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FINANCIAL TIMES

High-frequency traders battle to make big returns

By Jeremy Grant
Published: September 9 2010 20:13 | Last updated: September 9 2010 23:42

As debate unfolds in the US and Europe about the runaway growth of "high-frequency trading" a new question has arisen: is it really generating huge profits for the little-known groups that are driving it?

Critics of high-frequency trading, which uses computers to trade in and out of assets faster than the blink of a human eye, argue that markets have benefited little from it.

They worry about the pervasive use of algorithms to drive trades, a practice seen by many as contributing to the chaos of the "flash crash" in US share markets in May, when the Dow inexplicably tumbled hundreds of points in minutes only to rebound sharply.

They suspect that some high-frequency strategies are designed to reap profits for traders at the expense of others in the markets.

High-frequency trading groups have rejected such accusations, pointing out that, while there may be some traders who engage in questionable practices, the majority of companies provide useful liquidity and help to narrow bid-ask spreads for all investors.

Such companies are all privately held and never reveal financial information. But it is possible to get a glimpse of how much of a money spinner high-frequency trading, or HFT, is from the annual report of Optiver, one of the largest players.

Members of the Principal Traders Group	
Lobbying group for high-frequency traders	
Allston Trading	Kottke Associates
Atlantic Trading USA	Marquette Partners
Bluefin Trading	Nico Holdings
DRW Holdings	Optiver US
Eagle Seven	RGM Trading
Endeavor Trading	Spot Trading
Geneva Trading USA	Sun Trading
Getco	Tibra Trading America
Hard Eight Futures	Tradelink
HTG Capital Partners	Traditum Group
IMC Chicago	WH Trading
Infinium Capital Management	XR Trading
Source: Futures Industry Association	

Being based in the Netherlands, Optiver must file a financial report annually to the Dutch chamber of commerce. Its 2009 report reveals that the group, which employs 600 people globally, made just €6.3m. Industry insiders say that Optiver made over €200m the previous year.

On Thursday, Optiver said that

its chief financial officer, Edwin van de Ven, had resigned. It said this had nothing to do with the financial performance of the company.

Even allowing for the ravages of the financial crisis that are likely to have depressed its 2009 results, Optiver's profits are hardly a sign that the sophisticated traders who work at such companies are making fortunes. Rather, they suggest that HFT is becoming a fiercely competitive business, where profits can be far from easy.

Moreover, some industry experts suggest that HFT's best days may be behind it as a proliferation of groups intensify competition and recent unfavourable conditions in important markets make it harder for many trading strategies to work.

Justin Schack, director of market structure analysis at Rosenblatt Securities, says: "I think the peak of profitability and market share is behind us. It is clearly related to the crisis, where volumes and volatility surged to record levels and the trading by other market participants receded.

"But now volumes have declined and the opportunities for HFTs are fewer than they were. I think they are making quite a lot of money but it's not as if they are shooting fish in a barrel."

A report into high-frequency traders published in July by Northwestern University's Kellogg School of Management said that, while such traders had been portrayed as "making tens of billions of dollars from other investors", the 26 groups studied had made a combined $3bn a year, based on $30,000bn traded annually.

"Profitability varies substantially from day to day, even after smoothing out day-to-day fluctuations," said Jonathan Brogaard, the report's author.

HFT is not restricted to companies such as Optiver and US rivals Getco and RGM Advisers, all members of the Principal Traders Group, a recently formed lobby group. It is also carried out by hedge funds and Wall Street banks such as Goldman Sachs, which have arms that deploy strategies that fit into the HFT category. Banks' profits from such trading often eclipse what groups such as RGM Advisers make, industry experts say.

The immediate problem for all high-frequency traders in equity markets, where HFT accounts for over half of volumes in the US, is that trading volumes have slumped. Volatility, on which many HFT strategies thrive, is low.

The chief executive of one US-based high-frequency company, who declined to be identified, said: "The environment right now with low volumes and relatively low volatility is relatively challenging for HFT. It is not as profitable as many assume it is."

A deeper problem is that many HFT strategies rely on having the most up-to-date technology able to carry out sophisticated arbitrage-style trades between asset classes to ensure companies are able to exploit opportunities before rivals. That requires constant investment in innovation. Yet systems can quickly become obsolete.

Jesper Alfredsson, vice-president of product management at Orc Software, a trading technology company, says: "It's a high-risk business depending on what type of HFT you are doing. With latency [speed]-sensitive strategies you never know because tomorrow there might be someone who’s faster and it doesn’t matter that you just invested $20m in your system.”

All this may help to explain why high-frequency trading companies are finding the going increasingly tough in the US and Europe and are shifting their focus to Asia.

There, trading is only starting to fragment between exchanges and competitors. High frequency traders like fragmented markets because they can trade between rival venues, exploiting differences between their trading systems and tariffs.

Steve Edge, principal at Asiaetrading, a website which follows trading in the region, says: “More people are coming out here. This is where the growth is.”