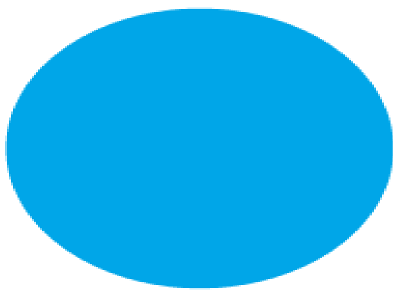

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Editorial: High-frequency trading insanity

In today's stock market, there are two kinds of trader.

One, the traditional investor, places a buy order based on a belief that a company will prosper and that its price will rise, or a sell order based on the opposite belief.

The other, the high-frequency trader, deploys massive computer capacity and complex algorithms to buy and sell individual stocks multiple times in a fraction of a second, all in search of micro-profits with each trade. This trader cares not a whit about a stock's fundamentals.

In a sane world, high-frequency trading would be a minor specialty at best. But in the bizarro world that Wall Street has become, such activity now makes up the majority of all trades. It is manufacturing risk while siphoning money and talent that growth-producing sectors of the economy need.
It has also sparked a technological arms race aimed at shaving milliseconds off each trade. New, more direct fiber optic cable routes have been laid between major trading cities, and now there are even serious proposals to position drone aircraft over the Atlantic Ocean to speed transmission times between New York and London.
And what does all this mean for conventional investors? Nothing good. Just gobs of needless danger.

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The biggest problem with high-frequency trading is that it greatly increases the chances of a major market crash. In 2010, the "flash crash" took the Dow Jones average down more than 1,000 points in a matter of minutes. Finding the cause — a single massive computerized trade made in error — took months.

Imagine, then, what might happen if the market started falling in response to a sudden event, such as an attack on Iran. The computers, which act on their own, would likely overwhelm the market with sell orders. Similar circumstances in 1987 caused a crash that took the Dow down 22.6% in a day and nearly crippled the entire financial system.

Today, the trade volume would be massively larger. Yet the regulatory response has been negligible, even as problems have continued. Just last month, a trading company called Knight Capital Group nearly collapsed after malfunctions in its computers sent the shares of 148 companies on wild rides.

Behind these events is a high-tech war fought among computer algorithms challenging each other for supremacy and unmindful of the destabilizing effect they are having. The growing concern they are causing was evident at a Senate hearing last week, and in a report by the Federal Reserve Bank of Chicago. Beyond the crash risk, these practices undermine the core purpose of markets, which is to raise capital in pursuit of enterprise, profit and economic growth.

That's not happening the way it used to. Even though the Dow is back above 13,000 and bond yields are low, investors have been pulling money out of stock mutual funds most of this year, according to the Investment Company Institute. And even sophisticated investors such as billionaire Mark Cuban say they're "terrified" about potential flash crashes triggered by high-frequency trading.

The traders argue that they add liquidity to markets that lowers transaction costs and eases dealing in thinly traded shares. There is some truth to this. But the negatives far outweigh the positives.

Next week, the Securities and Exchange Commission is holding a meeting to solicit ideas about what to do. Here's a simple one: Slap a small transaction tax on rapid trades, impeding the practice and returning markets to their core purpose.

That would be a big win for small investors, and the only people harmed would be those now putting everyone else at risk.