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Lessons from Trading History

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The old method of trading through market makers resulted in wider spreads, information leakage, lack of control, as well as a lack of speed even in an extraordinary bull market. It is no surprise, therefore, that increased liquidity needs would be eventually satisfied by numerous ECNs, followed by aggregators, buyside matching systems. More recently, the plethora of algorithmic trading options joined this group.

It appears that many firms are quite impressed with various machines' abilities to slice an order and piece it out over the course of a day. They are impressed by the machines' ability to be an exact percentage of volume and to receive some approximately average execution price. My problems with the logic of these systems are threefold.

Why even employ a buyside trading desk? Why pay them salaries, benefits, and incur the compliance costs associated with a desk if their jobs are to throw orders into an averaging machine? If the machines are providing such great execution, perhaps the buyside trading desk is unneeded.

A small firm with one trader, and smaller order sizes might benefit from such machines, as perhaps it might be difficult to get a large major firm to spend the time to work an order of 11,700 shares, and the buyside firm's single trader may just have too many orders for him or her to meaningfully strategize and control. I can see these systems being cost effective in this scenario. However, with larger order sizes, in small and mad-cap names specifically, I have my reservations. More on this in my third issue.

Motivations and psychology will not change over time, although technology will. As a result, trading desks comprised of experienced and adapting human beings will greatly outperform algorithms in executing equities.

I always make the analogy that trading is like a game. It has savvy participants who are at odds with each other: sheep and wolves if you will. Back in the day the name of the game was detecting institutional "footsteps" through "leakage"; having well oiled networks if you will. Today, with so many regulatory changes and technological innovations, the game hasn't changed (seeking out institutional footsteps), but it's played in a different way.

Proprietary algorithmic boxes entered the marketplace about ten years ago, and are highly prevalent today. As a matter of fact nearly all major brokerage houses utilize them to some extent as part of their proprietary trading engine. These systems look at 5-minute volumes, charts, which ECNs are bidding and offering, etc., and they automatically enter bids and offers in thousands of names in an automated way. When they take positions, automatic exit strategies get them out of their positions in a very profitable manner.

Add in to the mix numerous buyside trading desks entering orders into algorithmic machines that try to gauge VWAP, etc. The net result of all this automated flow is much increased intra-day volatility. One machine hits a bid, and three others have to then catch up on volume and do the same. Proprietary trading machines at the major firms jump into the fray. The result is big price swings, and a trading environment that requires steel stomachs, and much labor to execute properly. As more institutional firms employ these algorithmic trading systems, I sense the order flow will become even more predictable, the intra-day price swings will become even more dramatic, and the execution quality will become more "average."

We can always count on new technology and innovation in our business. In fact, we will demand it. However the one thing I know will remain constant over time, especially in a capitalistic environment, is human motives. There will be sheep and wolves. My sense is that the more firms use highly predictable systems and machines to try to "play this game", the more they will become like sheep. At what point will all the algorithmic traders cancel out each other's efforts to be average? In addition isn't the point of a trading desk to get best execution, and not average execution? If a specific trading desk is executing poorly versus some hypothetical average, then might that desk need to be re-trained and learn to adapt better, instead of relying on new systems that target an average?

Motivations and psychology will not change over time, although the technology will. My belief is that over time trading desks comprised of experienced and adapting human beings will greatly outperform algorithms in executing equities. But as in all things, time will tell.