DERIVATIONS

DEMYSTIFYING RISK MANAGEMENT SOLUTIONS

BANK OF MONTREAL HARRIS BANK NESBITT BURNS

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IMPROVING TRADE EXECUTION WITH ORDERS

Placing execution orders with your bank's FX, bond or derivatives trading desk is a good way to improve hedging and investment performance without increasing transaction costs.

To use orders effectively, it is important to understand how the order process works and the characteristics that differentiate one type of order from another. This issue of *Derivations* will focus on why, when and how to use orders to execute OTC transactions.

THE CHALLENGE

Investors and hedgers use orders to buy or sell a wide variety of financial instruments—exchange-traded instruments like stocks and futures contracts, as well as OTC instruments such as interest rate swaps or currency options. They leave orders for several reasons:

- To protect unhedged exposures against adverse price and rate movements
- To reap benefits from rapid and sometimes temporary changes in the market prices or rates
- To take special advantage of the reach and expertise of market professionals

Orders allow investors and hedgers to benefit from market volatility, locking in better transaction pricing than might be available any other way. They are also an efficient way to set hedges or reduce exposure in fast moving markets and to execute transactions when local markets are illiquid or closed altogether.

WHAT DOES IT MEAN TO LEAVE AN ORDER?

An order is a directive given to a dealer to execute a trade with the client, when certain price or other market conditions are met. Most financial managers cannot afford to take time away from other activities to scan markets continuously for the perfect execution window. Continuous market scanning, on the other hand, is fundamental to what dealers do every day.

• MARKET ORDER

A market order directs the dealer to execute a transaction at the prevailing market price or rate. In OTC markets most trades are implicitly done on this basis. Market orders are regularly used in global markets like swaps or FX to facilitate out-of-time zone transactions.

• LIMIT ORDER

A limit order directs the dealer to execute (or fill) a transaction only at a specified price or better. A limit order is best used when the actual price at which the trade is done is more important than the time at which it is done. Since a limit order is always entered away from the current market price, it is almost never executed immediately. A party that leaves a limit order trades off the certainty of immediate execution (and risks not getting it filled at all) in exchange for the expectation of getting an improved price in the future.

• STOP ORDER

A stop order becomes a market-order when a certain price level (the stop) is penetrated. Unlike the limit order it does not define the actual price at which the trade will be executed, but rather the price that will cause the trade to be initiated. While a stop order does not guarantee the price of execution, it ensures that the trade will be executed if the exact price is less important than just getting the trade done. Traders often use stop orders to protect profitable positions against unexpected market reversals.

• STOP LIMIT ORDER
A slightly more complex order strategy is the stop limit order, in which a limit order is activated when market prices move through a stop level. The stop (or trigger) can be set at the same price as the limit order price or it can be at an entirely different price. The stop limit order effectively establishes a worst case trade price. If the limit price cannot be traded after the stop is penetrated, the order will not be filled. This eliminates the risk of a fill at a worse-than-expected price. The stop limit order is most useful in markets where the price movements are choppy and unpredictable.

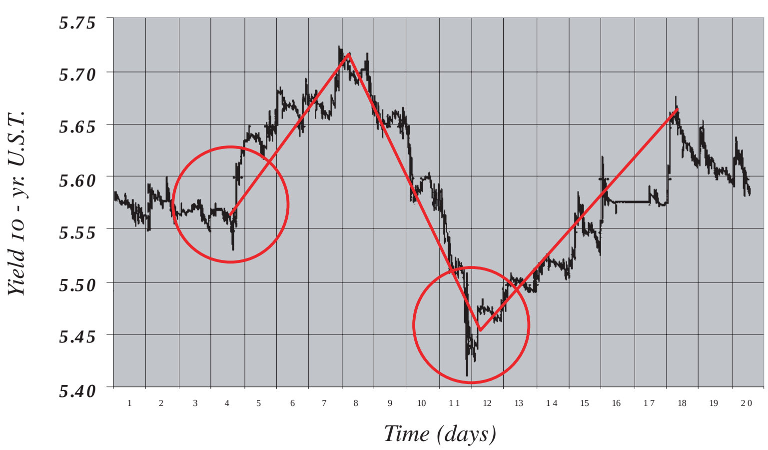
• DAY ORDER
Day orders are good until the close of business on the day given. These type of orders leave room for ambiguity unless "close of business" is explicitly defined, and will not get executed through the overnight market. Day orders do not guarantee that trade execution will take place.

• GOOD UNTIL CANCELLED ORDER
Good until cancelled specifies an order which is active until the client specifically revokes it. This type of order allows for price movement to a target level to take place over a longer period of time. It works best in situations where there is latitude in execution timing and a definitive target price. It is active until actually cancelled. If the client's objectives change and the dealer is not advised, then an undesired trade may occur.

Even though brokers serve to concentrate price information in OTC markets, there is no "official" OTC price. For this reason orders are most often executed on a best efforts or "not-held" basis. This means that while the dealer will do his best to fill the order, he is not compelled to execute it at the specified level.

USING ORDERS TO TAKE ADVANTAGE OF INTRA-DAY VOLATILITY
One of the most significant advantages of leaving an order is that it creates an opportunity to take advantage of short-term price/rate movements. Many markets are surprisingly volatile over short periods of time. Limit orders placed a reasonable distance from the current market price or rate provide a way to exploit this unpredictability in price behavior.

The chart below tracks the yield of a 10-year U.S. Treasury note between March 24 and April 15, 1998.



basis points. The trend reversed again over the next 7 days, taking yields up by almost the same amount as the prior week's decline. Interest rate swap limit orders set 15-20 basis points away from the market in this rate environment were quite likely to be filled, creating the potential for significant savings for hedgers.

Rates can move substantially even within a single day. Violent intra-day price/rate movements are sometimes triggered by surprises in closely watched economic releases like monthly payroll data or official crop forecasts. Orders give hedgers and investors the ability to position to take advantage of these rapid oscillations.

The circled areas on the chart show how yields responded to surprising new economic information. In the first instance, rates spiked lower on a weak durable goods number, then an hour later bounced sharply higher on a stronger-than-expected home sales statistic. The same pattern emerged a week later with the release of monthly payroll data—a knee-jerk overshoot reaction when the data was made public, then a rebound as the data was analyzed more closely. A day limit order placed ahead of the information releases would have had a good chance of getting filled, even though rates quickly bounced back in both instances.

SUMMING UP

Execution orders are underused but extremely useful financial tools that enable financial managers to make market price movements work to their advantage. Orders can be used to prevent erosion in the value of unhedged positions caused by a market move in the wrong direction. Orders can also free managers from the time needed to monitor market movements on a minute to minute basis to ensure best execution.