

## Going Tiger

**"Everybody said that tiger went crazy. That tiger didn't go crazy, that tiger went tiger! You know when that tiger was really crazy? When it was riding around on a unicycle!"**

Chris Rock, *Never Scared* (HBO, 2004)

I am a huge fan of author Michael Lewis. Over the years he has demonstrated a remarkable ability to take complex and often dry subject matter and — through the magic of language and storytelling — craft compelling narratives perfectly suited for mass consumption (and Hollywood adaptation). The talent Lewis possesses is truly rare, and something that I can only hope to vaguely emulate even on my best days as a writer...but I digress (wistful sigh).

Perhaps more than any other author of our time, Lewis' approach speaks directly to the adage that truth is indeed stranger — and quite often more entertaining — than fiction. And so the truth he communicates in his latest work, *Flash Boys: A Wall Street Revolt* (W.W. Norton & Company, 2014), is no exception. The book's central claim — that certain high frequency trading (HFT) practices exploit an informational advantage that is unfair, and arguably illegal — landed like a grenade. It also, frankly, shouldn't have surprised anyone.

We addressed HFT in our July 2013 K2 Perspective, *Ghosts in the Machine*. On the surface, aspects of the strategy have always seemed suspect. Not all HFT is nefarious. Many firms are simply running quantitative arbitrage models that don't involve any informational edge. But when the physical length of a fiber optic cable running from Wall Street across the Hudson River to New Jersey may mean the difference between profit or loss... something certainly smells rotten in Denmark (or at least in New Amsterdam). When success is determined by the ability to transact thousands of times in fractions of milliseconds and at the speed of light...even the most progressive thinkers among us must admit it feels wrong.

The media reaction to this revelation came as a surprise. The fire storm that erupted mere nanoseconds (forgive me) after Mr. Lewis' latest book hit the shelves was unexpected. Beginning with a Sunday night appearance on 60 Minutes — where Lewis explained to correspondent Steve Kroft that the stock market was 'rigged' in his view, and that this rigging was at the hands of a cabal of HFT firms and complicit investment banks — the hounds were released. Within hours, the CNBC and Bloomberg anchors were in full apoplectic meltdown. Rigged? How dare he. Surely the free market is perfectly level and fair?

To me, the outrage felt disingenuous at best, and willfully naïve at worst. From a business perspective I can accept the networks 'crisis on Wall Street' angle in terms of attracting viewers and boosting the bottom line. From a journalistic quality and integrity standpoint however... not so much. Markets have never been truly fair. Ask any experienced trader — someone who has watched a stock spike several percent at the close, only to see "news" emerge minutes later that conveniently explains the move. Or consider Jobs Friday: how often do markets move materially in the seconds before the data drops, and in precisely the direction the data would suggest? These things happen with a frequency that strains credulity. Where is the outrage over these oddities?

The bottom line is that I believe the financial news anchors, the pundits posting blogs on Seeking Alpha, and the rest of the media aghast at the treachery of the HFTs, are all on some level — if they are intellectually

honest with themselves — fully aware that markets are never fair. But in the interest of increased demographics they carry on.

The truth is, in any competitive arena — from the NCAA Tournament to Wall Street — participants will seek every available advantage. Most will do so within the rules, not just out of principle but because they're smart enough to know it's in their long-term interest. Some will push the envelope. A few will cross the line. This is not a malfunction of the system; it is the system. To borrow from Chris Rock: the HFT firms going tiger is not a surprise. It is simply in their nature. The tiger was always a tiger. The unicycle was the anomaly.

This is not a defense of firms that may be testing the boundaries of legality — and Lewis makes a compelling case that some clearly have. The most telling detail may be the simplest: many HFT firms pay to execute orders, sometimes tens of millions of dollars annually. You don't pay for something unless there's a profit in it. What exactly are they paying for?

Defenders will argue HFT benefits the market by providing cheap liquidity and reducing transaction costs for retail investors. There may be some truth to that. But let's not pretend these firms set up shop out of altruism. And we have all seen how quickly that so-called liquidity evaporates the moment something goes wrong.

Markets have always been tilted in someone's favor. Twenty years ago it was the specialists on the floor of the NYSE — privileged with physical presence and information the rest of us didn't have. Before that, it was the guy at the Buttonwood Tree standing on slightly higher ground. The earliest HFT, his technology a mound of dirt.

### **Crouching from the Tiger**

So where does this leave us? Markets have likely been scalped by HFT firms — perhaps egregiously — for over a decade. Should anyone be shocked? No. Will it happen again in some other form? Absolutely.

The practical takeaway is straightforward: tune out the noise, and focus on identifying opportunities where available information reflects an economic reality at odds with prevailing public opinion or media narrative. That divergence is where alpha lives. As we know well, these opportunities tend to be discrete and occasional — almost by definition. Not loudly debated by the financial media. Tigers will always be tigers. The key is to stop being surprised when they bite.

**Disclaimer:** I have been a devoted — and arguably pioneering — user of the em dash long before its conscription by AI as its punctuation of choice. The em dash did not choose this life. Neither did I. We were here first.