Editorial

High-Frequency Trading: Myths and Realities

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Lately, it has become conventional wisdom that high-frequency trading is making the equity markets more volatile. While it is true that the speed of trading has advanced enormously in the last several years, it is far too simplistic to blame technology for market volatility. In fact, academic research has shown that high-frequency trading has a dampening effect on volatility.

First of all, just to be clear, high-frequency trading is a method for executing trades. It can be used for a variety of different trading strategies, but it is not a strategy in itself. It is simply the latest phase in the evolution of electronic trading technology, much as the smart phone is the latest iteration of the personal communication device.

So why do members of FIA EPTA use high-frequency trading? The reason is simple – this method of trading makes it possible for high-frequency traders to provide liquidity to the exchange-traded markets more efficiently. Every price quote that high-frequency traders provide to an exchange creates a risk exposure. For any given quote, the value of this exposure is very low, but across an entire market the exposure can be significant, so high-frequency traders have to be very nimble in adjusting their quotes. In those markets where exchange speeds are very high and the latency of trading is very low, firms can manage their risk more effectively. And that allows high-frequency traders to quote narrower spreads for larger size and fill resting orders more frequently. This improves liquidity and reduces costs for end users.

There is a widely held view that restricting high-frequency trading will somehow reduce volatility. Nothing could be farther from the truth. As liquidity providers, high-frequency traders buffer the exchange-traded markets from external shocks. Without their participation, the screens will go dark and prices will go to extremes. Putting "sand in the gears" would reduce the ability to provide liquidity and make the markets more susceptible to volatility, not less.

This is borne out by research done by academics who have carefully analyzed data from a number of exchange-traded markets around the world. Their findings are consistent: volatility is dampened, not increased, by high-frequency trading. A sample of this research is available on the FIA EPTA website at http://www.futuresindustry.org/epta/academic-research.asp

It is often claimed that the increasing use of high-frequency trading is damaging investor confidence and making investors more reluctant to trade. This criticism seems misplaced. The reasons for investor uncertainty are all around us – the grave fiscal problems facing several European countries, the once-unthinkable downgrade of the U.S. credit rating, the potential for another round of huge losses in the banking system, and the growing fear that the tools of monetary policy have reached their limit in preventing a global recession, to name just a few.

In any case, sentiment alone should not be the basis for policy decisions. Regulators must arm themselves with empirical data to help them distinguish perception from reality. And to the best of our knowledge, all the empirical data show that high-frequency trading has improved the quality of exchange-traded markets to the benefit of all investors.

This view is also supported by Blackrock, a leading asset management firm. In a paper published in June 2011, Blackrock said high-frequency trading has a beneficial effect on European equity markets. "HFT helps to create efficient markets by facilitating price formation, lowering the cost of trading and improving the linkage between markets," Blackrock said. "All of this, in turn, aids in achieving optimal investment performance for end investors."