Discussion of: “Do retail traders suffer from high frequency traders?” by Malinova, Park and Riordan.

Abel Rodriguez
University of California, Santa Cruz.
Congratulations to the authors for a very relevant and interesting paper!
Summary

• Very relevant paper, the topic is clearly in the public eye.
• Three types of investors considered:
  • Intensive algorithmic traders (iATs).
  • Retail traders
  • Institutional traders.
• Outcomes of interest:
  • Effective spreads. (Bid-Ask)
  • Market impact. (Adverse Selection.)
  • Realized spreads. (Liquidity.)
  • Intraday Returns.
• At some level, the results are not very surprising. However, it is important to have empirical evidence to support the theory.
Data

• Study focuses on the months immediately before and after the change in fees.
  • Authors acknowledge that data for the month before the change is affected by traders preparing for it.
  • They also acknowledge that the behavior of traders during the month after seems to be driven by uncertainties in fee size.
• Both of these periods are arguably transient states.
  • After a few months, iATs are likely to learn what the optimal level message, which is likely to be higher than the one observed in April 2012.
• I would argue that comparisons should be based on data from steady states.
  • Do the results hold after iATs have “learned” the size of the fees they paid.
• Only a subset of all traders in the dataset are used.
  • Although they represent a large percentage of both messages and trades, I wonder if the subsample used is representative?
Methodology

• The authors use instrumental variables are used to get a causal relationship.
• Change in policy is used as an instrument
• Is this a valid instrument?
  • The change is policy is correlated with activity level: I believe this is true for iATs
  ✔
  • Not sure this is true for other market participants (institutional/retail), though ...
  • The change in policy must affect the dependent variable (e.g., the observed spread) only through its effect on iAT activity of the firm under consideration. But the level of trading activity of other firms are also likely to affect the spread!!!! ❌
  • A multivariate 2SLS that jointly models all dependent variables of a given type as a function of the iAT activity of all firms would seem more appropriate.
Other minor comments

• Why was FFH dropped from the dataset? (I did not see why price >$400 would be a good reason).
• Why was treated as a fixed effect? A random effect would seem a better idea. More sophisticated structures could also potentially be beneficial.
Is cost of individual trades the right question?

• We should care about the total cost to society of running a market.
  • Total cost involves the cost of running the market, the cost of inefficient capital allocation, the cost that participants need to pay, impact of financial markets on the wider economy, etc.
  • Costs to individual trades are just a small piece of the puzzle.
    • Lower price per trade might encourage more trades, leading to a higher total cost of trading for them.
    • Is this extra cost “improving” the market, or just benefiting certain participants at the expense of others?
    • Is there such a thing as “too much trading”, i.e., trades that do not contribute to more efficient capital allocation or more stable?
Is cost of individual trades the right question?

• Formal vs. informal market makers:
  • The participation of HFTs in the market reduces spreads, which squeezes formal market makers and institutional investors trying to trade large blocks of holdings, but *might* benefits retail investors (again, as long as they do not respond by trading more).
  • However, informal market makers can leave at any time! Effect on market stability needs to be accounted for to determine the societal cost.
Thank you!
Hypotheses/Results

• After the change in the regulatory fee
  • Traders that employ message-intensive strategies reduce their quoting activities.
  • The market-wide quoted bid-ask spread widens.
  • Traders who use market order pay higher effective spreads.
• After the change in the regulatory fee, the market-wide adverse selection component of trading costs increases.
• After the change in the regulatory fee,
  • Fast, liquidity providing traders experience an increase in adverse selection.
  • Slow traders who trade with limit orders do not experience a change in adverse selection.
Is cost of individual trades the right question?

- Market makers require compensation:
  - Algorithmic traders acting as Informal market makers draw part of that compensation by front running “slow” investors.
  - Arguably this has reduced the cost of trading for retail investors.
  - However, lower costs also encourage these retail traders to trade even more.
  - So overall cost to investors is not necessarily lower.
  - Furthermore, is there such a thing as “too much trading”?
  - Is the additional trading leading to more efficient allocation of capital in the economy?

- Total cost to society of running the market involves cost of inefficient capital allocation as well as total cost associated with traders themselves.
“Good” liquidity providers?

• Are iATs a viable replacement for formal market makers?
  • Informal market makers can leave the market at any point: implications for stability? This has to be taken into account when discussing the societal cost of the system.
Summary

• Very relevant paper, the topic is clearly in the public eye.
• At some level, the results are not very surprising. However, it is important to have empirical evidence to support the theory.