

INVESTOR'S BUSINESS DAILY

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IBD SPECIAL REPORT INVESTMENT TOOLS

Institutions Getting Into Algorithmic Deals

■ TRADING

Trend leads to smaller transactions and softer impact on stock prices

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Program trading has been around for well over a decade. A hybrid — algorithmic trading — has garnered the attention of brokers and fund managers in recent years.

Algorithmic trading uses computer systems to automate buy and sell decisions for stocks based on preset rules.

The goal is to get the best price and often make or beat a particular benchmark return.

Some types of algorithmic trading formulas take large orders and divide them up into smaller parts to try to get the best price without forcing big moves in the stock's price.

Those on the sell side of the equity market — brokerages that sell stocks to clients — have long been at the cutting edge in using various program trading tools.

Those on the buy side — mutual funds, hedge funds and other institutional investors who invest in stocks — have been slower to embrace the new systems.

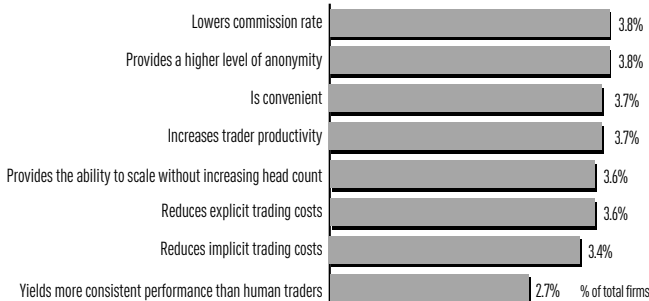
That's changing.

Adding Up

A survey earlier this year

Algorithmic Advantage

Investment firms use algorithmic trading because it:



Source: Financial Insights' survey of head equity traders at 60 of the top investment management firms, pension funds and hedge funds in the U.S. (survey was done for Banc of America Securities)

by Financial Insights and Bank of America Securities of 60 of the top buy-side investment management firms found that 67% used algorithmic trading.

It was most popular among large-cap fund managers, 60% of whom use algorithmic trading compared with 45% of small-cap funds and 40% of mid-cap funds.

But while more and more investment managers have the systems available, only 5% of all trades in the overall stock market are executed algorithmically. The study's authors estimate that number will grow to 20% by 2007.

Ian Domowitz, managing director and global head of research at Investment Technology Group, says the use of algorithmic trading has exploded in the past two years.

His company, which provides technology-based trading services to institutional investors and brokers, has long had systems that make trades based on

various volume-weighted criteria.

"But as the buy side has demanded more and more control over the orders and as price pressures have increased, the combination has promoted the growth of demand for these types of things," he said.

Algorithmic trading is often used to take advantage of periods of increased liquidity in a stock to try to get the best price.

Cutting Costs

"The current interest in algorithms comes from the fact that their purpose has changed," Domowitz said.

"Algorithmic trading as we talk about it today has to do with liquidity searching and getting the trade into the market in a computerized fashion to reach certain types (of returns)."

The funds and brokerages that use algorithmic and other program trading systems savor them because they cut their transaction costs by mechanizing part of the process and can help

them buy and sell stocks at a better price.

They also help traders be more productive.

"We deal with big institutional investors, and a (fund manager) might be handling 100 or 200 or even 1,000 stocks at a time," Domowitz said. "So you want to automate to let you figure out which (stock trades) require individual attention."

ITG's clients are a mixed bunch, but the majority are investment management firms such as mutual and hedge funds.

Peter Forlenza, managing director and global head of equities at Bank of America, says various factors have boosted the development and popularity of algorithmic trading.

It traces its roots to program trading systems for benchmark trading. The systems based trades on average price ranges set ahead of time were originally used for overseas customers who often weren't available during the hours the stock market was open in the U.S.

"Then people woke up to the fact that we can have the computer do this," Forlenza said.

Next came arbitrage trading — which involves traders trying to make gains based on short-term fluctuations in a stock's price.

That also contributed to the rise of algorithmic trading.

"What really got (algorithmic trading) to explode was

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the advent of statistical arbitrage trading and people running statistical arbitrage models, which take advantage of different short-term signals that computers could spot in the trading volume patterns,” Forlenza said.

The next step in the evolution was the advent of decimalization.

Along with algorithmic trading, that made it easier to split up trades into smaller chunks.

The combination has helped bring down the size of the average trade. According to data from the New York Stock Exchange, the average trade size on that exchange is 338 shares compared with 1,187 shares in 2000 and 2,082 in 1999.

In recent years, brokerages have come up with different algorithmic programs suited to different institutional clients depending on the trading needs and strategies of their particular fund or investment style.

“In order for your algorithms to be the ones used, you had to come up with different algorithmic strategies tailored to specific clients,” Forlenza said.

“A large-cap value manager will trade very differently than a small-cap growth manager at the same complex, so naturally those portfolios of stock are going to trade very differently.”

Despite all the bells and whistles, human decision-making is still a vital component.

“Algorithmic trading is still a means of execution, and now it’s become a core strategy,” Forlenza said. “But at the end of the day, brokers are still going to be valued for their advice and their knowledge and their capital.”

He added: “We have our traders operate algorithms, as opposed to the algorithms operating all trading. The machine can’t do it all. You still need traders who can understand patterns in the market and respond to them.”