Quick View: High-speed predators pounce on volatility
By Jeremy Grant
August 9, 2011

What is causing this astonishing volatility in equities? Three American academics have an answer: it is all because, at a certain point, the market loses sight of fundamentals the more trading there is – and volatility shoots up.

In a study out this week called “The Dark Side of Trading”, Ilia Dichev and Dexin Zhou of Emory University and Kelly Huang of Georgia State University, say that “high volumes of trading can be destabilising, injecting a sizeable layer of trading-induced volatility over and above the unavoidable fundamentals-based volatility”.

That may not be so surprising, given the sickening gyrations we’ve seen, but what is interesting is the study’s related finding: that, while “low to medium” levels of trading tend to benefit most investors, there may be an inflection point beyond which super-charged levels of trading accentuate volatility – benefiting “only a small circle of traders”.

That suggests there are big winners, and big losers, in markets right now. There’s no doubt that we reached those super-charged levels this week. The volume of message traffic has been huge.

Messages are the electronic carrier pigeons that carry buy and sell instructions along fibre-optic pipes to and from exchanges and traders. And those pipes are bursting with messages – propelled by the huge amounts of automated, electronic trading that dominates share trading these days. That includes “high-frequency” traders, using computer algorithms to seek out the best prices.

According to Market Data Peaks, a US company which measures trading traffic, messages were being sent at the rate of 4.7m per second on Monday, compared with 1.5m per second in September last year.

The academics point to “trading on slivers of new information a fraction of a second faster than anybody else” as of questionable value – an allusion to high-frequency trading (HFT).

But it would be simplistic to say HFT and algorithms are what’s super-charging the markets. There are various kinds of HFT – a catch-all phrase that tends to include electronic market-making. Many other academic studies have shown this actually provides useful liquidity to markets. And many participants in the turmoil have said there is plenty of liquidity out there. The problem is what Joe Saluzzi, of US broker Themis Trading, says is “predatory HFT”.

He says in his latest blog: “This style of HFT exacerbates price movements up and down, and is fed by exchanges and dark pools who court their volume.”

Nanex, a Chicago data specialist, has identified one such algorithm it calls The Disruptor, which it claims fools genuine arbitrageurs – and presumably benefits its creators. Investors are already dealing with great uncertainties. Rooting out predatory HFTs would remove one – and might just reduce volatility into the bargain.