

THE TRADE

WORKING FOR THE BUY-SIDE

**Dimensional Fund
Advisors'**

John Romiza

**GOOD THINGS COME
TO THOSE WHO WAIT**

The rewards of patience

The TRADE forum

■ **What should investors know about trading costs?**

Smart order routing

■ **Intelligent selection for the buy-side**

■ **The BIG idea – Is price discovery under threat from fragmentation?**

John Romiza, Dimensional Fund Advisors

Photos: Claudia Gannon



“From top to bottom, this is not your typical investment management organisation.”

Good things come to those who wait

John Romiza, head of international equity trading, Dimensional Fund Advisors, outlines the 'patient and flexible' trading approach that the US -based asset manager has exported to Europe and beyond.

From an investment and trading perspective, what makes Dimensional different from other asset managers?

Dimensional was founded on the beliefs that markets are largely efficient when incorporating information into prices and that risk and return are related. The firm will only target risk factors that have been identified through rigorous analysis to deliver attractive expected returns. These risk factors are generally captured through market exposure, size exposure and value exposure. A primary implication of this belief is that it is virtually impossible to identify an active asset manager that can regularly deliver above-market returns that are not explained by these risk factors.

From a trading perspective, I am aware of no other organisation that has a

comparable execution strategy to Dimensional. The fundamentals behind our strategy are grounded in a patient and flexible approach to trading.

Historically, this has been the cornerstone of our execution philosophy and still is today. By flexible, we mean stocks are substitutable or interchangeable within a particular asset class; by patient, we mean we will wait to execute on our terms in order to minimise market impact.

Within a particular bucket or asset class, we don't necessarily favour one stock over another, as the expected return of each is the same. Small-cap spreads can be 100-300 basis points and higher compared to 12-15 basis points in the FTSE 100, so we'd be giving away our expected returns in trading costs if we traded in any way but patiently.

Traditional managers, active or passive, have to own a particular stock. With active managers, the alpha comes from idea generation, not the trading desk, so their traders have to seek liquidity, which means crossing spreads and incurring implementation costs. Passive managers are required to minimise tracking error and the need to own a specific stock regardless of price. We're agnostic to the particular stock held and have an enormous amount of order candidates. Consequently, we'll allow others to be the aggressor and we'll sit passively while they seek liquidity in our stocks.

What's the nature of the relationship between portfolio managers and traders at Dimensional?

It's certainly not a traditional relationship. The individual order is not the motivation,

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so, rather than picking stocks, the portfolio managers' priority is to invest daily cash flows while providing an adequate value of suitable securities for a portfolio on a given day. They also need to factor in the output of the algorithm Dimensional uses to apply its investment philosophy across a large range of stocks, and to manage cash flows around corporate actions in around 14,000 names globally. Because our funds keep a very low cash component, the portfolio managers must maintain the appropriate level of equity exposure.

Taking all that into consideration, the PM will then provide the trading desk with a multiple of the dollar value of orders needed on a particular day to meet the portfolio's cash needs. If the PM has \$10m to spend, he could provide order flow in excess of \$30-40m. This is what allows our trading group to be flexible and remain patient.

What is the structure of trading responsibilities at Dimensional?

Overall responsibility lies with Dimensional's head of global trading, Henry Gray. I'm responsible for international trading outside of

American time zones, including our Far East desk in Sydney. I report locally to our European CEO and the investment team as a whole reports to our CIO in the US. Trading was separated formally from portfolio management around three to four years ago to enable traders to develop specialist expertise in, for example, market microstructure and managing liquidity costs. We have five traders here in London and four in Sydney. In London, the distribution of order flow is broken out by side, market cap and developed/emerging. At present, I'm one of the few who comes from the industry; most of the team members have backgrounds in mathematics, engineering or computer science, and have learned trading from inside Dimensional.

In line with its very lean, low-cost approach as an organisation, Dimensional has had an outsourcing agreement in place with the custodial and securities services group at Citi for the last three years, covering trade processing and portfolio record-keeping.

Over the past six years, we've worked with partner brokers in the US and internationally to develop

a cutting-edge electronic trading infrastructure, including execution algorithms and FIX network. Over the past few years, we've been exporting that infrastructure more aggressively ex-US.

How have Dimensional's international trading operations changed in the past 12-18 months?

Our patient and flexible execution strategy has always been a consistent global priority, but outside the US we largely outsourced implementation to the street. This has created a natural conflict and we still have a problem getting our message across to the sell-side. We are happy being passive, but because much of sell-side compensation is commission-based, brokers find it hard to understand when we say, "I could spend \$10m today, but I don't need to." To avoid this conflict, and ultimately improve our executions, we decided to bring more trading in-house. In 2007, around 15-20% of our European business was transacted by self-directed electronic means. Now, we're closer to 90%. Most traditional asset management firms in Europe, even the most advanced, are only

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From theory to practice

"From top to bottom, this is not your typical investment management organisation," says John Romiza, head of international equity trading, Dimensional Fund Advisors. Now one of the world's largest asset managers with \$125 billion under management, the firm still only has 450 employees worldwide. Dimensional was founded in 1981 on the principle that value can be delivered to investors on a diversified and low-cost basis, not by outsmarting the market, but by focusing on the dimensions of risk that deliver higher expected returns over the long term. At Dimensional, "trading is an important component in delivering these returns," says Romiza, who joined the firm last April from Franklin Templeton Investments, where he was director of European trading.

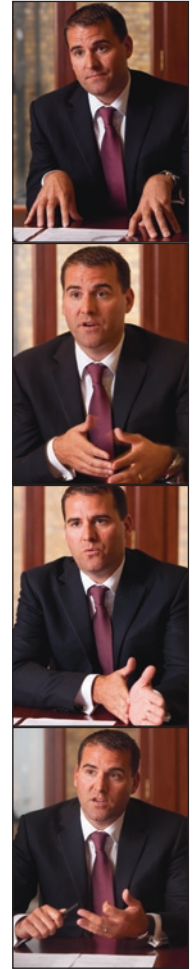
David Booth and Rex Sinquefeld established Dimensional based on the theories they had learned as MBA students at the University of Chicago Booth

School of Business. With renowned theorists such as Eugene Fama, Kenneth French, Robert Merton and Myron Scholes on its board, Dimensional has kept close to its academic roots. The firm started with a US small-cap fund, but its investment strategies have expanded around the world and beyond equities. Rather than picking stocks like most active managers, Dimensional's portfolio managers are focused on ensuring that the firm's individual funds stay in line with its guiding investment principles. "There are both quantitative and qualitative decisions that go into the portfolio process at Dimensional. The portfolio management function plays a key role in managing that balance," says Romiza.

Dimensional's investment philosophy means it holds positions in a vast number of stocks with broadly similar characteristics. The stocks' substitutability permits Dimensional's traders to

maintain what Romiza calls a "patient and flexible" approach to buying stocks, while earning substantial liquidity provision from other market participants, thereby reducing trading costs to a minimum. "The impact on returns of crossing a 200-basis-point spread is greater than having slightly more cash in the portfolio," he says. "Our patience is steadfast."

The firm has expanded rapidly over the last three to four years. As well as building a new headquarters in Austin, Texas that houses many of the traditional head office functions, Dimensional has also invested more heavily in technology and human resources. "This period has coincided with a decision to recruit from within the industry when necessary, whereas previously the firm had preferred to promote from within. International trading was one of a number of areas we needed to grow," says Romiza.



achieving levels of 35-40%. Commissions may be a fraction of overall potential trading costs in some of our names. Nevertheless, cutting our commission costs by 50-70% is a pleasing by-product of avoiding conflict.

How did Dimensional increase self-directed trading by so much in such a short space of time?

By investing in people and technology. We brought one senior trader over from the US who had been intimately involved in the development

of our electronic trading capabilities in the Americas. And we took existing US partnerships with agency-only brokerage firms to the next level in this region. A key part of the process was working with broker partners and leveraging parts of

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their infrastructure to build a comprehensive trading platform that supports our needs.

In addition to maintaining hundreds of orders on the pad on any given day, we might have capacity in another 3,000 names that we could trade if we had an opportunity. We have a system that captures and analyses indications of interest

from a variety of counterparties and alerts us to any matches. It's a useful way of utilising the new brokers that are offering small-cap liquidity and additionally supporting the partnerships we are creating.

Why have you worked more closely with agency brokers than bulge-bracket firms?

At the outset, bulge-bracket brokers published very little research in small-cap names and rarely trafficked in the types of names we invested in. The second-tier execution-only shops regularly played in these names.

Following that, some of the execution-only shops were very open to a partnership approach. Their input would help in the development of our platform and our input assisted in refining technologies and strategies that could, in other forms, be offered to other customers.

Having arrived from a shop that dealt with significantly more brokers, I did think it necessary to diversify our business in the region to secure access to a wider range information, technology and flow. The recent liquidity-sharing deals between brokers does suggest asset managers may

need fewer brokers over time, but diversification for us was more a matter of going from two brokers to four, and not from 50 to 100.

One of the major conflicts associated with trading desks comes from bundled commissions. When you rely on brokers for other services outside of execution, there will be conflicts. The regulators have done their best to address these, but I believe we're all comfortable with the fact that as long as directed brokerage and research budgets are in place, the buy-side trader will be hindered in getting the best possible result.

The underlying theme for broker selection is that Dimensional is not conflicted – no research obligations, no risk trading, and very little relationship or high-touch trading. The objective is simple: give traders flexibility in their process and expect transaction costs to come down and execution quality to go up.

How does the patient and flexible trading approach influence Dimensional's use of execution algorithms?

The strategies we utilise are key to how we provide liquidity to the market. All

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strategies – whether fully custom-developed algos, tweaked off-the-shelf offerings or strategies written on the fly by our traders – will focus on liquidity provision.

To understand the impact of our passive implementation, we measure our performance down the tick of each child order. Providing liquidity means that, on average, we should receive better prices than liquidity seekers. One common way to see this in microstructure is to look for price improvement relative to prevailing quotes. The message being, utilise ultra-passive, liquidity-providing strategies, but also measure and analyse to ensure we're seeing the results desired.

Dimensional conducts its own transaction cost analysis. How does this differ from third-party TCA? Our main issues with third-party TCA are that the data aren't as clean as we'd like and we don't use traditional benchmarks due to the extent of the flexibility provided to our traders. Instead, we have a dedicated team based in Austin, Texas, that assists in cost analysis. The team is directed by Sunil Wahal, Ph.D., who is the Jack D. Furst Professor of Finance at Arizona State University's

W.P. Carey School of Business, and a leading researcher on equity trading and market microstructure.

Sunil makes use of our tick database to analyse trader and algorithm performance at the child order level, including comparison with other algorithms we could have used. The breadth and depth of our analysis is the differentiating factor between our measurements and those of third-party vendors.

With that said, we utilise some data from third-party vendors, particularly on the cross-client comparison analysis, although we're not completely comfortable with the results since our peer group doesn't have as much flexibility as our traders.

Consequently, we'll always feature quite well in this type of analysis. Clients demand it, so we provide it, stating that, "Yes we're in the top decile, but the value we add extends beyond these numbers."

Why don't you use dark pools in Europe?

We utilised dark pools significantly in my previous role, but they don't feature in our world here because we're not comfortable crossing at the mid-point and counterparts that are willing to cross the spread

“Are we concerned about SOR being more driven by rebates than liquidity? Absolutely.”

are having a harder time reaching us due to regulatory restrictions in Europe on how order types interact.

The regulatory framework for dark pools in Europe is far from complete. We're looking at how best to optimise our execution strategy in the current environment, while also lobbying for the changes we think are necessary.

Are brokers' smart order routing (SOR) capabilities supporting Dimensional's need to access and provide liquidity across Europe's multiple venues?

We want to be intelligently providing liquidity in every possible venue. So we work closely with our sell-side partners to ensure we understand their SOR logic and, when necessary, tweak it. We have a regular dialogue with brokers on where we want to be represented and why.

Most brokers are not comfortable discussing the logic of their SORs, sometimes because they're not reaching

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all the venues you'd like them to and sometimes because it is a source of revenue.

However, our trading style and small circle of brokers have facilitated partnerships that allow us to look under the hood and understand where they're going, how often they're going there, with how much, and why.

Are we concerned about SOR being more driven by rebates than liquidity? Absolutely. Our flow is naturally conflicting on this front. Because we're passive providers of liquidity, and never seekers, brokers should theoretically pass the rebates all the way through. Our brokers pass this through in the form of very low commission levels. As with asset managers that use a much wider range of broker resources than us, there's a fine line between squeezing your brokers' margins and getting the services you want.

How is the value of the trading desk represented to the end-clients?

The entire organisation believes that to deliver what's on the label to our clients, we must implement the trading process as efficiently and effectively as possible.

Our trading style entirely complements our

management philosophy. Without the style we have adopted, we could not efficiently implement a good part of what Dimensional seeks to deliver to clients. And since our clients are very comfortable with our investment approach, it doesn't take much to show the benefits of our execution.

But everyone wants a number: how many basis points is trading saving? The primary goal of the trading function is to not give up our returns in the process. We can measure ourselves against other firms, but, as mentioned earlier, those comparisons are flawed. For self-directed trading, we regularly beat numerous benchmarks while not allowing traders to focus on any such measurements. The by-product of providing liquidity and passive/flexible trading is outperformance against traditional benchmarks. If you give a desk that much flexibility, it should be able to invest money in an efficient manner.

Now that Dimensional has achieved a high level of self-directed trading in Europe, what's next?

One priority is to grow the Sydney operation and

implement our trading approach in the same framework as we do here and in the US. The Far East is in a similar situation to where we were in Europe 24 months ago both internally and externally. Internally, people and technology will also be the key to pushing forward with the constant: flexible and patient trading. Externally, we should see the region go through a significant transformation in the next few years. Every indication points to much of the Far East behaving and growing in a manner not dissimilar to how Europe has developed on the electronic front. ■

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