In recent years, High Frequency Trading ("HFT") has received a significant amount of attention from the financial media. Despite this attention, there is still little clarity around what HFT is, what strategies it employs, and what effects, if any, these strategies have on the market.

HFT is characterized by an interest in trading large volumes at low margins, the use of electronic trading to maximize speed to market, and little reliance on fundamental analysis. Beyond those basics, approaches to HFT can vary from market-making to the leverage of complex algorithms to take advantage of market momentum. In aggregate, these trading strategies now account for at least half of the volume traded in U.S. equity markets, with the impact of this shift in market structure felt in a number of cases.

On May 6, 2010, the Dow Jones Industrial Average experienced its biggest one-day point decline in its history. Strangely enough, “The Flash Crash” was not driven by significant news or any particular market-moving event. In fact, within minutes the market recovered over 600 points. Analysis done in the aftermath suggests that the problems the market faced on that day were compounded by the fact that HFT firms left the market and that liquidity instantly dried up for others. Some panicked investors made sales at deep losses only to see their respective stocks recover almost immediately.

Since May 2010, the reliability of U.S. stock markets has remained in question. The removal of the “human element” has played a role in the botched Facebook IPO and Knight Capital’s $400 million dollar trading loss due to “computer malfunction.” There is concern about whether anything has been done to prevent another flash crash, with many wondering whether regulators should force HFT firms to take on a formal liquidity-providing role similar to that of the market-making specialist on the NYSE. In any case, more clarity around the ongoing shift in market structure is needed to restore investor confidence.

The Role of High Frequency Trading in Markets

HFT strategies are relatively new and, at the very least, misunderstood by the average investor. But do they play a necessary role in the machine? Do investors simply not realize the positive externalities that HFT creates?

High Frequency Traders argue that their activity in the market is beneficial because it creates tighter spreads and increased liquidity. However, recent research shows that the actions of HFTs may be quite different than their stated role. A trading study in the e-mini S&P 500 Futures contract led by Andrei Kirilenko, the chief economist of the U.S. Commodities Futures Trading Commission ("CFTC"), found that the most profitable HFT firms were the most aggressive and often reduced liquidity rather than increased it. The study also found that small retail investors lost an average $3.49 per contract to aggressive HFT firms.

There are a number of ways to question Kirilenko’s findings as it relates to trading in equity markets. The U.S. CFTC is obviously not interested in developing a better understanding of how equities trade and it is possible study results may vary among different products. Secondly, in trading circles small retail investors are thought of
High Frequency Trading and Market Stability in the Eyes of the Typical Investor

as “contra-indicators” on market direction, and many would not consider it unfair that more sophisticated High Frequency Traders would outperform the average retail investor. However, at the very least this study suggests that simply taking HFT firms at their word and assuming their primary function in the market is to provide liquidity may be naïve.

In reviewing this assumption on the liquidity issue, the value that it provides begins to come into question. For the moment, let us grant HFT firms the fact that they are in large part responsible for the highly liquid equity markets that exist today. Due to the current regulatory situation, these liquidity providers have no formal responsibility to remain in or stabilize markets during times of stress, and the “Flash Crash” is a perfect example of what could potentially unfold. Mike Konczal of theatlantic.com describes this situation best:

Liquidity from HFT is like having an airbag in your car that works all the time except when you are in a car accident. It isn’t there when you most need it, and it encourages you to drive a bit faster, and take turns a bit sharper, because you think you are protected. So instead of being a risk management tool everyone is aware of, it is instead misinformation.

The idea that the current market structure adds an element of misinformation being communicated to investors is chilling. Savvy traders are always looking for small inefficiencies to use to their advantage, but can anyone besides HFT firms win in an unstable volatile market environment where more than half of the volume completely ignores fundamentals? Recently, regulators have grown concerned that new market structures might be having an impact on the “fairness” of markets. But are they too far behind to make a difference?

The Role of Regulators

In some ways, regulators paved the way for, if not implicitly spurred the movement toward, High Frequency Trading. By allowing for a more fragmented market that included electronic exchanges, an opportunity for exploitation was created. Trading firms were quick to develop new capabilities, and the SEC has trailed behind in terms of their understanding of HFT practices.

In fact, it took until late 2012 for the SEC to reach out to experts for help. According to the New York Times, Tradeworx, a high frequency trading firm itself, will tutor the regulators on programs that have been in the hands of HFT firms for years. Better late than never, but there are still significant risks to relying on the technology of an HFT firm to fairly monitor the impact of high frequency trading.

Regulators need to quickly make significant progress, but this may be difficult as HFT firms continue to ramp up efforts to defend their actions. There have been a number of industry-sponsored studies showing that HFT strategies have no negative impacts, while the SEC has produced none. Additionally, as it has garnered more attention, the HFT industry has upped its presence in Washington through lobbying, unsurprisingly.
HFT firms seem prepared to fight to keep their profit making position in financial markets over the long-term. This does not have to be a negative thing for the average investor, as technology has been responsible for easier market access and decreased commissions. The difference in the case of HFT is that its development has coincided with a shift in market structure with which regulators have not kept adequate pace. As a result, investors feel unsafe and worry about the downside risk of putting capital to work. More needs to be done to allocate responsibility for stabilizing the market in times of stress. Investor psychology, trust and confidence are imperative to functional markets, and regulators need to do the necessary research to give market participants a transparent look at the effects of HFT. Until these steps are achieved, concerns over the timing of the next “Flash Crash” will remain indefinitely.

This all highlights the importance and advantages of having a largely (but not necessarily exclusively) fundamental-based, value-oriented, long-term investment horizon. Such a style of investing obviates to a substantial degree the interim noise, volatility and distortions inherent in markets, as well as reduces transaction expenses. Most importantly, it is designed to ultimately capture the full value embedded in securities, sectors and markets. Increasingly important given new tax code changes, it results in more advantageous tax treatment for taxable investors. Lastly, a long-term investment style results in a more steadfast, confident and even relaxed course that helps reduce the many corrosive behavioral finance traps lurking due to investor fear, greed and all the loud noise pervading everyone 24/7/365. This approach, therefore, can have the pleasant effect of not only more peace of mind but also freeing up the most scarce and valuable resource we all have: time.

If you have ideas or topic suggestions for Mr. Hennessy’s next thought piece, or if you would like to send us questions, comments or other feedback on this piece, please contact Andrea Szigethy at aszigethy@morgancreekcap.com. We look forward to hearing from you.

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