HIGH-FREQUENCY TRADING

BY ROBERT BENSON

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What LNWM Clients Need To Know

Although computerized high-frequency trading (HFT) has existed for the past 20 years, the recent publication of Michael Lewis' book, *Flash Boys*, has made HFT a hotly debated topic. Because there is much confusion about the role that HFT plays in the financial markets – let alone whether HFT is good or bad – I thought I would review HFT and how it affects LNWM clients.

WHAT IS HIGH-FREQUENCY TRADING?

HFT refers to a wide variety of algorithm-based strategies implemented via computers to buy and sell sometimes thousands of stocks within milliseconds (one-thousandth of a second). Today, roughly 50% of trades on U.S. stock exchanges are believed to be generated by such computer-driven transactions.

HOW WE GOT WHERE WE ARE TODAY

To understand the role that HFT plays in today's markets, it's important to know a bit about how we got where we are today. Historically, stocks were traded by people ("open cry"), and some people called "market makers" played a vital role by providing liquidity – offering to buy or sell stocks that were not frequently traded.

The role of market makers. If an investor wanted to sell a stock when no one wanted to buy, a market maker for the stock would step in and offer to buy. Conversely, if an investor wanted to buy but no one wanted to sell, the market maker for the stock would sell shares it had in inventory. In this way market makers (intermediaries) kept the equity markets investable during times of stress by increasing the level of market liquidity.

Market makers are not non-profits; they need to make money to remain in business. Their profit is generated by capitalizing on (and often widening) the bid/ask spread. This transferred money from the investor to the market maker with each transaction.

Over time, trading regulations compressed bid/ask spreads to pennies (decimalization). This was a positive trend for investors, but it put all but a few traditional market makers out of business.

Big changes in the 1980s. Enabled by computerization, HFT firms and "dark-trading pools" (private trading forums) started to function in the 1980s as intermediaries and to provide market liquidity. Using computers to automate the process, HFT firms drove down the price of making markets in illiquid stocks – savings that are shared with investors. The trend toward lower bid/ask spreads appears to be continuing today.

Competition among HFT firms typically compresses bid/ask spreads. However, the HFT firms also take a bit of the spread for themselves. Some of this "compensation" is derived by accurately predicting large trades (or purchasing trade information from the exchange) and positioning the HFT firm in front of the trade.

HFT firm's compensation has fallen considerably as HFT competition has increased. One common estimate from Vanguard is that revenue from HFT has declined from $7 billion down to $1 billion during the last five years.

DOES HIGH-FREQUENCY TRADING HARM LNWM CLIENTS?

This is a tricky question. HFT is a developmental change in how stocks are traded. Like most changes, it has both positive and negative consequences. In looking at the heated debate regarding HFT, it is important to remember that every proponent and antagonist has something to be gained or lost from convincing regulators that their view is the correct one.

BENEFITS FROM HFT:

- Greater market liquidity.
- Lower transaction costs for investors.

  FOR EXAMPLE: *Vanguard estimates that HFT has reduced transaction costs during the past decade by 1% annually for each "round-trip," or buy/sell transaction. A 1% reduction in costs each year is a significant benefit to our clients.*

- Improved integration of electronic stock exchanges, which in turn increases the transparency of trades.

NEGATIVES FROM HFT:

- **Trading crises, such as the "flash crash" in May 2010, are more likely** as the algorithms mature and become faster and more complicated "electronic traders."
- **Some HFT firms purchase preferential data feeds and access from the exchanges**. This raises concerns about the exchanges willingness to sell preferential access, which in turn aids the HFT firms in determining the direction of large trades and to capitalize on this information.

  This practice, however, may have less of an impact on most retail investors than it may initially appear. The race to ever-faster transactions and earlier access to data among HFT firms principally helps them compete against other HFTs, which works in the long run to reduce bid/ask spreads. Retail, or even most institutional investors, trade too infrequently and typically in lots too small for HFTs to generate sufficient profit.

Also, nearly all mutual funds and large institutional investors hire trading professionals to prevent their trade information from getting out to their competitors before they are able to transact. These traders attempt to confuse their competitors by entering trades at several exchanges at different times throughout a day. In many cases, traders also put in small buy orders when attempting to sell a large number of shares (or sell orders for a stock they are attempting to buy) to hide their ultimate objective.

> ***NOTE:*** *"Front-running" is when a broker or other trading intermediary acting on behalf of an investor trades against the investor before executing the trade. HFT firms, like all other market participants, are investors' competitors, not their agents or confidantes. So when HFT firms trade on information provided to them by the exchanges or captured by the HFTs themselves, this is not front-running, as Michael Lewis indicates in his book. The buying or selling of information is not illegal, although special access is a concern.*

- **HFT adds stress to the infrastructure of electronic exchanges**. However, given the fact that HFT firms are a very profitable source of business for these same exchanges, they should have sufficient incentive to bulk up their infrastructure to handle the additional strain.

WHAT LNWM DOES TO LIMIT THE NEGATIVE IMPACTS OF HFT

We do not trade unnecessarily. At LNWM, we have a long-term focus and a bias against transactions. Even given narrow bid/ask spreads, transactions come at a cost to our clients, often trigger taxable events and increase the probability of an operations error.

We direct large trades to an intermediary that can successfully manage the transaction. Large buy or sell orders for illiquid stocks should not be placed as a single order. Rather, they should be broken into several smaller orders to be placed at different times of the day and at different electronic exchanges. This is the procedure that Schwab, for example, uses when we utilize its trading team to for large and illiquid transactions.

We avoid trading when market volatility spikes. If stock prices are changing very rapidly with no obvious catalyst (such as the flash crash), we simply do not attempt to trade that day. This is the benefit of having a long-term investment perspective. Delaying our transactions by a day or two will seldom have profound effect on our long-term performance.

THE BOTTOM LINE

We believe LNWM clients are largely shielded from the negative effects of HFT. While the changes within the markets over the last several decades can be troubling, it is important to note that LNWM maintains a long-term perspective and bias against trading unnecessarily.

LNWM weighs all the costs associated with a transaction – including potential price movement, explicit trading costs, implicit trading costs and tax consequences – before executing a trade. This allows us to benefit from the improved liquidity and reduced bid/ask spreads, while mitigating the exploitation of trading information and volatility spikes that HFT may induce. Additionally, no investment managers used in LNWM client accounts have exposure to HFT firms.

ABOUT THE AUTHOR

ROBERT BENSON is chief investment officer at Laird Norton Wealth Management. He is responsible for setting and implementing investment strategy at the firm, as well as selecting managers for our client portfolios. Bob has more than 20 years of experience in the financial industry, most recently at Russell Investments, primarily in investment strategy, asset allocation and risk management. He received his CFA designation in 1997, and he's a member of the CFA Institute as well as the CFA Society of Seattle. He has an MBA from Northwestern University. Bob has served on the boards of both startup firms and non-profit organizations.

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