An Automated Revolution

Rather than killing jobs on the trading floor, it may create new ones, writes Steve Shaw.

An automated revolution has been underway for some time in the world of equity trading and it's been changing the shape of the entire industry.

"CNBC still reports live from the floor of the NYSE to preserve an outdated illusion for the public — the reality is the vast majority of the trading is now done by computers," Tradebot, a leading high-frequency trading (HFT) company in the US, touts on its own website.

New tech-driven trading approaches, particularly HFT, are driving the demand. As our readers know, HFT uses sophisticated computer programmes and automated algorithms to analyse market data and capitalise on trading opportunities, which are usually only available on a short-term intra-day basis. They range from well-resourced bank proprietary desks and hedge funds to a couple of guys operating out of an airless room. Often they arbitrage index or statistical anomalies, as well as take directional views. HFTS can create market volatility, but on the other hand they also supply liquidity.

Last year, automated trading accounted for more than 70% of equity transaction volume in the US. HFTs such as Getco, Tradebot Systems and RGM Advisors typically account for 5% to 10% of all US stock market trading volume on any given day.

It's also gaining traction in Asia. Asian exchanges have some technological catching up to do to facilitate greater volumes of electronic trading through direct market access (DMA), but the Tokyo Stock Exchange's adoption last year of a new and much faster trading platform saw high frequency trades grow to 30% of the market from 10%. The Sydney and Singapore exchanges too are gearing up for more HFT, which is being touted by some as "the next wave" for Asia's capital markets. Much attention is focused too on China and India although the equity trading rules and regulations in both markets are complex.

Yet, clearly there is still a role for the traditional sales-client relationship. Institutional and retail investors alike can benefit from a phone call from a salesman with good trade ideas, accurate flow information or, quite simply, a bit of gossip.

Exchange-traded funds

Another tech-driven relatively new player on the block that is changing the industry in the West are exchange-traded funds (ETFs), which are cost effective, flexible and an opportunity to diversify a portfolio quickly and easily. Because an ETF tracks an index without trying to outperform it, it incurs fewer administrative costs than actively managed portfolios.

Even before the onset of the global financial crisis, the ETF industry had been growing strongly. By the end of 2010 ETF industry assets in the US had reached a record $995 billion. This was the fourth year in a row where net inflows exceeded $100 billion. As investors have become more risk-averse in the wake of the global financial crisis, ETFs have continued to gain further traction with all types of investors:

"As awareness of core benefits of ETFs grows, they are becoming the preferred choice of a growing number of institutional, professional and retail investors," said Tom Anderson, global head of ETF strategy and research at State Street Global Advisors.

There were more than 250 ETFs listed on 15 exchanges in the region as at August 2010, with assets of more than $70 billion — the number of listed products in Asia has increased by nearly 200% since 2007. But compared to the West, it's still a nascent industry in Asia.

One of the bigger reasons for ETF's not taking off in the Asian region is the risk profile of Asian investors: they are typically far more likely to wish to seek leveraged products and platforms.

"Asian investors general levels of risk tolerance allow them to chase higher yielding instruments and hence are not inclined to embrace the concept of diversification so central to the very fabric of what all current ETF offerings in the region deliver to market participants," said David Rabinowitz, head of direct execution services, Asia for UBS.

A NEW MARKET LOOK?

So what would happen if high-frequency trading and ETFs really took off in Asia -- would they cut into low-touch trading volumes, which depend on relationships, conversations with clients and the expertise of the traders and analysts?

Not likely, say industry specialists. Relationships matter immensely in Asia, and the hunt for liquidity and sourcing of it is what remains important. Best execution comes in many forms, electronic trading is shaping it in one way with low latency, smart order routing and dark crossing capabilities, but it is not necessarily the end game, say specialists.

So even if ETFs grow in use, the traders will still be in demand. And banks will likely have to go on a hiring spree – in their compliance department. It seems almost a given that the regulatory environment for equity trading will become more complex in the years ahead. As the rules and regulations become more onerous, more people might be needed in middle and back offices to understand them and ensure the firm's adherence to them.