
ARE HIGH-FREQUENCY TRADING FIRMS GOOD OR BAD FOR INVESTORS?

Jeremy Schwartz — Global Chief Investment Officer

04/04/2018

On last Friday's "Behind the Markets" podcast, we had a great discussion focused on [high-frequency trading \(HFT\)](#)—a topic that generates emotional reactions among the investor community, with many HFT firms viewed as predators picking off retail and institutional investors alike. The trading ecosystem can be opaque and confusing, and we had a balanced discussion on elements that are good and bad for investors.

Our two guests were Dave Babulak and Alex Sadowski. Babulak founded Blink Trading and grew Blink to 12 people before selling it to Getco in 2002. Babulak was at Getco for 10 years during the electrification of markets, and he brought market-making principles to the trading screens and away from the trading pits and phone call orders. Sadowski was the deputy general counsel at KCG Holdings before it was bought by Virtu; he shared his views on the developments of electronic market making and how he transitioned from being on the legal team at the Securities and Exchange Commission to the legal team of Getco.

A Brief History of the Market-Making Community

Getco was one of the biggest trading and market makers in the United States; at its height, the company represented 20% of all trading volume on all U.S. exchanges.

In 2012, Getco and Knight Capital merged to become KCG Holdings, and KCG became one of the largest market participants until Virtu bought it in 2017.

- **Algos Run Amok:** We discussed how algorithm failures on August 1, 2012, led to Knight and Getco merging and other market incidents where algos were involved, such as the Facebook initial public offering (IPO), the BATS IPO and the flash crash¹.
- **Retail Investors' Liquidity Access:** Babulak discussed why he thinks today's liquidity environment for retail investors is the best ever—with the cost of execution as low as it has been.
- **The Move to Zero-Fee Commissions:** As we discussed commissions going down to zero, Babulak mentioned his reasons for becoming one of first investors in Robinhood, a free trading app that he remains very bullish about.
- **History of Payment for Order Flow:** The group discussed the incentive structure in the marketplace and the pros and cons of payment for order flow in providing liquidity.
- **The Dark Side versus the White Knight:** Depending on whom you ask, high-frequency trading can be either a benefit and liquidity provider or it consists of firms described as front-running other investors' orders. Babulak described a framework for evaluating if certain firms are good or bad, which is essentially if you are providing liquidity and thus selling an option for others to capitalize on. This practice would be providing a [bid and ask](#) that people decide to execute on which is value added to the marketplace. At his firm, 90% of his fills were customers choosing to trade with his quotes, so he sees that as value-added liquidity. Other firms were more mixed at 50/50 liquidity provider/liquidity remover, and some firms are 10%/90% as liquidity removers/providers.

- **Amateur Markets in Crypto?:** We also discussed market structure of cryptocurrencies, how the future probably will be more like regular equity markets and how the blockchain is likely to improve efficiency for custody firms over time.
- **Trading Lessons:** The first lesson for investors from Babulak is to use limit orders only. Stop-loss orders become market orders, and when volatility comes in the marketplace there is no guarantee you will have liquidity provided when you need it.

For those interested in learning more about the trading of markets and the liquidity ecosystem, with some also very useful business lessons provided by Babulak at the end, I encourage you to listen to this show.

¹A market event on May 6, 2010 where the Dow Jones Industrial Average fell more than 1000 points in ten minutes, the biggest such drop in history at the time.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

High Frequency Trading : A fast-speed, high volume trading program that uses algorithms to execute trades based on different market signals.

Bid/Ask Spread : This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.