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Snapshot

High-frequency trading on regulators' radar

High-frequency trading is one of the biggest developments on global share markets since tickertape machines were replaced by computers. While traders and regulators argue the merits of the trend, the challenge for private investors is to understand what it means for them.

High-frequency trading – or HFT for short - uses powerful computer algorithms and high-speed cable networks plugged directly into exchanges' computer systems to exploit small price differences.

Critics say this has the potential to manipulate the market while supporters say it results in greater market liquidity and lower fees. The truth probably lies somewhere in between.

On any given day HFT accounts for more than half the turnover on the New York Stock Exchange. There are no reliable figures for the Australian market but it is estimated to be much less than that, as the graph on the following page shows.

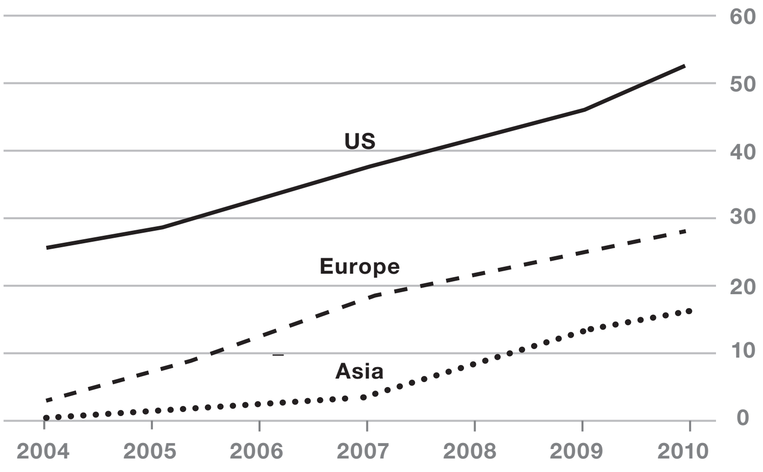
High speed, high volume, low margin

High frequency traders make money by moving millions of shares a minute, aiming to earn a fraction of a cent on each share traded. The sheer volume and speed of the trades, executed in milliseconds, is why ordinary investors can be left flat-footed when computers malfunction or the algorithms are faulty.

This is what happened during the so-called 'flash crash' of May 2010 when the US sharemarket plunged 10 per cent in minutes, bringing a shadowy corner of the market into the open.

Controversy around high-frequency trading has simmered ever since but it recently reignited following the release of the book Flash Boys by Michael Lewis. He claims high-frequency traders have rigged the market at the expense of investors.

The head of the Australian Securities Exchange, Elmer Funke Kupper says regulatory settings and structural differences between Australia and the US mean that concerns about the practice are not relevant here. But not everyone is convinced. Industry Super Australia has accused high-frequency traders of skimming $2 billion a year from local investors.



Source: The Economist http://www.economist.com/node/21547988

Increased regulation

Regulators have begun to respond to the trend but a comprehensive and co-ordinated response will take time. The US Securities and Exchange Commission is investigating the practice amid accusations that it is little more than insider trading.

Closer to home, the Australian Securities and Investments Commission (ASIC) is concerned that high-frequency trading has the potential to undermine trust and confidence in the market.

ASIC has threatened to introduce a pause on trades for half a second before being executed. This has been introduced successfully in the US by the IEX exchange in an effort to remove the speed advantage exploited by high-frequency traders.

ASIC also has its eye on so called "front running", where high-speed traders test the market to see what price buyers and sellers will accept then jump in ahead of them with large transactions.

The human touch

The one advantage mere mortals have over computers is judgement. If a company's share price plummets then rebounds faster than a bungee jumper, the cause is more likely to be a computer glitch in a remote trading room than any fundamental problem with the company.

Extreme volatility is a feature of modern financial markets and is probably here to stay. But the challenge for investors is the same today as it was decades ago.

If you focus on the fundamental value of an investment, diversify your holdings and ignore the swings and roundabouts of daily price movements, you will reap the rewards in the long run.

Along the way you may even profit from market fluctuations by picking up quality stocks that have been dumped by traders who focus on price not value.

If you would like to discuss any of these issues in light of your investments, don't hesitate to contact us.

Crest Financial Services

Newcastle: Level 1, 116 Darby Street NSW 2300
East Maitland: 97 Lawes Street NSW 2323
Nelson Bay: 1/67 Magnus Street NSW 2315

P 02 4929 2552
E newcastle@crestfs.com.au
W www.crestfs.com.au