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In Pursuit of Value

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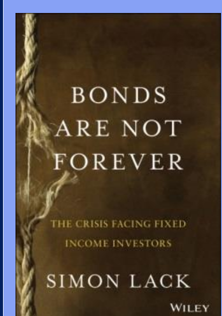

Flash Boys

Michael Lewis is a great writer. I have read most of his books from *Liar's Poker* on, and many essays that he has written over the years. I even read and enjoyed *MoneyBall*, his description of how the Oakland A's baseball team used statistics to uncover hidden talent; if a book on baseball can retain a reader whose sports interest is almost exclusively English football, it must be well written.

Flash Boys is a good read, but beyond that it must be Lewis's most impactful book (although Salomon's former CEO Jon Gutfreund may disagree since in discussing Liar's Poker with Michael Lewis he apparently said, "Your f*** book destroyed my career, and it made yours."). While we already knew that High Frequency Trading (HFT) has in recent years come to represent a substantial part of equity volumes, Lewis illustrates through market participants the patent absurdity of the current market structure. The book opens with the story of how $300 million was profitably invested to bury a dead straight fiber optic line from New York to Chicago (thus shaving tiny fractions of a second off order transmissions and facilitating arbitrage of slower orders), elegantly illustrating one winner in the zero-sum game. Even more startling was the discovery by Brad Katsuyama (then of Royal Bank of Canada) that HFT firms were front running his orders. After much dogged research and detective work, Brad figured out that the market's decentralized structure resulted in his orders reaching various liquidity pools at different times, allowing the algorithms used by HFT firms to exploit the time gap by using information gained at the closest exchange to get in front of the order as it traveled farther afield.

Today's Stock Market - No Buttonwood Tree Here*

Such differences are measured in hundredths of a second; yet while invisible to humans, trading algorithms are well able to slip in the way of a market order and gain a penny here, a penny there. It is obviously front running, which under laws written before HFT was contemplated is illegal when carried out by humans. The subsequent investigations announced following the publication of Lewis's book (some of which were apparently already under way) will show us whether the owner of a front-running algorithm is as culpable as a broker doing the same thing the old fashioned way.

Once you grasp the distortions caused by all this, and perhaps even grudgingly admire the intellect so effective in its misdirected pursuit of structural inefficiencies, surely the most obvious question is how this all happened in the first place? The quaint prism through which we view financial markets as efficient reallocators of capital may seem outdated in describing today's equity market, but nonetheless dozens if not hundreds of regulators and other market participants have collectively presided over and built a system that is patently not doing what the rest of us imagined it should. It's easy to attribute this to the inevitable advance in IT, but personally I think one glaring problem was the conversion of the NYSE to profit-making status. The premium rent charged HFT firms to locate their computers physically in or next to the exchanges (so as to shave more of those milliseconds) always sounded suspicious; an exchange run as a public utility would probably have considered the public interest in such an arrangement before aiding those few who profit from the higher transaction costs of many.

Then there's the payment for order flow. Apparently some brokerage firms have clients whose trade execution is sufficiently inept that it's worth paying for the chance to trade with them. Part of the appeal

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

comes from the ability to direct orders to "dark pools" which are seemingly created for HFT firms to scalp an extra penny many billions of times over the course of a year. The irresistible analogy is with a casino offering inducements to its biggest punters. But the stock market isn't meant to be a casino. The fact that the apologists for all of this invariably make their living from the current state of affairs simply reinforces the justifiable sense of wrong felt by so many. More volume doesn't necessarily equal greater liquidity, and even some hedge fund managers (such as David Einhorn) are crying foul.

So in recent years we've witnessed a suspension of sound judgment by the people who run the exchanges through which investors seek to grow their funds ahead of taxes and inflation, and of some of the brokerage firms who are not necessarily seeking best execution on behalf of their clients. How is an investor supposed to respond?

One solution is to trade less, and it doesn't take the existence of HFT firms to render this sound advice. The constant media focus on short term market direction is a response to the desire of so many to trade profitably. Stocks are so cheap to trade (at least, excluding the HFT tax) that many individuals do use the market as a casino, and this has helped create the HFT opportunity. Interactive Brokers for example discloses the percentage of its retail FX accounts that are profitable each quarter as required by the National Futures Association, and the money makers are always fewer than 50% of the total. Taxes take a further toll, since the slothful trader pays long term capital gains tax rather than ordinary income and perhaps doesn't pay it for a long time either.

Another point is to recognize the inherent conflict of interest faced by the broker-dealer (B-D) compared with the financial advisor. Of course there are many honest brokers in the industry and I count some of them among my friends. If you invest through a broker I hope you've found one of the good ones. At its worst, the B-D wants you to trade often (because your commissions are his revenue) and, if selling you something from inventory (i.e. acting as principal) wants you to pay a high price. Neither is going to make you richer over the long run. Financial advisors have a much clearer alignment of interests with their client since both parties simply want good investment outcomes for the client. Advisors that invest alongside their clients reinforce this alignment. Payment for order flow is one example of brokers unsuccessfully juggling profitability with their clients' best interest. Charles Schwab, where we custody most of our assets and through whom we execute our trades, has come out strongly critical of HFT activity. Founder "Chuck" Schwab described it as "a cancer" in an April press release. I'm happy to report that Schwab doesn't run a "dark pool" and doesn't profit from selling their order flow (though they're not totally beyond reproach, since *Flash Boys* noted that in 2005 they did enter into such an agreement with UBS). But Schwab is more clearly on the right side of this issue than many.

Using limit orders rather than market orders also provides some protection. We almost always enter our orders using limits; we're willing to buy at $25, but not at $25.05. Cheaper is less risky for most investments, so we pick a price at which we're comfortable and submit the order. Values change far less than prices, and if we miss the trade, well, there will always be another one. Entering a market order to buy at the "best" available price assigns unreasonable urgency to the transaction and, as we've seen, now provides a juicy opportunity to others. No doubt limit orders can also be gamed, but the highly rapid HFT strategies seem more likely to act as sand in the gears of investing activity than to cause significant repricing of individual equities.

The E.U. (notably excluding the UK) has long been a proponent of a transaction tax, dubbed a Tobin Tax after the economist credited with the idea. How ironic but appropriate that in America we have seemingly implemented our own transaction tax and yet ensured that it's administered by the private sector.

*The founding members of the original New York Stock Exchange are said to have gathered beneath a buttonwood tree in lower Manhattan.