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The Evolution of Trading: The Good, the Bad and the Ugly Jackets

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Speaker Key:

DP	David Pett
KM	Kevin McCreadie
JC	John Christofilos

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00:00:06	DP	Technology has revolutionised the way stocks and bonds are traded in recent years, but human ingenuity continues to play a critical role in achieving best execution. On this episode of the podcast, Kevin McCreadie, AGF CEO and chief investment officer, is joined by AGF's head trader, John Christofilos, to talk about the current trading environment and the opportunities and risks associated with it. I'm your host, David Pett. Let's get into it. So, John, you come by this trading business pretty honestly.
00:00:43	JC	My parents came over from Greece back in the early 60s, and my dad's first job was a dishwasher and then a bartender at a bar called the Cork Room Tavern, which was adjacent to the Toronto Stock Exchange floor on Bay Street, right next door. And as a young, 14-year-old kid, I used to take the subway down from Scarborough and sit at the end of the bar. Now, as you all know, today you can't do that. As a 14-year-old kid you can't sit at a bar, but back then you could.
00:01:08		And I would sit there and I would watch the traders come off the trading floor and stand in front of my father, have a drink, and tell horror stories, or great stories, about their day and whatever the case may be. And I couldn't believe how excited I was to hear these stories, and I caught the trading itch. And I remember telling my father one night, going home, that I wanted to become a trader, so it started for me really early, David, when I was 14, and I've never left the business. I'm passionate about trading. I love the trading game. It's in my blood and I don't think I could do anything else, at this point.

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00:01:38	DP	I've never asked you how you got into this business.
	KM	I started in a different way. I was an analyst and then became a PM. So the way we were structured… that we sat around a trading desk, even though it was a buy-side desk, and one of my first lessons in this business was when I asked, why is the stock down, and this wise old trader said, because there are more sellers than buyers. And every now and then, I go out to the trading desk here and I say, John, why's that stock down, and that answer hasn't changed in 30 years.
00:02:06	DP	Why would it change, right? And then, from the time that you first start as a trader, what's changed over that time?
	JC	A ton, obviously. In one word, technology. So let me take you back 15 years or 20 years, when I was running around the floor in one of those ugly blue jackets that we used to wear. We used to literally walk around with blue and pink tickets, buy and sell tickets, and we would run into a square and we would buy stock and sell stock.
00:02:33		Everything was done in open outcry system, where we would communicate and negotiate face-to-face. Well, today, everything is done computer-to-computer, it's no longer done face-to-face, so technology has been, bar none, the biggest change in our industry. Whether that's multiple marketplaces, algorithms, artificial intelligence systems, multiple venues, lit venues, dark venues, it's changed considerably over the last 15 or 20 years.
00:03:01		And it's only going to continue. That trend to technology is going to continue for as long as I'm in this business and for anybody else who's in this business. Technology is not going away. That's the biggest change.
	DP	And that comes with advantages as well as disadvantages.
	JC	Of course, it's good and bad. It's great from an efficiency perspective, I can get things done in milliseconds where it used to take me days, weeks, if not months sometimes, to get certain trades done. Now, you can do things almost instantaneously. But it also makes it more difficult.

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00:03:30		It's a lot tougher to trade today because of limited liquidity, the multiple marketplaces, which strategy to pick, which broker you want to choose for execution. We're bound by something called best execution: I have to make sure that we're meeting and beating our benchmarks on every single trade. We measure every single trade and I have to report that back to Kevin and to others on how we're doing. So it makes it more difficult, because if you pick the wrong partner and/or pick the wrong strategy, you may not beat or meet your benchmark. So it's become a lot more difficult to trade today than it was 15 or 20 years ago, for sure.
00:04:05	KM	In the late 70s or the early 80s, you'd have to get to the seven o'clock news at night and make sure you got home in time to find out what went on. We didn't have 24-hour news or business channels, and we certainly didn't have the internet to push whether it be real news, titbits, fake news, etc., at the markets at the same time. So I do think that some of the market volatility and the pace of news, speed of news as we've seen over the last bunch of years also impacts reaction functions of traders.
00:04:35	JC	So you'll see a headline come out, you'll see specific stocks and/or sectors react initially one way or the other, depending on what the news is. That's relatively new. If I step back 10 or 15 years ago, the news cycle was nowhere near as fast as it is today. Today, machines and algorithms and predatory algorithms are picking up these news releases in milliseconds and reacting to it and causing volatility in the market. That's relatively new versus ten years ago, when we had a much slower news cycle than we do today.
00:05:05		We describe that as noise in the market. It's [unclear] noise, it's real noise, but a lot of times that goes away fairly quickly, if it's half a day or a day, and then we're back to normal markets. But you have to not overreact to the noise and take all the information in and make some logical decisions along the way, but it is noise and it adds a lot of volatility on a short-term basis, and then it usually reverts back to a normal state.
00:05:29	DP	And then, within a broader investment management team, John, has your role changed as head trader, in that

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		maybe you were sort of siloed but you're more integrated in terms of how that function, in terms of the buy and sell, works?
	JC	Yes. We live in a world of information, and sharing that information, from my perspective, is vital to the investment process. So we actually sit in the middle of the trading floor on our investment management floor, and we share information as often as we possibly can, because a PM maybe sitting in their office may not see something.
00:06:00		So it's our job, on the trading desk, to be able to disseminate that information out as quickly as possible, so PMs and analysts and Kevin and others can make rational decisions about what's happening in the markets. So yes, it's changed considerably. Trading used to be stick the traders in a room in a corner somewhere and they'll execute trades; now, it's actually part of the investment process and we're trying to share as much information out to the PMs and analysts on a go-forward basis, on a continual basis.
	DP	And is that a conscious effort to set it up that way, Kevin, in terms of how that team works?
00:06:32	KM	Yes, I think if you think about our business, it is data, information, whether it be marginal at the measure, meaning it's something incremental that you've found, or something really changeable, like we just talked about. But not have it sit in the middle I think would probably leave you off-sides a little bit, and so I think of it as the decisions are made on a PMs team but they're going to need help to quarterback in the execution of that decision.
00:07:02		And that decision is going to be impacted by what liquidity's out there, given the event that maybe is causing it, and if it's a minor thing, it's probably nothing, but I think the ability to have it centralised allows us to basically play that quarterback in traffic cop role around what the market's telling us versus what the PM wants to do.
00:07:21	JC	Yes, and I think it's a really important point, Dave. We, as traders, don't talk to portfolio managers and analysts on what stocks to buy and sell; our role is to execute what they ask us to buy and sell. And using our experience, our logic, our technology and everything else, that's our role. It's not to tell a PM to buy or

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		sell a particular issue, because of a piece of information; it's how to buy and sell it. And that's our role on a day-to-day basis.
	DP	And that goes as far as saying, okay, the PM comes to you and says, we really like this security or this stock, and you may say, maybe we need to wait a little bit for a better price, is that the type of tactical stuff that you do?
00:07:59	JC	Yes, I use the example all the time: if there are ten sellers out there and we're coming in to buy stock, the prudent thing for me to do is not to buy, it's probably to wait for the sellers to start to really push on the stock, and then come in and pick away and start buying stock. So yes, we have that discussion on an ongoing basis with PMs and analysts on when to buy and how to buy it, that's part of what we do all day, every day, yes.
	DP	And it's interesting that there's a human element to that, and yet we are living in a time where machines are a bigger part of the trading environment than they've ever been. How does that dynamic work, from your perspective?
00:08:35	JC	Look, I come from the days of running around an old trading floor with an ugly-looking jacket – some people still think I have ugly-looking jackets, but that's beside the point – but combing the human aspect, the gut feel, with technology I think is the best of all breeds. Because you get the sense from humans. Machines don't have feelings, they don't have sentiment. They act very rationally when it comes to trading, but there's also an irrational part of trading where a human needs to come in and step in and find out what the right way to do this is, how quickly we want to do this, what strategy we want to use, and that's done in coordination with humans and technology, and we try to combine that, every day.
00:09:15	KW	Yes, I'm back to John's ugly jacket, and he still wears them, but when you started and I started in this business, the thing you did when you went to New York in our business, you got on the floor of the exchange, and that was probably the same here in Canada, and it was thousands of people screaming, it was this choreography of chaos.
00:09:37		And you look at it today, it's more a façade for the media, I think there are probably more media heads down on the

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		floor than there are true market-makers. And I think the market-making function, to John's point, has changed. It's been replaced by machines. In the old days, you were able to be a market-maker because you had to provide liquidity. Too many buyers, you had to sell some stock. And if there were too many sellers, you had to step in and buy. And before that, you got to make the spread.
00:10:04		Today, that function really doesn't exist in any meaningful way, and I think that part of the trading and market structure function probably leaves us in a place where things will heat up, if they do heat up. Where will that liquidity come from to take the other side in an orderly fashion? And we've had flash crashes.
00:10:23		And the question for us is are some of the events, compounded by some of the changing vehicles that people are using, passives and actives, which we can talk about, and then you throw this piece, and how it's all executed, it could be a bad combo at some point in terms of who's going to step in and provide that liquidity.
	JC	Yes, and talking about those ugly jackets, I heard a stat the other day, I think at the peak the New York Stock Exchange trading floor had upwards of 5,000 individuals down there. Today, it's one-tenth the size. So the floor today is a marketing façade. It's great for people to go visit, it's a great place to see, but it's really not a trading venue anymore. It's really a marketing venue.
00:11:04		And so, things have changed considerably with technology, for good and for bad. One of the things that I worry about, and Kevin just touched on it, is this obligation to maintain markets. That's what a market-maker used to do, and they were compensated to do it: stand in and buy stock when there are no other buyers and stand in and sell stock when there were no other sellers. Today, we see these flash crashes, and there are a lot more, Dave, than we actually report on, they happen every single day, almost.
00:11:29		When you see these gap-ups and gap-downs in particular stocks, it's because the market-makers have backed away for whatever reason. A technology issue, a confidence

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		issue, whatever it happens to be, and you get these gap-downs in stock. So it's a fear for us, going forward. Some people say the old methodology was old anyway and it needed upgrading, but there's good and bad with today's infrastructure.
00:11:51	KM	I tell people, you want to go where the trades are being done, then go to some data centre in Jersey City, because probably more than half the volume is being pushed through in those types of algorithmic, wire-to-wire type venues versus [overtalking] exchange.
	JC	There are stats out there that will show anywhere from 50% to 80% of the daily volume is done by either algorithms or high-frequency traders. That doesn't leave a lot for your traditional and/or institutions to interact with. So that's why you're seeing some additional volatility from time to time, because everything's being done electronically now and it doesn't leave a lot of natural liquidity for everybody else to transact in.
00:12:33	DP	And then, another wrinkle in the evolution of trading and market structure is that you're dealing with way more platforms to trade on, way more market venues as well, than you did in the past. What impact does that have on what you do, day-to-day?
00:12:50	JC	Well, for as much as technology has helped us, it's also hurt us. It's more difficult to trade today than it used to be. I always tell the story that if I wanted to buy 1,000 shares of Bombardier 15 years ago, I went to the Toronto Stock Exchange; it was only one marketplace to go to. Today, in Canada, there are 13 to 15 lit and dark marketplaces. And in the US, if I wanted to buy 100 shares of General Motors, I went to the New York Stock Exchange, or 100 shares of Sysco, I went to Nasdaq or to Amex. Today, there are 50-plus marketplaces.
00:13:17		So having the right technology on your desk, picking the right venue to actually preference to execute stock, is very, very important. So using technology's terrific, but also using some human intervention and some human smarts to combine with that is, I believe, ultimately the best way to move forward.
	DP	Presumably, the idea behind having more platforms and venues is that it would improve liquidity, and yet it sounds

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		like maybe that's not the case? And you also have a transparency issue in terms of…
00:13:49	JC	It actually fragments liquidity. So one of the tools that a lot of traders used in the past was this spray technology, so I need to buy 10,000 shares and I would spray out to 50 different markets, make sure I'm covered, so if somebody comes in to buy stock, I'm covered across the board. Today, what we're starting to see in IEX, one of the markets in the US, Brad Katsuyama, a good Canadian guy, actually set it up, has proven that sitting in a particular venue and not spraying is a better strategy than the strategy that everybody thinks, that spraying would be the best. It's not, it's actually vice versa to that.
00:14:27		It fragments liquidity, which is not a good thing, and it causes more issues, and it allows high-frequency traders this arbitrage opportunity because speed matters, and if you can get to a venue before somebody else can get to a venue, you can pick off, per se, a particular order. So there's good and bad with technology, it's just a matter of how you use it.
00:14:51	KM	Yes, and I guess for me the way to think about it is all those guys can turn off if they don't want to take the risk, versus the classical market-makers of old. All those machines, all those guys don't have to be in there to take any… If the market starts to run pretty negative pretty quickly, bet is that they probably have turned dark.
	DP	So given those concerns that we've talked about with regards to market structure, and when we look at the current market environment that we're living in, what concerns you most? Or what are the things that investors need to be concerned about?
00:15:26	KM	Dave, you and I were laughing, towards the end of the year, about what now, because we've cleared a bunch of the hurdles, Brexit seems to be somewhat behind us, we were going to get a phase-one trade deal, and we frankly aren't out of the woods in terms of how much damage was done on the trade aspect over the last year, and we don't know whether the rate cuts that were done in the latter part of the summer, early fall, are going to be enough to have helped; and we won't know that for another couple of quarters.

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00:15:51		And then, you think about market structure, you look at ten names in the S&P 500, I'll just use that as an example, people think it's the most liquid market, it may not be. Ten of those names are a quarter of the market cap, that one index. You then look at… half of the equity investments today in the US are passives, whether that be an index fund, an ETF, but passives, so they're flow-driven. If somebody gets scared and they sell the entire index, those indexes hold no cash so they've got to sell to pay off that redemption, typical PM, we get somebody who wants to sell something and the market's down, they'll wait until the market's having a better day, they don't have to sell if they get a redemption.
00:16:30		And then, you through in the fact that traditional liquidity providers, like we've talked about, the market-makers of old, the guys in the ugly jackets, aren't there. The banks, which were big providers of liquidity, pre the financial crisis but now post-Dodd-Frank and Volcker, really aren't. And then, the last one is some of the audience for buying equities isn't there either. Pension funds, the new darling, is has been [?] in the private equity space, and those allocations, in a decade, have gone from maybe 8% to 25% of portfolios.
00:16:59		And then, you throw in, okay, maybe something does happen bad at the end of the day, middle of the day, and then, John, what does that index fund do, when we scare a bunch of people in these passive investments?
	JC	Well, as you say, they hold no cash, so when they get a big redemption, they're out of the market as quickly possibly can. You look at the last half-hour, Dave, upwards of 40% to 45% of the daily volume trades in the last half-hour, so it's very concentrated to the close, because a lot of these passive funds are bench-marked to the close, so they're trying to get the closing price.
00:17:29		So they are loaded up in this facility called the Market on Close to actually try and get that closing price, and they have no discretion. It's going to go off, that trade will go off, and if it's a massive panic and/or sell programme, you're going to see reaction in the market quite considerably.
	KM	We had that one last fall of 18, which was a big trade. Do you remember that?

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00:17:54	JC	It was a $6 billion redemption in the S&P 500 and I think it took the market down 300 to 350 points in about two and a half minutes. It was massive. It was quick. They didn't wait for the close, they just actually sold into the market and the market-makers weren't there, they backed away, they must have sensed something, who knows what, and it took the market down immediately. That's one event. If that is compounded, to Kevin's point, multiple times, we could have some damage done in this market very, very quickly.
	DP	In that scenario, it would seem if it's a one-time thing, patience might be a virtue, where you stay pat, but how do you know that it's going to be just a one-time event?
00:18:32	JC	That's when we look into our crystal ball, Dave, that we have on the training desk. You don't know. You just don't.
	KM	We're at the end of the cycle and this has not been a euphoric rally. People are waiting for it to end, constantly. It's been now one of the longest, if not the longest, recovery in the markets since the 09 rebound, right after the 08 correction, and I think people are a little bit scared. It's not been a loved rally, and people do worry about where that's next recession, is it on the horizon?
00:19:01		So people already have had enough, especially after the 30%-odd you got out of the US last year, Canada didn't do as well, probably about 18% or 19%, but still pretty good years, people say maybe I don't need to take this risk with this unknown out there.
	JC	And people have short memories. 2008 wasn't that long ago, and depending on where you are in your evolution in life, you might not be able to afford another 2008, so people have become pretty defensive over the last while.
00:19:28		Cash levels around the world have been extremely high for a long, long time, and you see that cash come back into the market every time there's a pull-back, but at some point that will end. To Kevin's point, we are late-cycle, this is a ten to 11-year run of very, very good markets.
	DP	And that's really the big question facing investors, isn't it? Not if this great run in stocks ends, but really when. John, thanks for being here.

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	JC	That's, Dave.
	DP	It's been a pleasure. And Kevin. Until next time, when AGF equity analyst Auritro Kundu gives his take on the technologies that are poised to shape markets over the next decade.
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