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High-frequency traders slowed by headwinds

By Hal Weitzman in Chicago and Telis Demos in New York

When it opens next year, the 428,000 sq ft "co-location" facility will allow traders to place their computers next to the exchange's matching engine, shaving a millisecond off trade execution times that are already measured in tiny fractions of a second. Traders will, in industry parlance, benefit from the "lowest latency" available.

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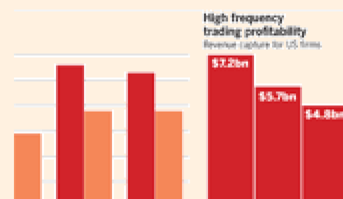

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The facility is a powerful symbol of how high-frequency trading – in which computers trade automatically using algorithms at speeds faster than people can match – is reshaping the world of finance and how exchanges are doing their utmost to capture the business.

Yet, while new and cheaper technology has enabled ultra-fast traders to grab greater market share, the cost of being the very fastest has been rising, to such a degree that only very big or highly specialised firms can afford to compete in the race to cut trading times by ever-smaller fractions of a second.

Just a few firms, such as Chicago-based Getco, have deep enough pockets to stay ahead of the pack. For the rest, the importance of speed has begun to diminish. Most HFT traders have become less interested in getting deals done as fast as possible than in developing profitable strategies that predict at what levels the markets are likely to be trading.

"We are seeing some high-frequency traders becoming old-fashioned quants," says Jose Marques, head of global electronic equity trading at Deutsche Bank. Quant funds traditionally use computers to look for price patterns in trading.

A natural development from the move since the 1980s from the open-outcry trading pits to electronic, screen-based trading, high-frequency trading (HFT) has come to play an increasingly dominant role in financial markets. It comprised more than 60 per cent of shares traded in US equity markets in 2009 and makes up much futures trading as well as a smaller proportion of the options market.

The cost of launching a high-frequency strategy has fallen from more than $1m to $200,000 or less, says Jayesh Punater, chief executive of Gravitas, a trading services firm for start-up funds. Cloud computing has cut the costs of storage and linkage. NYSE Euronext has started offering virtual co-location services.

"Once only certain people could afford a Ferrari. Now it's available to everybody," Mr Punater says.

But, as trading has become faster, opportunities to make money using speed alone are drying up. Making a profit from the difference in speeds between trading systems is now very difficult with many funds making the same trades and exchanges upgrading their technology.

Rajesh Nagella, head of algorithmic products for Europe at Citi, says: "There is already overcapacity in the speed game." At the same time, trading by small retail investors, the most profitable to trade against since these quotes can be quite far from expected prices, has been light. There has been a net outflow of $16bn from US equity mutual funds this year to the end of June, according to the Investment Company Institute.

The retail business that remains is also increasingly captured by institutional marketmakers such as Knight Capital, or by big banks such as Citigroup.

"HFT is cannibalising itself, since it is driving out of the market the very traders it needs to feed off," says Karim Taleb, of Robust Methods, a New York trading firm. In response, most traders are already turning to other strategies less dependent on speed.

Increasingly, they are investing in technology that enables them to try to predict where markets will move. Cameron Smith, general counsel at Quantlab, a proprietary trading firm, says: "The reality is you need to have some sort of model that sees something that others don't."

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Traders have also moved further into agricultural commodities and metals futures markets.

Some firms have indeed become more like 'quant' funds, leaving their computers to find patterns in trading, while investing more in human research – the judgment and experience of strategists – to obtain an edge. Ultimately, that could mean trading times slowing in mature markets over the coming years: from microseconds, to minutes, hours, and even days.

Additional reporting by Jeremy Grant