HIGH FREQUENCY TRADING: IT'S ABOUT THE TRADER NOT THE STOCK

By Ben Rebbeck, Executive Director*

Long term institutional investors hate it, mid-tier brokers are up in arms about it, ASIC has just launched an investigation into it, ASX is profiting handsomely from it and traders hail it as the answer to market liquidity. High frequency trading (HFT) is controversial. But what does it mean for companies and shareholders who own the stock being traded?

What is High Frequency Trading?

HFT is essentially computer-driven day-trading by institutional investors and is rapidly growing and has become one of the major categories of trading on the ASX. Its defining characteristics include:

- No net positions held by the trader at the end of each day;
- Trading is quantitatively based – driven by computers based on predetermined algorithms;
- Orders are executed in millionths of a second and positions are held for very brief periods of time – from milliseconds to hours;
- The traders are typically institutions trading for themselves;
- The trader is not interested in the company, its business, financial and operational performance or management.

Is HFT something Companies should care about?

If we go back to first principles, the primary purpose of the stock market, and for listing on it, is (for companies) to facilitate capital formation and (for investors) to access the benefit of a company's value- generating activities.

The link between these is paramount to an effective listing, and ultimately a strong and growing economy. Therefore, anything that facilitates these two objectives is a good thing: whether it be great corporate performance; high quality investor relations; a liquid secondary market; or a supportive regulatory and taxation regime.

HFT by definition only operates with a net zero position in a stock. As it never results in a shareholding, the trader is never in a position to contribute capital to a listed entity. From this standpoint HFT fails to meet the capital formation objective of listed companies.

HFT Institutions argue vigorously that their activities contribute to market liquidity. Indeed, there is ample evidence that HFT has contributed to the increase in volume of market trading.

In the USA, depending on the source, it is estimated that between 65% and 85% of trading is algorithm based, driven by technical data such as volume and volatility and market-making, and has little to do with fundamental investing. In Australia, the number is estimated at closer to 40%.

But Volume does not equal Liquidity.

Merely adding true day-trading to a market, does not necessarily, on a net basis, improve the ability of investors to dispose of, or acquire, securities. The exception is where HFT acts as a market-maker shifting stock between different markets or joining demand and supply that occur in different time periods.

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Globally, however, the jury is still out as to whether HFT plays a material market-making role. Indeed in flat and declining markets, such as the current environment, there is a distinct lack of academic evidence supporting any liquidity benefits from HFT.

HFT's impact on shareholders

HFT only exists at all because it is a profitable activity. The net profit from HFT must come from someone and that someone has to be a company's outgoing or incoming shareholders.

HFT is an offshoot of direct market access trading, which was popularised during the boom of the late 1990s. Direct market access allows investors to interact directly with the bid or offer of the market- place, bypassing the need to transact through a broker.

In the case of HFT on the ASX and other bourses, direct market access is very, very direct. In the pursuit of a micro-second competitive advantage vs all other investors, computers driving HFT, are co-located on ASX's premises (for a fee) and are plugged directly into both ASX's trading platform and its company announcement platform. This ensures no other investor can ever physically receive information and act on it quicker than they can.

This direct access also allows HFT to engage in 'price discovery.' In the course of a nano-second, buy and sell orders for a single share are put on to the market, and withdrawn at different prices. This action, almost unseen by the naked eye, flushes out orders from investors providing valuable information regarding the trading intention of others.

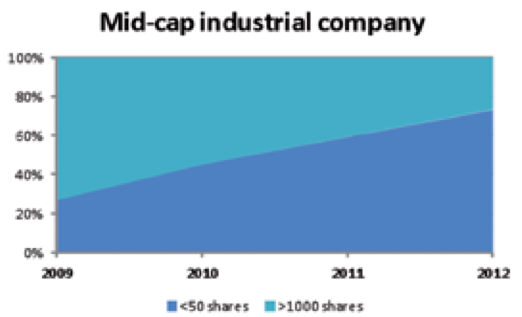
The potential impact of this is that the cost to buyers and sellers of securities is higher than it would otherwise be. With this outcome, HFT can be thought of as an 'Investing Tax' on shareholders.

Investors' reaction causes fragmentation of trades

To combat leakage of value to HFT, institutions are adopting algorithmic trading strategies that can have the appearance of HFT, to mask their intentions and make it more difficult for HFT traders to game their trading.

In practice, institutions are now breaking up their trades into smaller and smaller pieces and executing those trades on multiple exchanges. Far from improving liquidity, these actions to counter HFT are arguably having the effect of decreasing liquidity of a company's primary stock market listing.

The chart below shows the proportion of trades of less than 50 shares vs greater than 1,000 shares for an ASX- listed industrial company over four years.



Source: ASX, IRESS

Historically, small trade sizes were the domain of small retail investors. Today these trades are more often than not a small segment of an institution's order. For example, institution Russell Investments trades NYSE and NASDAQ listed stocks on 53 exchanges, with an average order size of less than 250 shares.

Even Exchanges' own shares are not immune. Today, more of NYSE's common stock is traded on third party-operated exchanges than its own.

Conclusion

As long as regulators and market operators support the practice, High Frequency Trading is likely to increase its presence and impact on our market.

For companies, due to the day trading nature of HFT, watching volumes traded through the market is no longer a reliable indicator of the level of underlying changes to the ownership of its shares. For this, regular beneficial ownership monitoring, supported by an active investor relations program, is now the only way of measuring these changes.

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