge fund managers.
- **Central Trade Repository, Risk Management, and Client Reporting:** An OMS can function as a realtime central trade repository and is able to provide periodic risk, transaction, commissions, and gain/loss reporting.

Recognizing the trend, industry-leading order management vendors are extending and tailoring their OMS product offerings to the hedge fund space.

The need for customization

A number of factors make implementation of OMS systems in hedge funds particularly complex. Because these factors vary from firm to firm, standard packages are not likely to meet the need.

Firm Size: Smaller firms often lack the necessary business or technical analyst resources to implement and maintain an OMS. Although hedge funds are looking for an OMS capability beyond their EMS needs, some smaller firms get by with ad-hoc tools provided by their prime broker or EMS provider.

A larger firm, perhaps one that is a subsidiary of a larger bank or investment bank, may have more resources, but still may want to outsource projects which are not directly related to investment strategy. Such a firm may consider an application service provider (ASP) outsourcing model as the best fit with their business model.

Outsourcing technical support or middle/back-office processing complicates the business/data model with which an OMS must integrate. For this and other reasons, some funds will maintain an OMS in-house in order to be able to customize and configure it to their specific needs.

Complexity of Strategies: OMS solutions have been developed with a focus on traditional “buy and hold,” institution-centric functionality. Customizing functions and features to accommodate the typical hedge fund investment strategy can be challenging.

For example, firms that employ straightforward equity only, long/short strategies have different needs than those firms employing fixed-income price arbitrage. More sophisticated analytics are required as well as the need for OMS support for more sophisticated security types.

The OMS may need to support a very broad array of investment types to meet the needs of hedge funds, especially larger hedge funds or those with more unusual strategies. Examples include various types of swaps (e.g., currency, interest rate, credit-default), inflation adjusted bonds, collateralized debt obligations (CDOs), and many other structured products.

Security Type: Most OMS solutions support basic derivatives such as futures and options and some swaps (e.g. interest rate, credit default). The more unusual the derivative or the underlying cash flow or pricing algorithm associated with it, the less likely it will be supported by a traditional OMS vendor. When a hedge fund has a large volume of derivatives activity or a large degree of exposure to more exotic derivative instruments, it may need the trading and accounting capabilities of a derivatives-specific trading and accounting product. Fortunately, a few vendors offer this support.

Integration with Derivatives Applications: Integration with derivatives-specific applications brings a set of complexities to any OMS integration. In general, multiple OMS and/or accounting systems increase complexity in defining business processes, determining data management needs and integration points, defining the audit trail and reporting needs. A major challenge to any firm with significant derivatives volume is how best to automate order management and accounting for derivatives and integrate with the order management and accounting for all non-derivatives assets.

Unconventional Workflows: Unconventional workflows (compared to institutional or mutual funds workflows) present additional challenges. Hedge funds look at positions somewhat differently than institutional investors; there is a greater emphasis on how the position is doing relative to the strategy. Often, positions are held across managers or accounts with very different investment strategies so further customization may be required.

A Culture of Privacy: Hedge funds often are managed by private companies which are uneasy with sharing information. Implementing OMS requires disclosure of information and integration with systems containing intellectual property (e.g. “black box” quant technology). The implementation team must be sensitive to the confidential nature of this proprietary information.

Summary

For hedge funds, as with other segments of financial services firms, there is no “one size fits all” OMS implementation. Each hedge fund must determine its own requirements for an OMS solution as well as its preferences for technical and operations support of OMS.

Larger hedge funds are becoming increasingly similar to large institutional investors, but with more diverse security trading and trade information needs, as well as specific unique workflows to support complex investment strategies. Workflow for smaller hedge funds is maturing as well, moving from spreadsheets and manual processes to more automated and robust trade routing and order execution capabilities.

Hedge funds are driving several key advancements in OMS, including increased security type coverage, more robust currency capabilities, faster trade execution and transparency for liquidity, and improved abilities to process higher trade volumes supporting more complex investment strategies.

An independent third party knowledgeable in OMS vendor functionality and deployment can help you develop a focused OMS implementation solution—one that incorporates your investment strategies and technical and operational support capabilities. The right partner can help you determine the amount of customization needed to meet business requirements.



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