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HFT Nightmare Gets Some Validation, But Only If You're a Whale

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To critics, high-frequency traders harm other investors by sniffing out their strategies and completing the juiciest trades first. New academic research from the Netherlands suggests naysayers have it at least partly right.

Large investors such as mutual funds and hedge funds break up their big stock trades into smaller pieces and execute them over the course of minutes or hours -- an attempt to disguise their plans and avoid driving prices away from them.

When the large investor's first slices are traded, HFT firms act as passive market makers, selling when the whales are buying, and buying when they're selling, according to a new paper from VU University Amsterdam's Vincent van Kervel and Albert J. Menkveld. In other words, they simply facilitate transactions for others.

But if the big investor keeps pumping orders into the market for hours, HFT firms switch roles: They start mimicking the whale's trades, making it more costly for them to buy or sell, according to the paper.

High-frequency traders "have no ability to detect initially that there are large orders coming into the market," Menkveld said in an interview. "But when it lasts long enough and it's persistent, they turn around and go with the order."

The two VU University Amsterdam professors examined 5,910 trades of Swedish stocks placed by four large investors in January 2011 through March 2013, including information on how 10 leading European HFT firms behaved while those trades were executed.

‘Flash Boys’

Michael Lewis helped spur more than a year of soul-searching in global markets with his 2014 book “Flash Boys,” which argued that HFT firms armed with powerful computers and the fastest connections to exchanges were picking off other investors’ trades. The paper from van Kervel and Menkveld suggests HFT firms do sometimes crowd into trades first identified by large investors -- meaning the whales get worse prices for their trades -- but not immediately.

“If I put in analysis and I find out that a stock is trading at a price that is too low and the company deserves more capital, but with the very first order I send to the market everyone is jumping on it and immediately it reaches the new fundamental price, I have no incentive to do something that’s valuable to society,” Menkveld said.