By John Spoto

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Beyond the hype of high-frequency trading

John Spoto is the founder and principal of Sentry Financial Planning, LLC. He specializes in advising individuals, families, professional practice and small business owners. Sentry has offices in Andover and Danvers. Visit sentryfinancialplanning.com or call 978-475-2533.

The American public has long viewed the financial securities industry and the institutions that regulate it with suspicion. In the past 13 years, confidence in the markets has been further undermined by two "once-in-a-lifetime" market declines that inflicted extensive damage on the nest eggs of American workers and retirees.

Add to that the wave of improprieties, recklessness and outright corruption perpetrated by some of the nation's largest banks, brokerage houses and hedge funds and it's no surprise that many investors view the financial markets as an insider's game.

"Flash Boys," Michael Lewis' provocative new book, may deliver another blow and re-ignite the debate about fairness in our financial markets. The upshot is that the U.S. stock market, the symbol of global capitalism, is "rigged" by a small group of traders, hedge funds and banks, who are aided and abetted by the stock exchanges to enrich themselves at the expense of ordinary investors.

Lewis focuses on the practice known as high-frequency trading, an umbrella term for a wide range of strategies that employ lightning-fast computers and complex instruction sets called algorithms to scour the markets for minute price discrepancies. When identified, the computers act on those discrepancies instantaneously and in quantities that can total tens of millions of shares per day.

High-frequency trading is the natural evolution of the application of computer technology to securities trading. It was further advanced by the 2005 SEC regulations designed to weaken the power of the New York Stock Exchange and NASDAQ by increasing the number of public exchanges from two to over a dozen.

While stimulating competition, the regulations also unleashed a technological arms race among traders willing to spend millions of dollars to garner a millisecond advantage over the competition. Worse, some traders use their technological acumen and preferential relationships with the exchanges to take advantage of less cunning rivals by employing a predatory practice known as front-running.

Front-running enables traders to exploit regulatory loopholes, receive information

ahead of others and then to trade on that information profitably and with incredible consistency. Some might characterize it as the perfect scam because although, in aggregate, the traders make billions virtually risk-free, the individual amounts on each trade are so small that others never take notice.

Despite the headline-grabbing attention, however, many high-frequency trading strategies are neither new nor nefarious. Most simply serve as "market-makers" in the same way that humans did on the floors of the exchanges just a few years ago.

In basic terms, market-makers are intermediaries between buyers and sellers whose purpose is to maintain a smooth-functioning market and earn profits based upon a fraction of the difference between the buy and sell price. Both the professional and average investor have benefited enormously from those forms of high-frequency trading that have improved market efficiency and driven down transaction costs.

At best, high-frequency trading may be positive to the market. At worst, it poses serious operational risks. Its technological complexity makes it nearly incomprehensible to humans. Therefore, it's almost impossible to prevent or reverse a systemic breakdown.

On May 6, 2010, the market plunge known as the Flash Crash exposed the vulnerabilities of the U.S. stock market to algorithmic trading. On that day, the Dow Jones Industrial Average suddenly dropped by nearly 1,000 points, then almost immediately reversed itself. Although securities officials did not blame high-frequency trading directly, they observed that once the decline began, many of these traders simultaneously withdrew from the market which further accelerated the slide.

"Flash Boys" is an interesting read with a strong and appealing populist message. The real danger, however, is that some investors may take this idea of a "rigged" system too far, convince themselves that it is impossible to get a fair shake and avoid the financial markets entirely. Rather than resorting to such extreme measures, it would be wise to distinguish between hype and fact, as well as trading versus investing.

We have known for decades that the financial markets are not a level playing field for short-term traders. Big players like hedge funds and investment banks have access both legally and illegally (through company insiders) to market-moving information before the investing public. These "early peeks," combined with the use of sophisticated technology, allow them to move in and out of individual positions quickly and profitably. In this realm of trading, it's delusional to think the small investor can compete successfully. Sensible investors understand that this activity is speculation, not investing, and steer clear of this loser's game completely.

Rational investors recognize that the way to build long-term wealth is through long-term investing, using a mix of stocks, bonds and cash that is consistent with their goals. They also understand that over the long term, markets grow and generate gains because the underlying economies and individual companies are growing in order to serve the world's demand for their products and services. The long-term growth trends of the U.S. and global economies provide smart investors with a level playing field on which they can successfully compete with the world's most sophisticated investors.

Lewis' "Flash Boys" provides advocates and critics of high-frequency trading a public forum to argue the benefits and dangers of the practice. More importantly, however, the high-profile attention the book has received has intensified the regulatory scrutiny of high-frequency trading. As a result, the SEC, FBI, DOJ and the New York Attorney General's office all are pursuing investigations into high-frequency trading, including front-running and other related practices.

Every U.S. citizen, corporation and financial organization has a powerful incentive to ensure that our nation's capital markets promote the fundamental principles of fairness, transparency and efficiency for the benefit of all market participants. The encouraging fact is that, despite the obstacles that exist, the U.S. equity markets remain the gold standard for the world. NOB

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