Size doesn't matter… really

By **Nell Sloane**, principal, Capital Trading Group

The process of investing can be described as a dance on the edge of a cliff. The investor engages in a controlled risky behavior that can produce an exhilarating high or end in disaster. The key term is "controlled."

When we invest in stocks, bonds, businesses or alternative instruments, we know we should be expecting a reward commensurate for the risk we take: higher underlying asset volatility should equal higher expected returns.

Once we pull the trigger on a trade, we recognise we will be fighting market risk, interest risk, non-systematic risk and we accept the challenge in expectations of future rewards.

However, one risk we should not be taking and for which the market will not reward us is custody and clearing risk.

The modern CTA needs to weave an efficient web of clearing relationships to reduce operational and execution risk. From this point of view, the recurrent instability of financial markets in the last 15 years has created opportunities but also new unknowns.

Once agreed that an investment manager needs multiple relationships, the next step is to create a process on how to choose the single relationships.

Originally, the most common discerning element was the balance sheet of the prospective clearing firm; a bigger balance sheet seemed to protect the clients' funds more efficiently and, especially for the emerging manager, it would act as a more powerful business card.

The abrupt and messy demise of MF Global, and before them of Lehman Brothers, highlighted how a large balance sheet might not necessarily coincide with strength and safety.

Nowadays, a CTA must go beyond size and truly understand its needs.

This process starts by determining what fund size the prospective clearing firm specialises in servicing; then one needs to understand features that are commoditised versus those that are unique and finally the manager must clearly identify what services are important to the current conduct and future growth of the business.

The following is a basic checklist of potentially important decision criteria besides size:

- **Costs:** service charges, trade costs, funding costs
- **Product coverage:** which products can the firm clear
- **Net settlement:** for international traders, it might be important to have all settlements flow into one currency before the morning open
- **Technology:** internet portal, electronic execution and trading platforms, communication
- **System integration:** how easy it will be to integrate the manager's systems with the clearing firm
- **Quality of support**
- **Margin calls management**
- **Support in regulatory reporting**
- **Exchange memberships**
- **Research**

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An analytical approach based on a set of inputs such as the ones listed above would lead a manager toward a careful weighting of all the variables and produce an outcome that on a longer term basis should result to be more satisfactory than a decision merely based on balance sheets.

Interestingly, on the subject of clearing relationships, we find similarities in trends between CTAs and traditional advisors, such as RIAs.

One 2014 wealth management benchmarking report shows that RIAs, like CTAs, are now interested in multiple clearing relationships as the result of three major elements.

The main driver seems to be the recognition of value of certain clearing firms' specific competencies such as technology, research or practice management.

Not so surprisingly, 47% of advisors state that client preferences for certain clearing firms were a reason to establish a relationship and last but not least, investment option availability was quoted as an important driver in the choice.

In conclusion, regardless of the screening elements used, it is imperative that the choice of a clearing firm carefully meet the current and future needs of the investment manager as clients will only notice when problems arise.

As Bing Waldert at Cerulli Associates Inc. said: "Nobody says: 'I had a great train ride today,' you only notice them (clearing firms) when something bad happens."