Contents

Preface xiii

Part I An overview of trading and markets 1

1 Overview 3
1.1 Introduction 3
1.2 Fundamentals 5
1.3 Core execution methods 6
1.4 Institutional trading types 8
1.5 Electronic trading 10
1.6 Algorithmic trading 11
Types of trading algorithms 13
The evolution of trading algorithms 13
1.7 Direct Access Trading 15
Direct Market Access 15
Sponsored access 15
Crossing 16
Direct Liquidity Access 16
Direct Strategy Access 17
1.8 Comparing execution methods 17
Efficiency 18
Usability 19
Performance / Cost 20
Other reasons 21
1.9 How much are these execution methods used? 21
1.10 Fears and myths 22
Safety of algorithmic trading 22
Performance of algorithmic trading 23
Usefulness of algorithmic trading 24
1.11 Summary 25

2 Market microstructure 27
2.1 Introduction 27
2.2 Fundamentals 28
Market function 28
Participants 28
Liquidity 29
2.3 Market structure and design 30
Types of markets 31
Order types 35
Trading Protocols 35

Transparency 36
After-hours and off-market trading 37
Other important market design features 38
2.4 Trading mechanism research 39
Price formation 39
Price discovery / trade execution 40
Reporting, clearing and settlement 46
2.5 Transaction cost measurement and analysis 47
Cost measurement 48
Analysing the components of transaction costs 49
2.6 Summary 51

3 World markets 53
3.1 Introduction 53
3.2 Asset classes 54
Equity 54
Fixed income 54
Foreign exchange 55
Money markets 55
Derivatives 56
Other asset classes 57
3.3 Market structure 58
Inter-dealer markets 59
Dealer-to-client markets 62
Alternative markets 63
3.4 Global market trends 66
Electronic trading 67
Transparency 69
Accessibility 69
Centralisation versus fragmentation 70
3.5 Global market comparison 74
Overall size 74
Average daily turnover 75
Adoption of electronic and algorithmic trading 77
3.6 Summary 78

Part II Algorithmic trading and DMA strategies 81

4 Orders 83
4.1 Introduction 83
4.2 Market orders 84
4.3 Limit orders 85
4.4 Optional order instructions 88
Duration instructions 88
Auction/Crossing session instructions 89
Fill instructions 89
Preferencing and directed instructions 92
Routing instructions 92
Linking Instructions 95
Miscellaneous instructions 95

4.5 Other order types 96
Hybrid order types *96*
Conditional order types *98*
Hidden order types *100*
Discretional order types *103*
Routed order types *106*
Crossing order types *108*
Order-contingent order types *109*
4.6 Summary 112

5 Algorithm overview 115
5.1 Introduction 115
5.2 Categorising algorithms 116
5.3 Common features of algorithms 118
Algorithm parameters *118*
5.4 Impact-driven algorithms 119
Time Weighted Average Price (TWAP) *120*
Volume Weighted Average Price (VWAP) *123*
Percent of Volume (POV) *127*
Minimal impact *130*
5.5 Cost-driven algorithms 132
Implementation Shortfall (IS) *133*
Adaptive Shortfall (AS) *138*
Market Close (MC) *141*
5.6 Opportunistic algorithms 143
Price inline (PI) *144*
Liquidity-driven *146*
Pair trading *150*
5.7 Other trading algorithms 154
Multi-leg *155*
Volatility-driven *157*
Gamma Weighted Average Price (GWAP) *159*
5.8 Summary 160

6 Transaction costs 161
6.1 Introduction 161
6.2 The investment process 162
6.3 Pre-trade analysis 165
Price data *165*
Liquidity data *166*
Risk data *166*
Transaction cost estimates *167*
6.4 Post-trade analysis 167
Performance analysis *167*
Post-trade transaction costs *172*
6.5 Breaking down transaction costs 173
Investment-related costs *175*
Trading-related costs *176*
Summary *184*
6.6 Transaction costs across world markets 184

6.7 Summary 186

7 Optimal trading strategies 189
7.1 Introduction 189
7.2 Assessing the difficulty of orders 190
7.3 Selecting the optimal trading strategy 192
The efficient trading frontier 192
Choosing the benchmark 194
Determining the level of risk aversion 196
Choosing a trading goal 196
Determining the optimal trading horizon 198
7.4 Choosing between trading algorithms 199
Mapping algorithms to the efficient trading frontier 199
Factors affecting algorithm choice 203
Other requirements for trading algorithms 208
7.5 To cross or not to cross? 211
7.6 Market conditions during the 2007-09 financial crisis 213
7.7 A decision tree for strategy selection 214
7.8 Summary 217

Part III Implementing trading strategies 219

8 Order placement 221
8.1 Introduction 221
8.2 Price formation 222
Valuation 222
Models of price formation 223
8.3 Price discovery/Order matching 226
Continuous matching 226
Call-based matching 231
8.4 Order placement decisions 234
Signalling risk 234
Venue choice 235
Order choice 237
Order aggressiveness 237
Market factors affecting order placement decisions 238
8.5 Dealing with hidden liquidity 247
Spotting hidden liquidity 248
Estimating the probability of hidden liquidity 250
8.6 Estimating execution probability 252
8.7 Summary 254

9 Execution tactics 257
9.1 Introduction 257
9.2 Designing execution tactics 258
Impact-driven tactics 259
Price/Risk-driven tactics 262
Opportunistic/Liquidity-driven tactics 265
9.3 Algorithm selection 270

Factors affecting the choice of execution tactics 271
9.4 Summary 275

10 Enhancing trading strategies 277
10.1 Introduction 277
10.2 Forecasting market conditions 278
Predicting asset prices 278
Predicting trading volume 281
Predicting liquidity 287
Predicting volatility 288
10.3 Estimating transaction costs 292
Market impact 293
Timing risk 299
10.4 Handling special events 300
Predictable events 300
Unpredictable events 306
10.5 Summary 309

11 Infrastructure requirements 311
11.1 Introduction 311
11.2 Order management 312
Order entry 313
Order routing 316
11.3 Algorithmic trading 322
Infrastructure requirements for algorithmic trading 323
Designing an environment for algorithmic trading 326
Implementing trading rules 329
Testing 332
11.4 Other requirements 334
Clearing and settlement 335
Regulations compliance 335
11.5 Summary 337

Part IV Advanced trading strategies 339

12 Portfolios 341
12.1 Introduction 341
12.2 Portfolio risk 342
Portfolio volatility 342
Diversification 345
Decomposing portfolio risk 346
Portfolio risk measures 349
12.3 Transaction cost analysis for portfolios 351
Market impact 351
Timing Risk 352
12.4 Optimal portfolio trading 352
Additional goals for portfolio trading 354
Hedging 354
Minimising the overall portfolio risk 359

12.5 Portfolio trading with algorithms 360
Portfolio trading with standard trading algorithms 360
Tailoring algorithms for portfolio trading 363
12.6 Summary 367
Addendum A: Covariance 369

13 Multi-asset trading 371
13.1 Introduction 371
13.2 Multi-asset trading strategies 372
13.3 Utility strategies 374
FX cash trades 374
Covering short sales 374
13.4 Structured strategies 374
Principal protected notes 375
13.5 Hedging strategies 375
Hedging market risk 376
Hedging interest rate risk 378
Hedging derivative risk factors (the "Greeks") 380
13.6 Arbitrage strategies 383
Multiple listing/depositary receipt arbitrage 384
Basis trading 386
Index arbitrage 387
ETF Index Arbitrage 390
Option arbitrage 392
Futures and options arbitrage 394
Dividend arbitrage 395
13.7 Adapting algorithms for multi-asset trading 397
Factors to consider for multi-asset trading algorithms 397
Minimising risk 399
Trading algorithm choice 399
13.8 Summary 400

14 News 401
14.1 Introduction 401
14.2 Types of news 401
Macroeconomic news 402
Corporate news 403
14.3 The changing face of news 404
Digitisation of news 404
Digitisation of corporate reports/research 406
Changing sources of news 407
14.4 Computerised news handling techniques 409
News filtering 410
News association 410
News analysis 412
News interpretation 413
News mining 414
14.5 Market reactions to news 416
Reactions to macroeconomic news 416
Reactions to corporate news/announcements 423

Other factors which affect the impact of news 427
14.6 Incorporating news into trading strategies 432
Precautions for automated news handling 432
Potential news-based indicators 433
News-based algorithms 436
14.7 Summary 437

15 Data mining and artificial intelligence 439
15.1 Introduction 439
15.2 Data mining 440
Data mining techniques 440
Finding patterns/associations 442
15.3 Artificial Intelligence 448
Types of artificial intelligence 449
Predicting data and trends 455
15.4 Incorporating in trading strategies 461
Applying short-term forecast models 461
Generating trading strategies/rules/parameters 464
Back-testing 465
15.5 The future 468
15.6 Summary 469

Epilogue 471

Appendices 473
A Equity markets 474
B Fixed income markets 495
C Foreign exchange markets 504
D Money markets 509
E Derivatives markets 515
F Other markets 534

Abbreviations & Acronyms 543

References 545

Index 569