Q & A with Livewire Markets – 14 April 2014

Q. Who is BestEx and what do you do?

A. BestEx is a broker neutral, buy-side trading desk that enables investment managers to achieve best execution in multi-market environments. We use technology and our extensive broker relationships to source liquidity and execute orders for our clients, allowing them to deliver superior returns to their investors.

Our clients are typically boutique fund managers who would describe themselves as low-turnover, long-term investors. Historically, they have not needed a trader and paid little attention to their trade execution. These days they recognise that markets have become increasingly complex and that their trade execution now has a material impact on their performance.

BestEx offers clients access to more liquidity than any individual broker and the ability to execute trades with minimal market impact. We don't seek to compete with brokers or interfere with existing broker relationships.

Q. What is high-frequency trading?

A. HFT is a subset of algorithmic trading where large numbers of orders, usually small in size, are sent to the market at high speed, with execution times measured in fractions of a second.

There is 'good' HFT and 'bad' HFT. Good HFT includes market-making (increases displayed size and narrows spreads), statistical arbitrage (decreases intra-day volatility) and index arbitrage (keeps securities pricing efficient). Bad HFT includes latency arbitrage (taking advantage of delays between exchange feeds and market data providers) and liquidity detection (detecting the presence of orders and positioning to profit from them).

Approximately 1 in 3 shares trades in Australia involve HFT.

Q. Is the Australian share market rigged?

A. Of course not.

Much of the opposition to HFT in Australia has been emotional and ill-informed. HFT has been described as 'legalised front-running' and unfairly accused of causing market instability. Opponents have called for the practice to be banned, arguing that participants that don't have a sufficiently long-term investment horizon have no business participating in public equity markets (though it is unclear where day-traders, hedge funds and other short-term speculators fit in).

In contrast, the academic evidence and the findings of a recent ASIC investigation indicate that HFT is mostly positive and that it supplies liquidity more often than it demands it. Moreover, quarterly data published by ASIC continues to show relatively low order to trade ratios in Australia.

Unlike the US, Australia bans payment for order flow and imposes a messaging tax. Critically, our exchanges do not offer preferential co-location or order types to some participants but not others. It is therefore inaccurate to suggest that any participant has an unfair advantage over another.

That is not to say that brokers and fund managers that have been slow to adapt to the new market structure are not at a disadvantage to their peers. Investors that have not yet changed the way they execute trades since the introduction of competition in Australia (October 2011) will continue to experience an avoidable drag on their performance, part of which will translate into dollars in the hands of HFT firms. But is there anything unfair about that? We think not.

Q. What can investors do to protect themselves?

A. The first step is to appreciate that the market has changed and that the old way of picking up the phone and handing an order to a broker is now the last thing they want to be doing. Instead, investors should take advantage of the technology available to them to achieve better trading outcomes. In particular, they should use technology to decide which of the 20 trading venues currently available in Australia they use for trading. How they exercise that choice will determine the extent to which they interact with HFT and will often mean a 1-2% difference in the price at which they get filled.

Secondly, investors need to understand that their broker is generally not their friend when it comes to dealing with HFT. On the one hand, there are the boutique brokers who don't have the algorithms or the order routing smarts to counter HFT or to access all of the order types offered by the exchanges. Unless they have the natural other side of an order (which is increasingly uncommon), it is simply too expensive to work orders in the market through these brokers. A more prudent strategy is to deal in another manner and obtain the best price for the order while using commission sharing agreements to pay for broker research as appropriate.

On the other hand, the bulge bracket brokers are conflicted because they typically send orders to the cheapest venues for them instead of the best venues for their clients. In practice, this means that client orders are first sent to a brokers' dark pool in order to avoid exchange fees. Frequently though, this results in clients being forced to interact with the brokers' HFT clients or prop desk to their detriment.

Finally, investors need to remember that HFT rely on signals that they pick up from large investors. Most orders in Australia are still executed using VWAP or percentage of volume as a benchmark. This means that investors are 'touching' the market hundreds of times each day and at highly predictable intervals. This plays right into the hands of HFT and means that although the investor may beat VWAP or achieve their volume target, they have signalled their intentions to HFT and only succeeded in moving the price away from themselves.