Algorithmic trading: Still an Asian conundrum

The onus lies with the regional institutions to take the initiative

By Bertrand Rassat*

Asia seems to enjoy a difficult relationship with algorithmic trading. It is now becoming a topic and regional institutions, buy-sides or sell-sides, have it as a requirement on their request for proposals (RFPs) for a new trading platform.

The appetite to learn more about algorithmic trading and to align their practices with Western execution norms is a strong driver, but other forces are at play that may pull them in the opposite direction.

The region is endemically conservative and cautious in its approach to new products; it is equally cautious to algorithmic trading, for which the benefits and usage are not often fully understood.

This duality is today reflected in the current usage of algorithmic trading in Asia.

Volume Weighted Average Price (VWAP) remains the overwhelming benchmark and probably the most used algorithm in the region – most agree it is better suited for liquid markets.

Also, the lack of pre-trade analytic functionality makes the analysis of a pertinent algorithm difficult to apprehend for regional institutions that do not have large exposure to global institutions and the regulatory constraints of Best Execution.

The regulatory void and the lack of a centralised enforcement authority do not create the right situation for local buy-sides to explore algorithmic trading.

This challenge primarily applies to Southeast Asia but not to Japan and Hong Kong, which are way ahead in terms of a learning curve.

This does not mean that algorithmic trading is less relevant in Asia than in the West; tactical trading algorithms, for instance, may be the right fit, as opposed to schedule-based algorithms, since they are better designed to navigate difficult markets and to trade less liquid instruments.

Bertrand Rassat

One example is a float and grab type of algorithm, which essentially pegs to the bid and takes the offer when it is below a certain price with a certain size.

This type of algorithm makes sense for markets that are less liquid and have wide spreads, which is the case with many of the regional markets.

For a buy trade, it sits a certain number of ticks above the first best bid and constantly adjusts itself so it's above the (now second) best bid. If someone joins on the bid, it will not go ahead, as it's already first in the queue. If someone comes into second best bid with a small size, it will not go ahead. If the offer comes below the GrabPrice with the GrabSize, it will take the offer.

This demonstrates that algorithms can be adapted to the dynamics of the regional Asian markets and that local players can benefit from those if they are properly used and understood.

The puzzling aspect of VWAP in Asia is that it was designed with the view that markets are liquid and not too volatile as opposed to Implementation Shortfall, which assumes that volatility risk is just as important as market impact.

It is a paradox as Asian markets include many emerging markets that are notoriously volatile and not very liquid.

So why is VWAP still so popular in Asia and in Southeast Asia?

One can argue that VWAP is fairly easy to implement. Again, at the other end of the spectrum, implementation shortfall requires a good grasp of the dynamics behind algorithmic trading and also involves assumptions and input from the user, such as risk aversion.

This input may make some traders uncomfortable given that they have a direct impact on the algorithm's performance whereas VWAP is purely based on a volume curve and does not require a market view beyond the timing of the VWAP itself.

The usage of algorithmic trading in Asia goes hand-in-hand with an understanding of the dynamics and benefits of algorithms.

To this end Transaction Cost Analysis (TCA) is a necessary stepping stone in the process as it will help traders to familiarise themselves with pre-trade analysis, which gauges the risk and the impact associated with certain trades, and is the most relevant tool to determine the type of algorithm that needs to be used in various trade scenarios.

TCA is critical for anyone who wants to understand algorithmic trading; it is intrinsically linked to algorithmic trading and a mandatory stage in its learning process.

However, and to come back to our initial argument, the rise of TCA was a by-product in the US and in Europe of the new market regulations. The need to justify Best Execution created the right conditions for the emergence of new technologies and TCA was probably one of its most visible outcomes.

Without regulations, TCA becomes a good-to-have tool that is no longer playing its educational role vis-à-vis algorithmic trading.

As a result, Asia is left in a no man's land where regional institutions are told to explore algorithmic trading without benefiting from an environment

Continued on page 41

WARNING: Unauthorised reproduction in part or in whole of this publication is in violation of copyright law.

had feared. The country's economy grew by 6.9% year-on-year, compared to the 7.7% growth seen in the June quarter and 8.4% in the earlier quarter.

"India was growing below potential for 2011 and perhaps for 2012 as well," says Alroy Lobo, chief strategist and global head, equities asset management at Kotak Mahindra Asset Management Co Ltd. He expected gross domestic product (GDP) to grow at 7.25%-7.5% in 2011-12 and believes the lagged effect of tighter monetary policy will have affected 2011's growth too.

Rising inflation has led to a tightening of interest rates and, taken together, both have affected industrial growth. Add to this the global economic worries and it is no surprise that Indian equities fell sharply last year. Inflation has been a key concern for policymakers as both food and non-food inflation increased markedly during 2011. The sharp depreciation in the value of the rupee, down by 15.6% to end-November last year, is another concern.

In October, wholesale price inflation stood at 9.7%, far higher than the Reserve Bank of India (RBI) comfort level of 5%. Worried by rising inflation and its effect on the economy, the RBI has been pushing up interest rates, which affects both consumers and businesses. Since October 2009, the repo rate has been raised by 375 basis points.

The consensus among fund managers is that inflation will be brought under control, mirroring the central bank's projection that interest rates would decline starting from December 2011. Provisional data on inflation for the week ended November 19, 2011 showed primary inflation down to 7.74% from the previous week's 9.08%, a significant improvement if

"The consensus among fund managers is that inflation will be brought under control, mirroring the central bank's projection that interest rates would decline starting from December 2011"

sustainable and reflected in monthly data as well.

Sankaran Naren, chief investment officer – equities, ICICI Prudential AMC, says that there are no structural problems and so he sees inflation coming down to 7% levels. "If we are able to create some more fiscal consolidation, I think the monetary side can see substantial easing."

Fund managers are hopeful that the government will take steps to lower the fiscal deficit. "The combined level of central and state government fiscal deficit is about 8%. We have to bring down both fiscal and current account deficit for long-term economic growth," says Puneet Pal, fund manager, UTI AMC.

In the fixed income market, players see interest rates peaking and RBI taking a pause. "Credit growth is coming down, deposit growth is now on par with credit growth. The global economy is slowing down. That could act as a positive trigger for RBI to take a pause on interest rate hikes," says A Balasubramaniam, chief executive officer, Birla Sun Life AMC. "High interest rates will start peaking in June. In a 12-month period, we see the rupee at 47-49 rupees to the US dollar," says Kotak's Mr. Lobo.

With regard to the stock market, fund managers do not expect it to go back to earlier levels; however, they also believe that equities are inexpensive. "Valuations have become cheap," says Mr. Balasubramaniam. In the past, when faced with a slowdown, the government has taken the right policy decisions, and he is hopeful that an appropriate policy framework will be put in place now as well.

Fund managers also think that India's long-term potential remains intact. Sundeep Sikka, CEO, Reliance Capital AMC, expects money to keep coming to India and that global allocations will increase, purely on market fundamentals and its strengths. India's key structural positive stems from its demographic profile. Consumption has shown a sustainable trend. We have seen a J-curve effect in many sectors," says Swati Kulkarni, executive vice-president and fund manager, UTI AMC.

Corporate earnings have been hit because of the current problems and fund managers do not see the situation improving anytime soon. Mr. Lobo believes that the next two years will be challenging for earnings growth, but that once there is an easing of policy measures, corporate India will be back with a bang. Foreign direct investment (FDI) in retail has recently been permitted by the government.

"It will be a range-bound market as the next one to two quarters will not be very encouraging," says Mr. Balasubramaniam, who believes asset allocation is the right strategy at such times, since timing the market is difficult. Historically, markets have also bounced back strongly when they see signs of a revival. The only uncertainty is how the global economic situation will evolve and what it will do as regards capital flows to emerging markets such as India. ■

Continued from page 39

that legitimises, educates and encourages them to fully adopt it.

The technology is available, but the lack of education is a hurdle that neither the vendors nor the Asian institutions can today overcome alone.

How do we solve this conundrum?

There isn't an easy answer but the onus firmly lies with the regional institutions to take the initiative and align their execution practices with the global institutions.

If it is not be triggered by a regulatory initiative it may only come down to a conscious effort by the regional players to forcibly raise the awareness level and embrace new execution tools with the eventual view to better compete on the global stage. ■

**Bertrand Rassat is principal at FlexTrade Systems, PTE Ltd*

WARNING: Unauthorised reproduction in part or in whole of this publication is in violation of copyright law.