3.2 The Business of Trading

In part, traders make their living either by charging a fee for providing a service (broker, underwriter, "pure market maker"[77]), or charging a fee to take on some risk (prop trader, or arbitrageur), or a bit of both perhaps (most market makers). The trading and the activities that directly support the trading can be expressed as a cycle of events. However, the trade cycle is just one component of the business of trading, where net profits are of primary importance. The net profit of the trading operation is the amount that is left over after costs and losses have reduced the revenues/fees. Moreover, the amount of net-profit should also be consistent with the risk-adjusted returns requirements on the employed capital. Such matters, along with how to compensate traders to motivate them to continue to generate profits and manage risks, costs allotted to operating expenses (computers, capital, etc), and addressing trading losses become activities that tend to dominate the business management process (as opposed to the trading cycle process).

Trading may appear to be the pricing and risk assessment of contracts. However, to transact even a single trade and to actually book the deal is considerably more involved. Often the "iceberg" metaphor is used to suggest that the $1/10^{th}$ bit sticking out of the water is the effort required for pricing, while the rest of the "berg" represents the effort for booking and maintaining the trade/operation. Importantly even this iceberg is a tiny component of the entire effort for managing the trading operation as a complete business. This means that in addition to a good understanding of valuation methods, the day-to-day activity of a trader (the trading cycle) and that of the manager of the trading operation[78] in the context of the business mandate are a central and critical function.

In this light, this Section introduces some basic components of both trade management, and trading business management. The introduction of the trading cycle as a schema for controlling the position keeping process will include a short review of strategies that might be used. The manner in which money is actually made, with a hint as to possible concerns/abuses, is also discussed. Following that, an introduction to the basics of managing the trading operation is considered, and the connections developed in this Chapter will be emphasised throughout this Series of books.

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[77] In the vernacular, brokers and underwriters are not really traders. In addition, the term "pure market maker" is used to indicate a market maker who is not permitted to take any (or very much) risk, so that (essentially) all of their revenue is generated from bid/offer spread flows.

[78] Management of people, capital, risk and P&L, of course to some extent this depends on the nature of the business (prop vs. broker vs. market maker etc).

3.2.1 The Trading Cycle

Any control process can be broken down into five basic steps: detection, identification, decision, action, and audit (DIDAA). Trading is no exception. The control loop that incorporates these components will be referred to as the "trading cycle". In this Section, the trading cycle will be introduced primarily as applicable to prop trading and market making, with important differences highlighted. More detailed treatment of managing the trading cycle is provided in [4] and the respective TG2 "product" and especially the TG2 "trading" books.

Notice that the trading cycle applies at each stage, including both the inception date trade and to the closeout date trade.

In the context of trading, the components of the cycle would be:

1) Trade idea generation – following detection of an opportunity and assessing a trade strategy that best exploits that opportunity.
2) Structuring – choosing the best instrument(s) with which to express the idea including initial valuation, risk/return considerations, and consideration of operational/cost issues (transactions costs, liquidity, capital utilisation, credit, etc).
3) Execution – the actual transaction, though some skill may be required here as well.
4) Position keeping – the process of managing the position throughout its holding period and administering the relevant strategy, and analysis as introduced in Section 2.1.10
5) Audit – review of the trade's performance and adjustment to any of the components as may be required (e.g. forecast was off by an unexpected amount, or the pricing/rebalancing calculation needs to be updated, etc).

Trade idea generation will depend on the business mandate. Prop traders will use any combination of Technical, Fundamental, statistical, or arbitrage-based methodologies[79] (e.g. see [4]) to generate directional views or look for arbitrage opportunities to be able to produce capital gains. For example, a trader might be a good "chartist" and after some analysis takes the view that there is a "bull flag formation" in the S&P 500 Futures (SPX), with an upside of 70 points, that should complete within a month. Or a trader with success using Fundamentals/economics considers that the global economies interaction with Japans macro-economic circumstances will require Japan to raise interest rates by 50 bps within 2-months.

[79] In fact any methodology that consistently generates profits will do. For example, there are many jokes about connections between sun spot activity and the markets or predicting the US equity markets based on the out come of the Super Bowl. At the end of the day, if you are able to consistently push a wheelbarrow full of "wedge" down to your bank, then your methodology will be envied.