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In The Dog-Eat-Dog World Of Asset Management, Prime Brokers Are Vultures

By OWEN DAVIS

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Here's a puzzle. You're a prime broker. One day a client comes crawling with desperate request: Liquidate everything. This presents an opportunity and a dilemma. Depending on the fund's size, news of the fire sale could be quite valuable for your other clients, who would shower you in adulation and commissions should you choose to divulge it in a timely and profitable manner. Then again, your relationship with the manager in need might suffer if they found out you spread word of their distress, thereby deepening it. Also there's ethics.

So. Do you let the hyenas in or keep them at bay?

If you're like a statistically significant sample of other brokers, you're gonna go ahead and invite your best clients to take a nibble off the dying prey. That's according to a new study authored by Andrea Barbon, Marco Di Maggio, Francesco Franzoni and Augustin Landier:

> This paper highlights that brokers' incentives to attract and retain clients affect how order flow information is shared with other market participants. Specifically, the evidence suggests that brokers tend to reveal the occurrence of a fire sale by the liquidating funds to their best clients, allowing them to generate significant profits by predating on the liquidating fund. However, this information leakage comes at the expense of higher price impact, and then a more costly liquidation, for the fire sale originator.

Given the scale of the incentives, this probably isn't too surprising a result. But it's striking how clear the results are. As the study finds, clients of brokers participating in fire sales made about 10 percent more "predatory trades" – selling the stocks that the dying fund was trying to offload.

To test the broker-leakage hypothesis, researchers assembled a set of fund liquidations – think Long Term Capital Management – of which there were 485 between 1999 and 2014, involving an average $377 million in sales across 23 stocks. Then they determined which brokers took part in the fire sales and, further, who those brokers' best clients were at the time.

One would expect these managers to take advantage of their brokers' awareness that so-and-so was on the brink of death. And so they did. Here are returns on capital for the best clients of those brokers who knew shit was going down (green), as compared to clients of brokers who were in the dark (red):

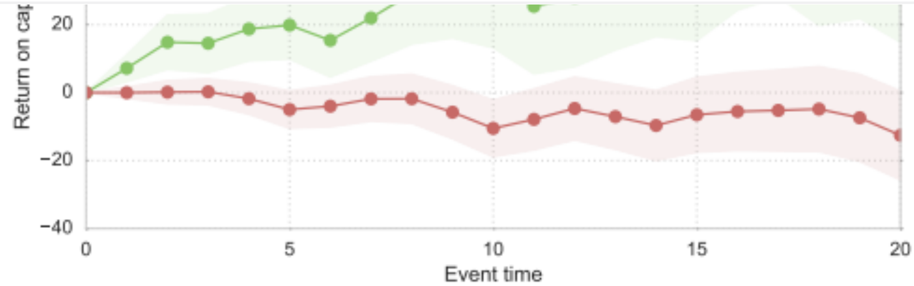

Figure 5 This figure plots the profits of the managers that are best clients of the aware (green line) and unaware (red line) brokers during the fire sale.

(Barbon, Di Maggio, Franzoni and Landier.)

“Those who prey on the liquidating managers exhibit significantly higher profits than those who are not aware of the sales,” the authors write. In case you were wondering whether these clients are just generally better traders, here’s the returns for these groups at randomly selected times:

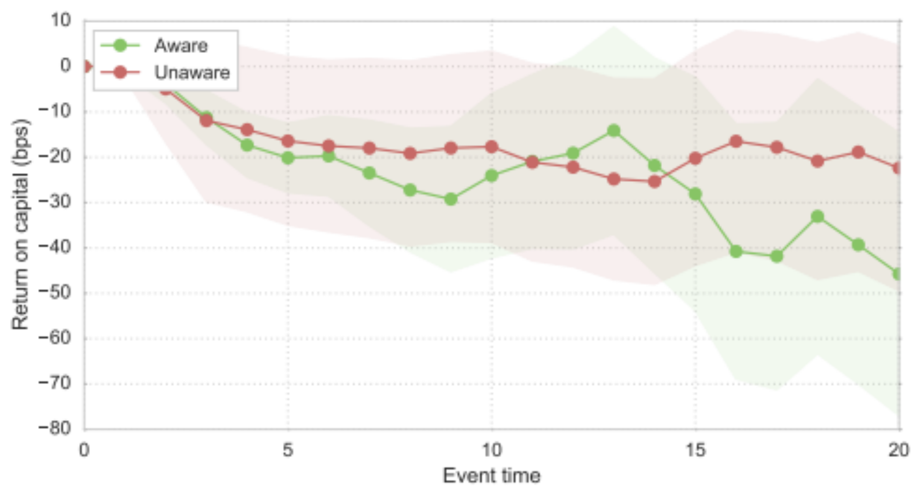

Figure 6 This figure plots the profits of the managers that are best clients of the aware (green line) and unaware (red line) brokers during random windows other than the actual fire sales employed in the analysis.

(Barbon, Di Maggio, Franzoni and Landier.)

Of course, there are a few relatively benign ways one could explain away the fact that the clients of brokers participating in fire sales tend to sell the same stocks. One is that funds tend to move in herds and respond to the same external stimuli – a downgrade, an industry-wide headwind, etc. Another is that liquidations might cluster around major crises (2001, 2008) and thus skew the results. But the fire sales examined were “randomly distributed across time,” the authors found. Moreover:

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that is employed by the liquidating fund, which corroborates the hypothesis of a quid pro quo between investors and brokers.

The paper – Brokers and Order Flow Leakage: Evidence from Fire Sales – is one in a series of recent studies exploring the just how gossipy prime brokers tend to be when there's some potential benefit for them, be it in trading revenue or just that special bonhomie that comes from violating client confidentiality to one's favorite hedge funds.

Yet none of those studies have identified a set of potential victims as clearly as this one. Thus the somewhat visceral language of "predators" and "prey" the authors use describe the fund managers involved. One could say it's just the market's version of the circle of life: Even in death, funds contribute a bit of alpha back to the broader ecosystem through the help of the circling vultures who identify the dying prey for the ravenous hunters.

As Schopenhauer reminds us, however, this is hardly any consolation to the funds being liquidated (or their clients for that matter):

> The pleasure in this world, it has been said, outweighs the pain; or, at any rate, there is an even balance between the two. If the reader wishes to see shortly whether this statement is true, let him compare the respective feelings of two animals, one of which is engaged in eating the other.

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