



# **Transaction Cost Analytics in DROP**

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# Volume-weighted Average Price

## Overview

1. Volume-weighted Average Price (VWAP): Volume-weighted average price (VWAP) is the ratio of a security or financial asset to the volume of transactions during a trading session (Wikipedia (2023)). It is a measure of the average trading price for period (Berkowitz, Logue, and Noser (1988)).
2. Time Period for VWAP Estimation: Typically, the indicator is computed for one day, but it can be measured between any two points in time.
3. VWAP as a Trading Benchmark: VWAP is often used as a trading benchmark by investors who aim to be as passive as possible in their execution. Many pension funds, and some mutual funds, fall into these categories.
4. Aim of VWAP Trading Target: The aim of using a VWAP trading target is to ensure that the trader executing the order does so in line with the volume on the market.
5. Impact on the Transaction Cost: It is sometimes argued that such execution reduces transaction costs by minimizing market impact costs, i.e., the additional cost of the market impact due to the adverse effect of a trader's activities on the price of a security.
6. Best-effort/Guaranteed Algorithmic Execution: VWAP is often used in algorithmic trading.
7. Definition of Guaranteed VWAP Execution: The broker may guarantee the execution of an order at the VWAP price and have a computer program enters the orders into the market to earn the trader's commission and create P&L. This is called a guaranteed VWAP execution.
8. Definition of Best-effort VWAP Execution: The broker can also trade in a best-effort way and answer the client with the realized price. This is called a VWAP target



execution; it incurs more dispersion in the answered price compared to the VWAP price for the client but a lower received/paid commission.

9. Volume Participation Algorithm: Trading algorithms that use VWAP as a target belong to a class of algorithms known as *volume participation algorithms*.

## Formula

VWAP is calculated using the following formula:

$$P_{VWAP} = \frac{\sum_j P_j \cdot Q_j}{\sum_j Q_j}$$

where  $P_{VWAP}$  is Volume Average Price,  $P_j$  is price of trade  $j$ ,  $Q_j$  is quantity of trade  $j$ , and  $j$  is each individual trade that takes place over the defined time period, excluding cross trades and basket cross trades.

## Using VWAP

1. Price Probing as Bullish/Bearish Indicator: The VWAP can be used similar to moving averages, where price above the VWAP reflect a bullish sentiment and prices below the VWAP reflect a bearish sentiment.
2. Position Initiation Signals: Traders may initiate short positions as a stock price moves below VWAP for a given time period or initiate long positions as the price move above VWAP.
3. Other Uses of VWAP: Institutional buyers and algorithms often use VWAP to plan entries and initiate larger positions without disturbing the stock price.



4. VWAP as Broker Performance Metric: VWAP slippage is the performance of a broker, and many Buy-side firms now use a MIFID wheel to direct their flow to the best broker.

## References

- Berkowitz, S. A., D. E. Logue, and E. A. J. Noser (1988): The Total Cost of Transactions on the NYSE *Journal of Finance* **43** (1) 97-112
- Wikipedia (2023): [Volume-weighted Average Price](#)



# Exchange Order

## Overview

1. Definition of an Exchange Order: An *order* is an institution to buy or sell on a trading venue such as a stock market, bond market, commodity market, financial derivative market, or crypto-currency exchange (Wikipedia (2023)).
2. Instructions for Executing an Order: These instructions can be simple or complicated, and can be sent to either a broker or directly to a trading venue in direct market access. There are some standard instructions for such orders.

## Market Order

1. Definition of a Market Order: A *market order* is a buy or sell order to be executed immediately at the *current market* prices. As long as there are willing sellers and buyers, market orders are filled.
2. Motivation behind Using Market Orders: Market orders are used when certainty of execution is a priority over the price of execution.
3. Lack of Control over Price: A market order is the simplest of the order types. This order type does not allow any control over the price received.
4. Filling up of Market Order: The order is filled at the best price available at the relevant time.
5. Ability to execute at Quoted Price: In fast-moving markets, the price paid or received may be quite different from the last price quoted before the order was entered.
6. Slicing up the Market Order: A market order may be split across multiple participants on the other side of the transaction, resulting in different prices for some of the shares.



7. Commissions for the Market Order: It is the most basic of all order and therefore, they incur the lowest of commissions, from both online and traditional brokers.

## **Limit Order**

1. Definition of the Limit Order: A *limit order* is an order to buy a security at no more than a specific price, or to sell a security at no less than a specific price – called “better” for either direction.
2. Uncertainty over the Order Execution: This gives the trader/customer control over the price at which the trade is executed; however, the order may never be executed/”filled”.
3. Trader Control over the Price: Limit orders are used when the trader wishes to control price rather than certainty of execution.
4. Definition of Buy Limit Order: A *buy limit order* can only be executed at the limit price or lower. For example, if an investor wants to buy a stock, but doesn’t want to pay more than \$30 for it, the investor can place a limit order to buy the stock at \$30.
5. Purpose of the Buy Limit Order: By entering the limit order rather than a market order, the investor will not buy the stock at a higher price, but, may get fewer shares than he wants or not get the stock at all.
6. Definition of Sell Limit Order: A *sell limit order* is analogous; it can only be executed at the limit price or higher.
7. Marketability of the Limit Order: A limit order that can be satisfied by orders in the limit book when it is received is *marketable*.
8. Filling up of Buy Order: For example, if a stock is asked for \$86.41 – a large size, a buy order with a limit of \$90 can be filled right away.
9. Filling up of Sell Order: Similarly, if a stock is bid \$86.40, a sell order with a limit of \$80 will be filled right away.
10. Partial Fill of Limit Order: A limit order may be partially filled from the book and the rest added to the book.



11. Constrained Buy and Sell Orders: Both buy and sell orders can be additionally constrained. Two of the most common additional constraints are fill or kill FOK, and all or none AON.
12. Definition of FOK and AON Orders: FOK orders are either filled completely on the first attempt or canceled outright, while AON orders stipulate that the order must be filled with the entire number of shares specified, or not filled at all.
13. Scheduling the Unfilled Orders: If it is not filled, it is still held on the order book for later execution.

## **Time in Force**

1. Good for Day Order GFD: A *day-order* or *good-for-day-order* GFD – the most common – is a market or a limit order that is in force from the time the order is submitted to the end of the day's trading session.
2. Closing Time for Stock Markets: For stock markets, the closing time is defined by the exchange.
3. Closing Time for FX Markets: For the foreign exchange market, this is until 5 PM EST/EDT for all currencies except the New Zealand Dollar.
4. Good-till-Canceled GTC Orders: GTC require a specific canceling order, which can persist indefinitely – although brokers may set some limits, for example, 90 days.
5. Immediate or Cancel IOC Orders: IOC orders are immediately executed or canceled by the exchange. Unlike FOK orders, IOC orders allow for partial fills.
6. Fill or Kill FOK Orders: FOK orders are usually limit orders that must be executed or canceled immediately. Unlike IOC orders, FOK orders require full quantity to be executed.
7. Open/Close Single-Price Auctions: Most markets have single-price auctions at the beginning – or “open” – and the end – or “close” – of regular trading. Some markets may also have before-lunch and after-lunch orders.



8. On the Close/Open: AN order may be specified *on the close* or *on the open*, then it is entered in an auction but has no effect otherwise. There is often some deadline, for example, orders must be in 20 minutes before the auction.
9. Definition of Single-Price Orders: They are single-price because all orders, if they transact at all, transact at the same price, the open price and the close price, respectively.
10. MOC/MOO/LOC/Loo Orders: Combined with price instructions, this gives *market-on-close* MOC, *market-on-open* MOO, *limit-on-close* LOC, and *limit-on-open* LOO.
11. Example - Market-on-Open: For example, a market-on-open order is guaranteed to get the open price, whatever that may be.
12. Buy-Limit or Buy-Open Order: A but limit-on-open order is filled if the open price is lower, not filled if the open price is higher, and may or may not be filled if the open price is the same.
13. Regulation NMS Compliant Order Routing: Regulation NMS – Reg NMS – which applies to US stock exchanges, supports two types of IOC orders, one of which is Reg NMS compliant and will not be routed during an exchange sweep, and one that can be routed to other exchanges.
14. Liquidity Impact on Order Routing: Optimal order routing is a difficult problem that cannot be addressed with the usual perfect market paradigm. Liquidity needs to be modeled in a realistic way (Polimenis (2005a)) if one is to understand such issues as optimal order routing and placement (Polimenis (2005b)).
15. Adopting the Order Protection Rule: The Order Protection or Trade Through Rule – Rule 611 – was designed to improve intermarket price priority for quotations that are immediately and automatically accessible, but its role in predatory trading behavior has faced mounted controversy in the recent years.

## Conditional Orders





A conditional order is any order other than a limit order which is executed only when a specific condition is met.

## Stop Orders

1. Definition of Stop-loss Orders: A *stop-order* or *stop-loss order* is an order to buy or sell a stock once the price of the stock reaches a specified price, known as the *stop-price*. When the stop price is reached, a stop order becomes a market order.
2. Definition of Buy-stop Order: A buy-stop order is entered at a stop price above the current market price. Investors generally use a buy-stop order to limit a loss or to protect a profit on a stock that they have sold short.
3. Definition of Sell-stop Order: A sell-stop order is entered at a stop price below the current market price. Investors generally use a sell-stop order to limit a loss or to protect a profit on a stock that they own.
4. Impact of Using Stop-Orders: When a sell-stop order is reached, the stop order becomes a market order. This means that the trade will definitely be executed, but not necessarily at or near the stop price, particularly when the order is placed into a fast-moving market, or if there is insufficient liquidity available relative to the size of the market.
5. Markets where Stop-orders are Used: The use of stop orders is much more frequent for stocks and futures that trade on an exchange than those that trade in the over-the-counter OTC market.

## Stop-Sell Order

1. Purpose of the Sell-stop Order: A *sell-stop order* is an instruction to sell at the best available price after the price goes below the stop price. A sell-stop price is always below the current market price.



2. Sell-stop Order in Action: For example, if an investor holds a stock currently valued at \$50 and is worried that the value may drop, he/she can place a sell-stop order at \$40. If the share price drops to \$40, the broker sells the stock at the next available price.
3. Advantages of Sell-stop Order: This can limit the investor's losses or lock in some of the investor's profits – if the stop price is at or above the purchase price.

## **Buy-stop Order**

1. Purpose of Buy-stop Order: A *buy-stop* order is typically used to limit a loss – or to protect an existing profit – on a short sale. A buy-stop price is always above the current market price.
2. Buy-stop Order in Action: For example, if an investor sells a stock short – hoping for the stock price to go down so they can return the borrowed shares at a lower price, i.e., *covering* – the investor may use a buy-stop order to protect against losses if the prices go too high.
3. Advantages of Buy-stop Order: It can also be used to advantage in a declining market when an investor decides to enter a long position at when he perceives to be prices close to the bottom after a market sell-off.

## **Stop-limit Order**

1. Definition of Stop-Limit Order: A *stop-limit order* is an order to buy or sell a stock that combines the features of a stop order and a limit order.
2. Stop Order to a Limit Order: Once the stop price is reached, a stop-limit order becomes a limit order that will be executed at a specified price – or better.
3. Lack of Execution Certainty: As with all limit orders, a stop-limit order doesn't get filled if the security's price never reaches the specified limit price.



## Conditional Trailing Stop Order

1. Definition of Trailing Stop Order: A *trailing stop order* is entered with a stop parameter that creates a moving or *trailing* activation price, hence the name.
2. Specification of Trailing Activation Price: This parameter is entered as a percentage change or actual specific amount of rise – or fall – in the security price.
3. Using Trailing Stop-sell Orders: Trailing stop-sell orders are used to maximize and protect profit as a stock's price rises and limit losses when its price falls.
4. Trailing Stop-sell Example #1: As an example, a trader has bought stock ABC at \$10.00 and immediately placing a trailing stop sell order to sell ABC with a \$1.00 trailing stop, i.e., 10% of its current price. This sets the stop price to \$9.00.
5. Trailing Stop-sell Example #2: After placing the order, ABC does not exceed \$10.00 and falls to a low of \$9.01. The trailing stop order is not executed because ABC has not fallen \$1.00 from \$10.00.
6. Trailing Stop-sell Example #3: Later, the stock rises to a high of \$15.00 which resets the stop price to \$13.50. It then falls to \$13.50 - \$1.50 or 10% from its high of \$15.00 – and the trailing stop sell order is entered as a market order.

## Trailing Stop-limit Order

A *trailing stop-limit order* is similar to a trailing stop order. Instead of selling at market price when triggered, the order becomes a limit order.

## Peg Orders

To behave like a market maker, it is possible to use what are called peg orders.



## **Peg Best Orders**

1. Market Making Stepper Step #1: Like a real market maker, first, the stepper uses the other side of the spread.
2. Market Making Stepper Step #2: Second, the stepper always jumps over the competitors order to be the best one, the first one in the line.
3. Conditions that Limit Pegging:
  - a. Price limitation, no more jumping over, unless the price moves back to its area
  - b. Step value

## **Mid-Price Peg Order**

1. Definition of Mid-Price Order: A mid-price is an order whose limit price is continually set at the average of the “best bid” and “best offer” prices in the market.
2. Definition of Peg-to-Midpoint: The values of the bid and the offer prices used in the calculation may be either a local or a national best bid and offer. They are also called peg-to-midpoint.
3. Mid-price Peg Order Type: Mid-price peg order types are commonly supported on alternative trading systems and dark pools, where they enable market participants to trade whereby each pays half of the bid-offer spread, often without revealing their trading intentions to others beforehand.

## **Market-if-Touched Order**



1. But Market-if-Touched Order: A buy *market-if-touched order* is an order to buy at the best available price, if the market price goes down to the “if touched” level. As soon as this trigger price is touched the order becomes a market buy order.
2. Sell Market-if-touched Order: A *sell market-if-touched order* is an order to sell at the best available price, if the market price goes up to the “if touched” level. As soon as this trigger price is touched the order becomes a market sell order.

## **One Cancels Other Orders**

1. Definition of the OCO Order: One-cancels-other OCO orders are used when the trader wishes to capitalize on only one of two or more trading possibilities. For instance, the trader may wish to trade stock ABC at \$10.00 or XYZ at \$20.00.
2. A Sample OCO Order: In this case, he would execute an OCO order composed of two parts: A limit order for ABC at \$10.00 and a limit order for XYZ at \$20.00.
3. Triggering of an OCO Order: If ABC reaches \$10.00, ABC’s limit order would be executed, and XYZ limit order would be canceled.

## **One Sends Other Orders**

1. Definition of OSO Order: One sends other – OSO – orders are used when the trader wishes to send a new order only when another one has been executed.
2. Example of an OSO Order: For instance, the trader may wish to buy stock ABC at \$10.00 and then immediately try to sell it at \$10.05 to gain the spread.
3. Components of an OSO Order: In this case, they would execute an OSO order composed of two parts: A limit buy order for ABC at \$10.00, and a limit sell order for the same stock at \$10.05. If ABC reaches \$10.00, ABC’s limit order would be executed, and the sell limit order would be sent.



4. Sequential Execution of OSO Trades: In short, multiple orders are attached to a main order and the orders are executed sequentially.

## Tick-sensitive Orders

1. Uptick and Downtick Orders: An uptick is when the last non-zero price change is positive, and a downtick is when the last non-zero price change is negative.
2. Buy-on-downtick: Any tick-sensitive instruction can be entered at the trader's option, for example *buy-on downtick*, although these orders are rare.
3. Tick Sensitive Short-sell Order: In markets where short sales may only be executed on an uptick, a short-sell order is inherently tick-sensitive.

## Opening Orders

1. At-the-opening Order: *At-the-opening* order is an order type to be executed at the very opening of the stock market trading day.
2. Cancel on Failure to Execute: If it wouldn't be possible to execute it as part of the first trade for the day, it would instead be canceled (Weiss (2006)).

## Discretionary Order

1. Definition of a Discretionary Order: A *discretionary order* is an order that allows the broker to delay the execution at its discretion to try to get a better price; these are sometimes called not-held orders.
2. Use in Electronic/Voice Trades: It is commonly added to stop-loss orders and limit orders. They can be placed via a broker or an electronic trading system.



## **Bracket**

1. Pair of Two Orders: Puts to the market a pair of two orders, for the same title and direction, e.g., both to sell, as below:
2. Sell Order #1: One sell order is to realize the profit.
3. Sell Order #2: The second is to lock the loss, not to get even deeper.

## **Quantity and Display Instructions**

1. Prevention of the Order Display: A broker may be instructed not to display the order to the market. Examples are provided below.
2. Case of an AON Order: An “all-or-none” buy limit is an order to buy at the specified price if another trader is offering to sell the full amount of the order, but otherwise not display the order.
3. Case of Iceberg/Hidden Order: A hidden – or “iceberg” – order requires the broker to display only a small part of the order, leaving a large undisplayed quantity “below the surface”.

## **Electronic Markets**

1. Availability of the Order Type: All of the above order types are usually available in modern electronic markets, but order priority rules encourage simple market and limit orders.
2. Priority of Market and Limit Orders: Market orders receive the highest priority, followed by limit orders. If a limit order has priority, it is the next trade executed at the limit price.



3. Order Priority Determined by Time/Complexity: Simple limit orders generally get the highest priority, based on a first-come-first-served rule.
4. Priority of Conditional Orders: Conditional orders generally get priority based on the instant the condition is met.
5. Priority of Iceberg/Dark Pool Orders: Iceberg and dark pool orders – which are not displayed – are given lower priority.

## References

- Polimenis, V. (2005a): A Realistic Model of Market Liquidity and Depth *Journal of Futures Markets* **25** (5) 443-464
- Polimenis, V. (2005b): Slow and Fast Markets *Journal of Economics and Business* **57** (6) 576-593
- Weiss, D. (2006): *After the Trade is Made: Processing Securities Transactions* **Portfolio Publishing** London UK
- Wikipedia (2023): [Order \(Exchange\)](#)





# Time-in-Force: Definition, Types, and Examples

## Abstract

1. Motivation behind Time-in-Force: Time-in-force indicates how long an order will remain active before it expires with the broker (Chen (2021)).
2. Time-in-Force Option Settings: Time-in-force settings option is accomplished through different order types.
3. Time-in-force Order Examples: Common examples of time-in-force specifications include day order, immediate-or-cancel IOC, fill-or-kill FOK, or good-till-canceled GTC.

## What is Time-in-Force?

Time-in-force TIF is a special instruction used when placing a trade to indicate how long an order will remain active before it is executed or expires. These options are especially important for active traders and allow them to be more specific about the time parameters.

## Basics of Time-in-Force

1. Focus of the TIF Concept: TIF orders are a useful way for active traders to keep from accidentally executing trades. By setting time parameters, traders don't have to remember to cancel old trades.



2. Impact of Unintended Trade Executions: Unintended trade executions can be very costly, if they occur during volatile market conditions when prices are rapidly changing.
3. Price Control Using Limit Orders: Most active traders use limit order to limit the price they pay for a stock, which means that they set a TIF option to control how long the order stays open.
4. Most Common TIF Order Type: While day orders are the most common type of order, there are many circumstances when it makes sense to use other order types.
5. TIF Options Offered by Brokers: Some brokers only offer a limited set of order types, but active traders are often given more options.
6. TIF Type Acronyms in Use: Many brokers use acronyms like DAY, GTC, OPC, IOC, GTD, DTC, etc. to refer to these orders. The next section looks a little more closely at these order types.

## **Types of TIF Orders**

1. DAY Type TIF Order: DAY orders are a popular type of TIF order. They are canceled if the trade does not execute by the close of the trading day. These are often the default order types for brokerage accounts.
2. Good-Till-Canceled GTC Orders: Another type of TIF order is the Good-Till-Canceled GTC order, which is effective until the trade is executed or canceled.
3. Exceptions when GTC Does not apply: Some common exceptions include stock splits, distributions, account inactivity, modified orders, and quarterly sweeps.
4. Wait Duration inside the GTC: GTC can be a useful option for a long-term investor who is willing to wait for a stock to reach their desired price point before pulling the trigger. Sometimes, traders might want to wait for several days or even weeks for a trade to execute at their desired price.
5. Fill-or-Kill FOK Orders: Fill-or-kill – FOK – orders are a third type of order. They are canceled if the entire order does not execute as soon as it is available.



6. Usage of the FOK Orders: Often, FOK orders are used to avoid purchasing shares in multiple blocks at different prices and to ensure that an entire order executes at a single price.
7. Effectives of the FOK Orders: FOK orders can be popular during fast-moving markets when day traders want to ensure that they get a good price on their trade.
8. Remaining TIF Order Types: A few other order types include Market-On-Open MOO and Limit-On-Open LOO orders, which execute as soon as a market opens; Immediate-Or-Cancel IOC orders which must be filled immediately or are canceled; Day-Till-Canceled DTC orders that are deactivated at the end of the day instead of canceled, making it easier to re-transmit the order.

### **Example of Time-in-Force**

1. John's ABC Alpha Projection View: John believes that the price of stock ABC, currently trading at \$10, will rise, but it will take time, approximately three months.
2. \$15 Call Plus GTC Order: John purchases ABC call option with a strike of \$15 and places a GTC order. To avoid having the order remain on hold indefinitely, he places a limit of three months on the order.
3. Response to Realized ABC Price: After 3 months, ABC's price is still struggling to break past the \$12 mark. John's order is canceled immediately.

### **References:**

- Chen, J. (2021): [Time in Force: Definition, Types, and Examples](#)



# Smart Order Routing

## Overview

1. Definition of Smart Order Routing: *Smart Order Routing* SOR is an automated process of handling orders, aimed at taking the best available opportunity throughout a range of different trading venues (Wikipedia (2023)).
2. Liquidity Consequence of Venue Availability: The increasing number of various trading venue and the MTFs leads to a surge in liquidity fragmentation, when the stock is traded on several different venues, so the price and the amount of stock can vary among them. SOR serves to tackle liquidity fragmentation, or even benefit from it.
3. Purpose of Smart Order Routing: Smart Order Routing is performed by smart order routers – systems designed to analyze the state of various and the place orders the best available way, relying on the defined rules, configuration, and algorithms.

## Benefits and Disadvantages of Smart Order Routing

1. Advantages of Smart Order Routing: SOR provides the following benefits:
  - a. Simultaneous access to several venues
  - b. Automatic search for the best price
  - c. A good framework for usage of custom algorithms
  - d. Opportunity to get additional validation, control, and statistics
2. Drawbacks of Smart Order Routing: There are, however, some disadvantages:
  - a. Additional Latency
  - b. Additional complexity, and therefore, additional risk of loss/outage
  - c. Transparency of information, concerning transactions, for the third party

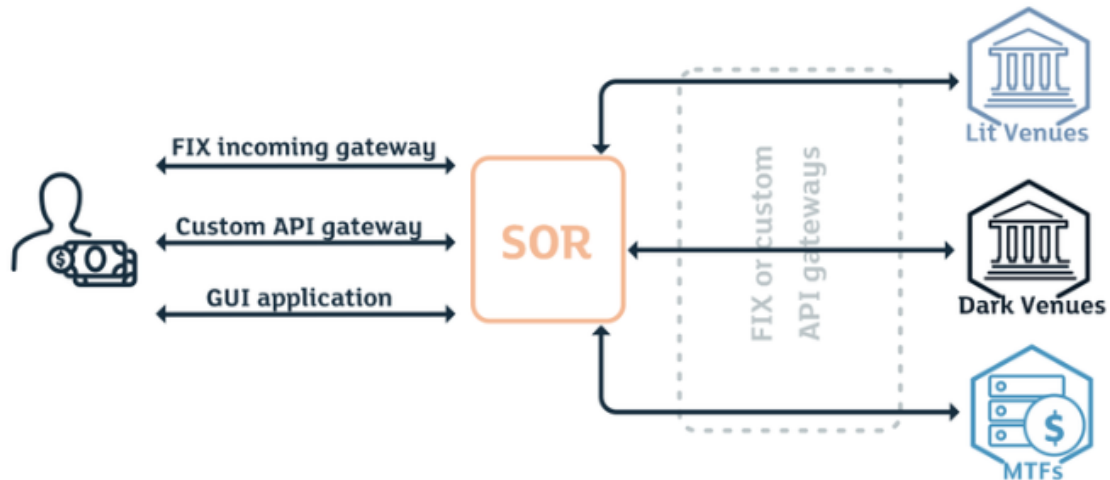


## Brief Concept

1. SOR – Base Idea and Stages: The idea of smart order routing is to scan the markets and find the best place to execute a customer's order, based on price and liquidity. Thus, smart order routing involves the following stages:
2. Receiving Incoming Orders: This is done through different channels:
  - a. An incoming FIX gateway
  - b. An incoming gateway based on any custom protocol
  - c. A front-end
3. Processing Orders inside SOR System: This takes into account:
  - a. Characteristics of available venues
  - b. Custom algorithms
  - c. Settings/preferences of a certain client
  - d. State of available markets/market data
4. Handling the Venue Parameters: Venue parameters, such as average latency, commissions, and rank can be used to prioritize certain venues.
5. Utilization of Custom Algorithms: Custom algorithms, like synthetic orders – peg, iceberg, spraying, TWAP – can be used to manage order automatically, for instance, if a specific client has certain routing preferences among several brokers, or certain rules for handling of incoming, or creation of outgoing orders.
6. Incorporation of Venue State: It is also crucial to track the actual venue situation, like the trading phase, as well as the available opportunities.
7. Integration of Venue Market Data: Thus, any smart order router requires real-time market data from different venues. The market data can be obtained directly by connecting to the venue's feed handlers, or by using market data handlers.
8. Interfacing with the Target Gateway: Routing the orders to one or several venues according to the decision made at the second step above using either a FIX gateway, or a custom API gateway.



9. Dynamic Routing via Order Creation/Swap: Routing here does not imply just static routing to a certain venue, but dynamic behavior with updates of existing orders, creation of new ones, and sweeping to capture a newly appeared opportunity.
10. Client Gateways:



At a closer look, the structure of the SOR system usually contains *client gateways*, to receive incoming orders of the SOR customers.

11. Market Gateways: This sends order to specific exchanges.
12. SOR Implementation: The SOR implementation keeps the SOR logic and custom algos and tackles the clients' orders.
13. Feed Handlers: These provide market data from exchanges for decision making.
14. Client Front-ends: These provide GUI for SOR.

## Algorithmic Trading and SOR

1. Algorithmic Trading vs. SOR: In some cases, algorithmic trading is rather dedicated to automatic usage of synthetic behavior. Algorithmic trading manages the “parent” order while a smart order router directs the “child” orders to the desired destinations.



2. Slicing Parent Orders to Children: In effect, slicing a big order into a multiplicity of smaller orders and timing these orders to minimize market impact via electronic means.
3. Slice Size and Dispatch Time: Based on mathematical models, and considering historical and real-time market data, algorithms determine ex-ante, or continuously, the optimum size of the next slice and its time of submission to the market.
4. Inputs that Determine the Routing: A variety of principles is used for these algorithms, it is aimed at reaching or beating an implicit or explicit benchmark, e.g., a volume weighted average price VWAP algorithm targets at slicing and timing orders in a way that the resulting VWAP of its own transactions is close to or better than VWAP of all transactions of the respective security throughout the trading day or during a specified period of time.
5. Algorithmic Trading as an SOR Extension: However, smart order routing and algorithmic trading are connected more closely than it seems. Since even Smart Order Routing can be considered the simplest example of an algorithm, it is reasonable to say that algorithmic trading is a logical continuation and an extension of Smart Order Routing.
6. Simple Smart Order Routing Strategy: Shown below is a common example of a simple smart order routing strategy.
7. Child Orders to fulfill Parent: Having the initial Order Book, the SOR strategy will create the child orders, that is orders that aim at completing the initial SOR parent order.
8. Orders can be Passive or Aggressive: These orders can be either passive or aggressive depending on the current context and the SOR algorithm.
9. Illustrative Example of Using IOC Orders:

Preferred venue		Venue 1		Venue 2	
Buy	Sell	Buy	Sell	Buy	Sell
	100@21.5		200@21.5		300@21.6



In the example below, IOC – immediate or cancel – orders are used.

10. SOR Example Step #1: AN SOR Buy Day order for [1000@21.5](#) arrives.
11. SOR Example Step #2: Aggressive child order to grab opportunity in preferable venue is created: But IOC [100@21.5](#)
12. SOR Example Step #3: Aggressive child order to grab opportunity in venue 1 created: Buy IOC [200@21.5](#)
13. SOR Example Step #4: The remaining part placed passive to the preferred venue:

Preferred venue		Venue 1		Venue 2	
Buy	Sell	Buy	Sell	Buy	Sell
700@21.5					300@21.6

14. SOR Example Step #5: New liquidity on venue 2 appears: Sell 150@21.4

Preferred venue		Venue 1		Venue 2	
Buy	Sell	Buy	Sell	Buy	Sell
700@21.5					150@21.4
					300@21.6

15. SOR Example Step #6: The algo “sweeps” from preferred venue to grab the opportunity on venue 2. Buy [150@21.4](#) IOC

Preferred venue		Venue 1		Venue 2	
Buy	Sell	Buy	Sell	Buy	Sell
550@21.5					300@21.6





16. SOR Example Step #7: New liquidity on venue 1 appears: Sell [600@21.5](#)

Preferred venue		Venue 1		Venue 2	
Buy	Sell	Buy	Sell	Buy	Sell
550@21.5			600@21.5		300@21.6

17. SOR Example Step #8: The algo “sweeps” from the preferred venue to grab the opportunity on venue 1: Buy [550@21.5](#) IOC

18. SOR Example Step #9: The trade happens, the algo terminates, because all the intended shares were executed:

Preferred venue		Venue 1		Venue 2	
Buy	Sell	Buy	Sell	Buy	Sell
			50@21.5		300@21.6

19. Possibility of Child Order Rejects: As there are latencies involved in constructing and reading from the consolidated order book, child orders may be rejected before the target order was filled before it got there.

20. Handling Rejections and Partial Fills: Therefore, modern smart order routers have callback mechanisms that re-route orders if they are rejected or partially executed.

21. Need for Additional Liquidity: If more liquidity is needed to execute an order, smart order routers will post day limit orders, relying on probabilistic and/or machine learning models to find the best venues.

22. Dark Venues for Child Orders: If the targeting logic supports it, child orders may also be sent to dark venues, although the client will typically have an option to disable this.



23. Tradeoff between Cost and Time: More generally, smart order routing algorithms focus on a tradeoff between execution cost and execution time (Cont and Kukanov (2017)).

## **Cross-Border Routing**

1. Cross-Border Routing for Stocks: Some institutions offer cross-border routing for inter-listed stocks. In this scenario, the SOR targeting logic will use real-time FX rates to determine whether to route to various venues in different countries that trade in different currencies.
2. Most common Cross-border Routing: The most common cross-border routers typically route to both Canadian and American venues; however, there are some routers that also factor in European venues while they are open during trading hours.

## **References**

- Cont, R., and A. Kukanov (2017): Optimal Order Placement in Limit Order Markets *Quantitative Finance* **17** (1) 21-39
- Wikipedia (2023): [Smart Order Routing](#)



# Central Limit Order Book

## Overview

1. Definition of a Central LOB: A *central limit order book* – *CLOB* – is a centralized database of limit orders proposed by the SEC in 2000. However, the concept was opposed by securities companies (Wikipedia (2023)).
2. CLOB as an Order Matching System: A central limit order book or “CLOB” is a trading method used by most exchanges globally. It is a transparent system that matches customer orders, e.g., bids and offers, on a “price time priority” basis.
3. Best Market or “Touch”: The highest/best bid order and the lowest/offer order constitutes the best market or “the touch” in a given security or swap context.
4. Crossing the Bid/Ask Gap: Customers can routinely cross the bid/ask spread to effect immediate execution.
5. CLOB Market Depth or “Stack”: Customers can also see the market depth or the “stack” in which customers can view bid orders for various sizes and prices on one side vs. viewing offer orders at various sizes and prices on the other side.
6. Fully Transparent, Real-time, or Anonymous: The CLOB is by definition fully transparent, real-time, anonymous, and low cost in execution.
7. D2D, D2C, and C2C Trades: In the CLOB model, customers can trade directly with dealers, dealers can trade with other dealers, and importantly, customers can trade directly with customers anonymously.
8. The Request-for-Quote Method: In contrast to the CLOB approach is the Request-for-Quote – “RFQ” trading method.
9. RFQ as an Asymmetric Trade Execution Model: In this method, a customer queries a finite set of participant market makers who quote a bid/offer – a market – to the customer.



10. Trading Options available to Customers: The customer may only “hit the bid”, i.e., sell to the highest bidder, or “lift the offer”, i.e., buy from the cheapest seller.
11. Stepping inside Bid/Ask Group: The customer is prohibited from stepping inside the bid/ask spread and thereby reducing its execution fees.
12. Only D2C Allowed: Contrary to the CLOB model, customers can only trade with dealers. They cannot trade with other customers, and importantly, they cannot make markets themselves.

## References

- Wikipedia (2023): [Central Limit Order Book](#)



## Retail SOR Strategy Builder

### Retail SOR Wave Instructions

1. Wave #1: Send quantity to SOR with Sweep venue inclusion list (LX and BBOK).  
Order type will be mid-pegging, and time-in-force will be IOC.
2. Wave #1 Attributes/Strategy Parameters:

Time In Force	IOC
Pegging Instruction	Mid-point
Ping Type	SEQUENTIAL
Sweep Include Venue List	LATS (LX) and BBOK
Post Type	NO POST

3. Wave #2: Send any remaining quantity to SOR with Sweep venue inclusion list that correspond to inverted venues. Order type will be mid-pegging, and time-in-force will be IOC.
4. Wave #2 Venue Choice Customization: The inverted venue set is designed to be flexible, as exchanges can change fee schedules and can change from inverted to make/take.
5. Wave #2 Attributes/Strategy Parameters:

Time In Force	IOC
Pegging Instruction	Mid-point
Ping Type	SEQUENTIAL
Sweep Include Venue List	XBOS, BATY, EDGA, XCIS
Post Type	NO POST



6. Wave #3: Send any remaining quantity to SOR with Sweep venue inclusion list (LX and BBOK) with time-in-force of IOC.
7. Wave #3 Attributes/Strategy Parameters:

Time In Force	IOC
Pegging Instruction	NONE
Ping Type	NONE
Sweep Include Venue List	LATS (LX) and BBOK
Post Type	NO POST

8. Wave #4: Send any remaining quantity to SOR with IOI Sweep venue inclusion list with time-in-force of IOC.
9. Wave #4 Attributes/Strategy Parameters:

Time In Force	IOC
Pegging Instruction	NONE
Ping Type	NONE
Sweep Include Venue List	IOI
Post Type	NO POST

10. Cancel any remaining Quantity to the User.

## Phase-based Conditional Action

1. Pre-open Phase: Here

$$AsOfTime \leq ContinuousStartTime$$



This corresponds to pre-market opening auction, and takes full fill or partial fill, the rest is canceled. The order is sent pre-market, the auction is skipped, and continuous logic is applied.

2. Continuous Phase: Here

$$ContinuousStartTime \leq AsOfTime < ContinuousEndTime$$

This corresponds to pre-market opening auction, and takes full fill or partial fill, the rest is canceled. The order is sent pre-market, the auction is skipped, and continuous logic is applied.

3. Post-close Phase: Here

$$AsOfTime \geq ContinuousStartTime$$

There will not be any trade in the Post market phase.

## **Additional Considerations**

1. DAY Parent Orders from Client: The client may send TIF as either IOC or DAY, but the underlying wave will always be IOC orders, hence the parent will be treated the same.
2. Processing of Price/Quantity Amendments: Amendments will be processed by canceling the current wave and restarting from Wave #1 in line with other Strategy Builder algos.
3. Processing the Cancels: For cancels, the wave in progress will be allowed to complete, and any leaves will be canceled.
4. Case where Symbol is an IPO: If the symbol is an IPO, the Strategy Builder will reject the order.



5. Rejection from the Strategy Builder: Rejections from the Strategy Builder will not pause at the desk as it is a SOR workflow.

## Continuous Trading Scenario Overview

1. Send a Marketable Limit Order with TIF = IOC: All wave sequences above apply.
2. Send a Market Order with TIF = DAY: All wave sequences above apply.
3. Pre-open Order with TIF = DAY: Order received before pre-open should be parked and then trade – waves will be sent – in continuous.
4. Amend Price Up: The current wave will be canceled and restarted from Wave #1 in line with other Strategy Builder algos. The waves will go at the amended price after the amend.
5. Amend Price Down: The current wave will be canceled and restarted from Wave #1 in line with other Strategy Builder algos.
6. Amend TIF to DAY: From IOC to DAY. Wave should not be canceled after the amend, and the order should execute normally.
7. Amend TIF to IOC: From DAY to IOC. Wave should not be canceled after the amend, and the order should execute normally.
8. Amend Quantity Up: The parent quantity is first amended. The current wave will be canceled and restarted from Wave #1 in line with other Strategy Builder algos.
9. Amend Quantity Down but above Leaves: The parent quantity is first amended. The current wave will be canceled and restarted from Wave #1 in line with other Strategy Builder algos.
10. Amend Quantity Down but below Leaves: The parent quantity is first amended. The current wave will be canceled and restarted from Wave #1 in line with other Strategy Builder algos.
11. Closed IPO Order: Order should be rejected.
12. Marketable Limit Order sent to a Halted Symbol: The order will be accepted but will not trade.





13. Marketable Limit Order sent to a Halted-to-Open Symbol: The order will be accepted but will not trade. Once the symbol is open, the full wave scenario will apply.
14. Order Followed by Cancel: The sliced waves are processed, but the leaves are canceled.



## Execution Cost and Transaction Trajectories

### Motivation and Practice Overview

1. Definition of Trade Execution Cost: Execution cost is the difference in value between an ideal trade and what was actually done. The execution cost of a single completed trade is typically the difference between the final average trade price, including commissions, fees, and all other costs, and a suitable *benchmark* price representing a hypothetical perfectly executed trade.
2. The Execution Cost Sign Convention: The sign is taken so that the positive cost represents a loss of value; buying for a higher price or selling for a lower price.
3. Value Assigned to Unexecuted Trades: If a trade is not completed either for endogenous reasons (for example, the price moves away from an acceptable level) or for exogenous reasons (the trader gets sick or the system fails), then some value must be assigned to the unexecuted shares.
4. Cumulative Cost of Portfolio Execution: The cost of a portfolio transaction, or a series of transactions, is computed as a suitably weighted average of the cost of individual executions.
5. Direct Costs of Trade Execution: Some of the costs of trading are direct and predictable, such as broker commissions, taxes, and exchange fees. Although these costs can be significant they are not commonly included in the quantitative analysis of execution costs.
6. Indirect Costs of Trade Execution: “Indirect” costs include all other sources of price discrepancy, such as limited liquidity (market impact) and price motion due to volatility. These are much more difficult to characterize and measure, and are much more amenable to improvement.



7. The Arrival Price Benchmark: The benchmark is commonly taken to be the *arrival price*, that is, the quoted market price in effect at the time that the order was released to the trading desk.
8. Zero Cost Arrival Benchmark: Using that benchmark is equivalent to saying that a perfect trade – one with zero execution cost – would be one that executed instantaneously at the arrival price. The cost measured using the arrival price benchmark is called the *implementation shortfall* – a term introduced by Perold (1988).
9. Arrival Price Execution Cost Example: Suppose that an overnight investment decision assumed that a large quantity of stock could be purchased at the previous day's closing price of \$50 per share; if the trade was fully completed at an average price of \$50.25, then the execution cost would be reported at 25 cents per share.
10. Trade Duration Execution Cost Assignment: But execution costs are only part of the picture; if the stock closed that day at \$51, then the trade would be successful despite its positive cost; a naïve cost model may assign \$1 profit to the portfolio manager and 25 cents cost to the trader.
11. Execution Gain Instead of Cost: Execution costs can be negative, for example, if the price dropped in the course of a purchase program and the asset was acquired at a lower price than was anticipated; or in the above example, if the benchmark price were the day's close.
12. High Uncertainty in Cost Forecast: The forecast execution costs in any particular order have a very high degree of uncertainty, due to market volatility and other random effects.
13. Empirical Validation of the Cost Model: A well-calibrated model for the execution costs is an important part of the quantitative investment process. At a minimum it is a tool for the portfolio manager to evaluate the performance of his or her trading desk and the external brokers; were the results achieved on a particular execution compatible with the costs estimated from the pre-trade model (Almgren (2010))?
14. Cost Model as Decision Tool: Furthermore, the anticipated transaction costs should be a component of the portfolio formulation decisions; turnover should be minimized,



and the expected transaction costs must be incorporated in the portfolio construction model along with the expected alpha. Grinold and Kahn (1999) discuss in depth the use of transaction costs models in investment management.

15. Component of the Execution Process: This chapter is divided into three parts corresponding to the order in which the three aspects should be addressed in designing an investment process, although the order is reverse chronological from the point of view of a single trade. The post-trade cost reporting is looked at first, the optimal trading to minimize execution costs next, and finally the per-trade cost estimation.

## **Post-Trade Reporting**

1. Benchmark Relative Cost Reporting: The first step in any program to estimate execution costs is to measure them systematically. For each trade executed the cost should be reported relative to a collection of benchmarks.
2. Rolled Up Trade Cost Statistics: In addition the cost statistics should be computed across all trades over a suitable time period (daily or weekly) and broken down by any relevant parameters – primary market, size of trade, market capitalization of stock, etc.
3. The VWAP Cost Benchmark: As noted above the most common benchmark is the pre-trade arrival price. Another common choice is the “Volume Weighted Average Price” (VWAP) taken across the time interval over which the trade was executed. Although this most likely does not correspond to an investment goal directly, it is a popular benchmark for assessing the quality of execution, because it largely filters out the effects of volatility.
4. Post-Trade Price Benchmark: One would typically also use a post-trade price – for example the closing price on the day during which the trade was executed. Typical post-trade reporting systems display execution price relative to all of these benchmarks – before, during, and after trading.



5. Aggregating the Trade Cost Numbers: When aggregating the cost numbers across a diverse variety of trades, the individual cost numbers should be weighted so that the result is representative of the overall change in the portfolio value.
6. Pre-trade Prediction Validation: If a pre-trade cost model has been developed, then the realized values should be compared with the forecast values, both on the level of individual execution as well as the overall portfolio level. This will help identify trades that have been badly executed as well as maintaining accurate calibration of the pre-trade model.
7. Standard Deviation of the Trade: In addition to the average it is useful to report the standard deviation of the costs. This is useful for the reality check of the significance of the mean. For example if the standard deviation were 25 bp on 100 independent trades, then the expected error in the sample mean would be 2.5 bp and a change 1-2 bp in the mean cost would not be significant.
8. Nomenclature of the Standard Deviation: The standard deviation should also be weighted by the trade size; the most reasonable weights are the same ones used for the average cost. The standard deviation does not good properties under sub-division.
9. Sub-dividing Aggregate Trade Costs: Ideally aggregate cost numbers would be reported so that the result is indifferent to the sub-division of the trade costs, but this is often not possible. For example suppose that 100,000 shares were purchased throughout the day; a natural benchmark price would be the day's open price.
10. Aggregation Cost Division Granularity - Caveat: But if this block were considered as 40,000 shares in the morning and 60,000 shares in the afternoon, the arrival price for the second block would be the mid-day price and the overall reported cost would be lower. The choice can only be made with the knowledge of the investor's overall goals. This difficulty does not arise with a VWAP benchmark or with a benchmark price at a fixed time such as at the close.
11. Incomplete Trades - Transaction Cost Reporting: Additional difficulties in cost reporting come from price limits and incomplete trades. Suppose that a buy order is put in for a stock that is currently trading at \$50 but a condition is imposed that no shares are to be bought at a price higher than \$50.05. It will then be certain that the



price impact on this trade will be almost \$0.05 a share, but it may be that only a small fraction of the requested shares is actually executed. If the limit is below the initial price then the situation may be even more extreme. Similar difficulties arise if the trade is halted for other reasons.

12. Process Oriented Trade Cost Reporting: The solution to this difficulty rests on the valuation of the unexecuted shares, but there is no simple rule. The most straightforward would be to imagine that the unexpected shares were purchased at the day's closing price. In practice this rule is far *too* stringent and does not take into account the variety of possible reasons that the trade may have been halted due to. Trade cost reporting must take into account of the entire investment process.

## **Optimal Trading**

1. Motivation behind "Best Execution" Practice: Once a system is in place for measuring and reporting trade costs, and after it has been agreed what criteria define a good trade or a collection of trades, one can then design optimal strategies to meet investment goals. "Best execution" is not only advantageous to investors, but is also required by regulation in most markets.
2. Goals of the "Best Execution" Practice: The most important goal is always to reduce the mean expectation cost, which is largely due to market impact and the uncaptured short term alpha. One also often desires to reduce the standard deviation of the trade costs in order to reduce the overall investment volatility.
3. Reduction in Market Impact Costs: Reducing cost is achieved by searching for liquidity in "space" as well as in time, accessing as many pools of potential liquidity, and as many potential counterparties for each piece of trade. This includes routing to non-exchange trading venues such as "dark pools" and block-crossing services when possible. Rapid changes in the market structure make this increasingly complicated – see Hasbrouck (2007) for a discussion of the US equity markets.



4. Consequence of Altering the Trade Rate: Accessing liquidity in time means willing to slow trading to give potential counterparties the time to appear in the market. If the short term price drift is not expected to be significant, then the average trading costs can generally be reduced by trading more slowly.
5. Factors Determining the Optimal Execution: Other aspects of trading push for rapid trading – most significantly the anticipated price drift and the underlying market volatility (Alford, Jones, and Lim (2003)). The actual trade schedule is determined by using a quantitative balance of all these factors. This schedule may need to be dynamically adapted depending on the observed liquidity and other market components. For a portfolio the correlation between the assets should be included in addition to the volatility of each one, and the schedule may need to maintain a strict neutrality to a market index or other risk factors.
6. Mean Variance Tradeoff Strategies: In practice, optimal strategies for a mean-variance tradeoff, and optimal strategies that are calculated to optimize expected costs in the presence of short-term drift, are generally similar; at the beginning of each execution rapid trading reduces the exposure to the volatility or alpha, then the trading slows to reduce the overall impact costs (Almgren and Chriss (2000)).
7. Determining the Speed of Execution: The most important question is the overall speed of execution; should it be completed in minutes, hours, or days? Regardless of the model, an approximate quantitative model is an essential element of this decision.

## **Pre-trade Cost Estimation**

1. Estimating Transaction Cost Mean/Uncertainty: After a measurement system has been running for long enough to generate a useful amount of data, one can then think about developing an analytical model. The goal of the model is to forecast the execution cost to be expected on any anticipated trade, along with an estimate of the uncertainty of the forecast.



2. Market Impact Models in Literature: In its most general form such a model must contain a full explanation of how trading in markets affects prices. This is a rich area of research with a large literature – see Madhavan (2000) for an extensive survey, and Lillo, Farmer, and Mantegna (2003) and Bouchaud, Gefen, Potters, and Wyart (2004) for more subtle models.
3. Prediction of the Transaction Cost: The goal is to give the predicted cost  $\mathcal{C}$  - in cents per share of bp – in terms of input variables, including at a minimum the number of shares traded  $X$ , the daily volume  $V$  of the stock (either historical average of volume on the day of trading), and the effective duration  $T$  over which the trade was executed.
4. Normalization of Input/Output Metrics: In order to normalize across many different stocks, one should also include properties such as volatility  $\sigma$ , perhaps market capitalization, primary exchange/country, and other economic parameters. In addition one might include trade information across anticipated short-term alpha, and which algorithm or other means was used to trade the stock.
5. Classification using Supervised Learning Algorithms: For any proposed trade the pre-trade model predicts the cost based on the cost that was measured using *similar* trades in the past. “Supervised learning” algorithms (Poggio and Smale (2003)) could in principle be used to carry out this classification.
6. Curse of the Input Dimensionality: In practice because the dimension of the parameter space is so large, there may be no, or very few, trades that are sufficiently similar to the proposed ones in all variables. This argues for a regression approach in which a specific functional form is proposed, calibrated to data, and evaluated using standard statistical tests of significance.
7. Empirical Calibration of Market Impact: The most detailed such study was done by Almgren, Thum, Hauptmann, and Li (2005). The model is based on a separation of costs into “permanent” and “temporary” components. Although both trade components contribute to a realized cost on every trade, it is useful to calibrate each separately.





8. Price Observables used in the Calibration: The calibration relies on three observed prices;  $S_{PRE}$  denotes the arrival price, that is, the market price just before the order begins trading; typically this would be the bid-ask mid-point before the first execution.  $S_{EXEC}$  is the actual average price for which the order finally executes, which is of course the quantity of most interest to the trader.  $S_{POST}$  denotes the market price just after the order has finished executing, possibly with a short time lag to allow transient effects to dissipate.
9. Temporary/Permanent Market Impact Signals: The model of Almgren, Thum, Hauptmann, and Li (2005) measures two quantities  $I$  and  $J$  for permanent and temporary impacts, respectively. For a buy order these are

$$I = \log \frac{S_{POST}}{S_{PRE}} \approx \frac{S_{POST} - S_{PRE}}{S_{PRE}}$$

$$J = \log \frac{S_{EXEC}}{S_{PRE}} \approx \frac{S_{EXEC} - S_{PRE}}{S_{PRE}}$$

and for a sell order the sign would be reversed.

10. Model Parameter Applicability Range: The approximate equalities are valid for moderate sized order for which the price does not move more than a few percent during execution. These quantities represent the price changes relative to the pre-trade price, as fractions of that benchmark.
11. The Permanent Market Impact Signal: The permanent component of the cost is interpreted as the net displacement of the market due to the buy/sell imbalance introduced by this particular trade. The simplest model sets

$$I = \gamma \sigma \frac{X}{V} + \langle\langle \text{noise} \rangle\rangle$$

In this expression the trade size  $X$  is normalized by the trade volume  $V$  so  $\frac{X}{V}$  is the trade size as a function of the typical day's flow.



12. The Universal Permanent Impact Parameters: The impact  $I$  is also normalized by the volatility  $\sigma$ , so that then impact may be represented as a fraction of the typical amount the stock moves without trading. The trading coefficient  $\gamma$  is taken to be constant across all stocks, widely varying daily volumes and volatilities. The noise term arises from intra-day volatility, and the actual cost experienced on any particular trade may be very different from the mean predictions from the model.
13. Linear Permanent Market Impact Coefficient: In this form of the model the permanent impact is linear in the total number of shares traded. This model is particularly convenient for theoretical modeling, but must be justified by empirical analysis of real trade data. Almgren, Thum, Hauptmann, and Li (2005) found a reasonable agreement with their data, but later other empirical studies have suggested that the linear form might not be justified.
14. The Temporary Market Impact Signal: The temporary impact component of the cost is interpreted as the additional premium that must be paid for execution in a finite time, above a slightly prorated fraction of the permanent cost. It is modeled as

$$J = \frac{I}{2} + \eta \sigma \left( \frac{X}{VT} \right)^\beta + \langle \langle \text{noise} \rangle \rangle$$

where  $T$  represents the effective duration of the trade as a fraction of the trading day. Thus  $\frac{X}{VT}$  represents the “participation rate”, of the fraction of the market flow that this trade constitutes during the time it is active.

15. The Universal Temporary Impact Parameters: The factor  $\frac{1}{2}$  on the permanent cost component represents the fraction of the post-trade impact that is paid on the trade itself. As for the permanent cost, the impact cost is expressed as a fraction of typical volatility; the coefficient  $\eta$  is taken to be constant across all stocks. Other factors such as bid-ask spread and market capitalization were not determined to be significant in the US equity markets.
16. Two Stage Permanent/Temporary Calibration: Almgren, Thum, Hauptmann, and Li (2005) calibrate this model to a large sample of US equity trades using a two-step



procedure. First the permanent term  $I$  is calibrated, testing the hypothesis of linear impact and estimating the value of  $\gamma$ . Next the temporary impact term  $J$  is calibrated, determining the values for the exponent  $\beta$  and the coefficient  $\eta$ . A key aspect of the verification is the characterization of the error terms to verify that volatility is an adequate explanation of the residuals.

17. Permanent/Temporary Calibrated Market Parameters: The result has

$$\beta \approx 0.6$$

which is roughly compatible with earlier square root models (Barra (1997)) as well as for the coefficients  $\gamma$  and  $\eta$ . For trades that are a few percent of the daily volume executed across several hours, the predicted impact costs are 10's of basis points.

18. Approximate Nature of the Model #1: A number of factors make such models at best approximate. First is the extremely low values of  $R^2$  in the regression, typically around a few percent at best. That is, the ability of the model to predict the cost of any single trade is very poor, because the market volatility due to other trading activity is usually very large.
19. Approximate Nature of the Model #2: Second is the difficulty of the model in differentiating market impact from alpha; did the price move up because the buy program impacted the price, or was the trade executed because the manager correctly anticipated a price rise?
20. Approximate Nature of the Model #3: A third difficulty is the difference in behavior between small and large trades; although the model claims to be universally valid, in practice a model developed for small trades gives poor results on large trades.
21. Approximate Nature of the Model #4: In any particular application, the model should be critically evaluated by the user and recalibrated and extended as necessary. Despite its intrinsic difficulties and limitations, this model and its extensions are extremely useful in providing approximate anticipated cost values for pre-trade planning, optimal trade scheduling, and post-trade evaluation.



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## Execution of Portfolio Transactions – Optimal Trajectory

### Overview, Scope, and Key Results

1. Portfolio Transactions under Market Impact: Almgren and Chriss (2000) consider the execution of portfolio transactions with the aim of minimizing a combination of volatility risk and transaction costs arising from temporary and permanent market impact.
2. Efficient Frontier under Linear Cost: For a simple linear cost model, they explicitly construct an *efficient frontier* in the space of time-dependent liquidation strategies, which have the minimum expected cost for a given level of uncertainty.
3. Choice of the Utility Function: This enables one to select optimal strategies either by minimizing a quadratic utility function, or by minimizing the Value-at-Risk.
4. Liquidity Adjusted Value at Risk: The latter choice leads to the concept of liquidity-adjusted VaR, or L-VaR, that explicitly considers the best trade-off between the volatility risk and the liquidity costs.

### Motivation Background, and Synopsis

1. Transactions Changing the Portfolio Composition: Almgren and Chriss (2000) consider the optimal execution of portfolio transactions that move a portfolio from a given starting composition to a specified final composition within a specified period of time.
2. The Bertsimas and Lo Approach: Bertsimas and Lo (1998) define the best execution as the dynamic trading strategy that provides the minimum cost of trading over a fixed period of time, and they also show that under a variety of circumstances one can



find such a strategy by employing a dynamic optimization procedure; but they ignore the volatility of revenues of different trading strategies.

3. Maximization of Expected Trading Revenue: Almgren and Chriss (2000) work in the more general framework of maximizing the *expected revenue* – or equivalently minimizing the costs – with a suitable penalty for the *uncertainty* of revenue (or cost).
4. Market Microstructure Framework: This general framework arises in the market microstructure theory, but with a different purpose in mind. The *uninformed discretionary trader* trades an exogenous endowment over an exogenously specified amount of time to maximize the profits (Admati and Pfleiderer (1988)); the informed strategic trader trades over multiple periods on information not widely available, again to maximize profits (Kyle (1985)). In both cases the literature focuses on the link between the trader and the market maker, and a theory is produced to predict the market clearing price of the security at each period. Thus a trader's optimal strategy is used as a means to study the price formation in the markets, not as an object of interest in itself.
5. Variance of the Trading Cost: Almgren and Chriss (2000) study the variance of the trading cost in optimal execution because it fits in with the intuition that the trader's utility should figure in the definition of *optimal* in "optimal execution".
6. Example: Trading Illiquid Volatile Securities: For example, in trading a highly illiquid, volatile security, there are two extreme outcomes; trade everything now at a known, but high, cost, or trade in equal sized packets over a fixed time at a relatively lower cost. The latter strategy has a lower expected, but this comes at the expense of greater uncertainty in the final revenue.
7. Estimation of the Trading Uncertainty: How to evaluate the above uncertainty is partly subjective, and is a function of the trader's tolerance for risk. All that can be done is to insist that for a given level of uncertainty that the cost be minimized. This idea extends to a complete theory of optimal execution that includes an efficient frontier of optimal execution strategies.
8. Consistency with Expectations from Intuition: The framework of risk in execution yields several results that are consistent with the intuition. For example, it is evident



that all else equal, a trader will choose to execute a block of illiquid security less rapidly than a liquid security.

9. Models Lacking Consistency with Intuition: While this seems obvious, Almgren and Chriss (2000) demonstrate that a model that ignores risk does not have this property; without enforcing a strictly positive penalty for risk one cannot produce models that trade differently across the spectrum of liquidity.
10. Arithmetic Brownian Motion Price Dynamics: The incorporation of risk into optimal execution does not come without cost. First, in order to be able to produce tractable analytical results, Almgren and Chriss (2000) are forced to work in largely in the framework of price dynamics that are an arithmetic walk with independent increments.
11. Use of Static Optimization Procedures: They obtain results using *static optimization* procedures which they show lead to globally optimal trading trajectories. That is, optimal trading paths may be determined in advance of trading. Only the composition of the portfolio and the trader's utility function figure on the trading path.
12. Why does Static Optimization Work? The fact that the static strategy can be optimal even when the trader has the option to dynamically change his trading mid-course is a direct result of the assumptions of independence of returns and symmetry for the penalty functions for risk.
13. Using Non-Symmetric Penalty Functions: An interesting deviation from the symmetric penalty function was communicated by Ferstenberg, Karchmer, and Malamut at ITG Inc. They argue that the opportunity is a subjective quantity and is measures differently by different traders. Using a trader defined cost function  $g$ , they define opportunity costs as the expected costs of  $g$  applied to the average execution price obtained by the trader relative a benchmark price. They assume that the risk-averse traders will use a convex function  $g$  that is not symmetric in the sense that there is a strictly greater penalty for underperformance than for the same level of outperformance. They show that in this setting, the optimal strategy relative to  $g$  not only depends on the time remaining, but also on the performance of the strategy up to



the present time, and the present price of the security. In particular, this means that in their setting, optimal strategies are dynamic.

14. Serial Correlations among Price Movements: As it is well known that price movements exhibit some serial correlations across various time horizons (Lo and MacKinlay (1988)), that market conditions change, and that some participants possess private information (Bertsimas and Lo (1998)), one may question the usefulness of results that obtain strictly in an independent-increment framework.
15. The Dynamic Nature of Trading: Moreover, as trading is known to be a dynamic process, the conclusion that optimal trading strategies can be statically determined calls for critical examination. Almgren and Chriss (2000) examine what quantitative gains are available that incorporate all the relevant information.
16. Impact of the Serial Correlations: First they consider short term serial correlations in price movements. They demonstrate that the marginal improvements available by explicitly incorporating this information into trading strategies is small, and more importantly, independent of the portfolio sizes; as portfolio sizes increase, the percentage gains possible decrease proportionately.
17. Combining “Correlated” and “Shifting” Strategies: The above is precisely true for linear transaction cost models, and is approximately true for more general models. The results of Bertsimas and Lo (1998) suggest that trading a strategy built to take advantage of serial correlation will essentially be a combination of a “correlation free” strategy and a “shifting strategy” that moves from one trade period to the next based on the information available in the last period’s return. Therefore Almgren and Chriss (2000) argue that by ignoring serial correlation, they a) preserve the main interesting features of their analysis, and b) introduce virtually no bias away from “truly optimal” solutions.
18. Impact of Scheduled News Events: Second, Almgren and Chriss (2000) examine the impact of scheduled new events on optimal execution strategies. There is ample evidence that anticipated news announcements, depending on their outcome, can have a significant temporary impact on the parameters governing price movements.





19. Scheduled News Events - Literature Review: For a theoretical treatment see Brown, Harlow, and Tinic (1988), Kim and Verrecchia (1991), Easterwood and Nutt (1999), and Ramaswami (1999). For empirical studies concerning earnings announcements, see Patell and Wolfson (1984) for changes in mean and variance of intra-day prices, and Lee, Mucklow, and Ready (1993) and Krinsky and Lee (1996) for changes in the bid-ask spread. For additional studies concerning news announcements, see Charest (1978), Morse (1981), and Kalay and Loewentstein (1985).
20. Model Incorporation of Scheduled Events: Almgren and Chriss (2000) work in a simple extension of their static framework by assuming that the security again follows an arithmetic random walk, but at a time known at the beginning of trading, an uncorrelated event will cause a material shift in price dynamics, e.g., an increase or decrease of volatility.
21. Combining Piece-Wise Static Strategies: In this context they show that optimal strategies are piece-wise static. To be precise, they show that an optimal strategy entails following a static strategy up to the moment of the event, followed by another static strategy that can only be determined once the outcome of the event is known.
22. Variation from the Original Static Strategy: It is interesting to note that the static strategy that one follows in the first leg is in general not the same strategy one would follow in the absence of information concerning the event.
23. Accommodating Unanticipated External “Sudden” Events: Finally Almgren and Chriss (2000) note that any optimal execution strategy is vulnerable to *unanticipated events*. If such an event occurs during the course of trading and causes a material shift in the parameters of the price dynamics, then indeed a shift in the optimal trading trajectory must also occur.
24. Adaptation at Parameter Shift Edges: However if one makes a simplifying assumption that all events are either “scheduled” or “unanticipated” one then concludes that optimal execution is always a game of static trading punctuated by shifts in the trading strategies that adapt to material changes in the price dynamics.
25. Pre-determined vs. Active Approaches: If shifts are caused by events that are known ahead of time, then optimal execution benefits from a precise knowledge of the



possible outcomes of the event. If not, the best approach is to be actively “watching” the market for such changes and react swiftly should they occur.

26. Simple Proxy for Unexpected Uncertainty: One approximate way to include such completely unexpected uncertainty into the model is to artificially raise the value of the volatility parameter.
27. Risk Averse Optimal Trading Strategies: As a first step, Almgren and Chriss (2000) obtain closed form solutions for trading strategies for any level of risk aversion.
28. Efficient Frontier of Optimal Strategies: They then show that this leads to an efficient frontier of optimal strategies, where an element of the frontier is represented by a strategy with a minimal level of cost for its level of variance of the cost.
29. Graphical Structure of the Frontier: The structure of the frontier is of some interest. It is a smooth convex function differentiable at its minimal point. The minimal point is what Bertsimas and Lo (1998) call the naïve strategy because it corresponds to trading equally sized packets using all available trading time equally.
30. Differential at the Minimum Point: The differentiability of the frontier at its minimum point indicates that one can obtain a first order reduction in the variance of the trading cost at the expense of only a second order in cost by trading a strategy slightly away from the globally minimal strategy.
31. Curvature at the Minimal Point: The curvature of the frontier at its minimum point is a measure of the liquidity of the security.
32. Half-Life of Optimal Execution: Another ramification of the Almgren and Chriss (2000) study is that for all levels of risk aversion except risk neutrality, optimal execution trades have a “half-life” that fall out of the calculations.
33. Independence from the Time to Complete Execution: A trade’s half-life is independent of the actual specified time to liquidation, and is a function of the security’s liquidity and volatility, and the trader’s level of risk aversion.
34. Half-Life as Execution Time: As such Almgren and Chriss (2000) regard the half-life as an idealized time to execution, and perhaps a guide to the proper amount of time over which to execute a transaction.



35. Time Lesser than Half Life: If the specified time to liquidation is short relative to the trade's half-life, one can expect the cost of trading to be dominated by transaction costs.
36. Time Greater than Half Life: If the time to trade is long relative to the half-life, one can then expect most of the liquidation to take place well in advance of the limiting time.

## The Definition of a Trading Strategy

1. Price Dynamics and Trade Execution: As a starting point, Almgren and Chriss (2000) define a trading strategy, and lay out the dynamics that they study. They start with a formal definition of a strategy for a sell program consisting of liquidating a single security. The definitions and results are analogous for a buy program.
2. Problem Setup - Security Liquidation: Suppose that the seller holds a block of  $X$  units of a security that they want to completely liquidate before time  $T$ . To keep the discussion, Almgren and Chriss (2000) speak of *units* of a security. Specifically they have in mind shares of stock, futures contract, and units of a foreign currency.
3. Trading Strategy - Price/Unit Strategy: The seller divides  $T$  into  $N$  units of length

$$\tau = \frac{T}{N}$$

and defines the discrete times

$$t_k = k\tau$$

for

$$k = 0, \dots, N$$



The *trading trajectory* is defined to be the list  $x_0, \dots, x_N$  where  $x_k$  is the number of units that the seller plans to hold at time  $t_k$ .

4. Outright/Re-balanced Trajectories: The initial holdings is

$$x_0 = X$$

and liquidation at time  $T$  requires

$$x_N = 0$$

A trading trajectory can thought of as either the ex-post realized trades resulting from some process, or as a plan concerning how to trade a block of securities. In either case one may also consider *re-balancing* trajectories by requiring

$$x_0 = X$$

the initial position, and

$$x_1 = Y$$

the new position, but this is formally equivalent to studying trajectories of the form

$$x_0 = X - Y$$

and

$$x_N = 0$$



5. Outstanding Holdings/Incremental Trade Lists: Equivalently, a strategy may be specified using the “trade list”  $n_1, \dots, n_N$  where

$$n_k = x_{k-1} - x_k$$

is the number of units that the seller will sell between times  $t_{k-1}$  and  $t_k$ . Clearly,  $x_k$  and  $n_k$  are related by

$$x_k = X - \sum_{j=1}^k n_j = \sum_{j=k+1}^N n_j$$

$$k = 0, \dots, N$$

6. Simultaneous Portfolio Buying and Selling: Almgren and Chriss (2000) also consider more general programs of buying and selling simultaneously several securities.
7. Inter-Execution Time Interval Specification: For notational simplicity they consider all the time intervals to be of equal length  $\tau$ , but this restriction is not essential.
8. Behavior at  $N/\tau$  Limits: Although they do not discuss it, in all their results it is easy to take the continuous-time limit of

$$N \rightarrow \infty$$

and

$$\tau \rightarrow 0$$

9. Definition of a Trading Strategy: Almgren and Chriss (2000) define a “trading strategy” to be a rule for determining  $n_k$  in terms of the information available at  $t_{k-1}$ . Broadly speaking they distinguish between two types of trading strategies – static and dynamic.



10. Static vs. Dynamic Trading Strategy: Static strategies are determined in advance of trading, that is the rule for determining each  $n_k$  depends only on information available at  $t_0$ . Dynamic strategies, conversely, depend on all information up to, and including, time  $t_{k-1}$

## Price Dynamics

1. Exogenous/Endogenous Price Move Factors: Suppose that the initial security price is  $S_0$  so that the initial market value of the position is  $XS_0$ . The securities' price evolves according to two exogenous factors – volatility and drift, and one endogenous factor – market impact.
2. Market Forces vs. Trading Impact: Volatility and drift are assumed to be the result of market forces that occur randomly and independent of the trading.
3. Earlier Literature on Market Impact: Almgren and Chriss (2000) discussion largely reflect the work of Kraus and Stoll (1972), and the subsequent works of Holthausen, Leftwich, and Mayers (1987, 1990) and Chan and Lakonishok (1993, 1995). See also Keim and Madhavan (1995, 1997).
4. Origin of the Market Impact: As the market participants begin to detect the volume that the seller (buyer) is selling (buying), they naturally adjust their bids (offers) downward (upward). Almgren and Chriss (2000) distinguish two kinds of market impact.
5. Definition of Temporary Market Impact: *Temporary* impact refers to the temporary imbalances in supply and demand caused by the seller's trading leading to temporary price movements away from equilibrium.
6. Definition of Permanent Market Impact: *Permanent* impact refers to the changes in the "equilibrium" price due to the seller's trading, which remain at least for the life of the liquidation.
7. Price Evolution Stochastic Difference Equation: Almgren and Chriss (2000) assume that the security price evolves according to the discrete random walk



$$S_k = S_{k-1} + \sigma\sqrt{\tau}\xi_k - \tau g\left(\frac{n_k}{\tau}\right)$$

for

$$k = 1, \dots, N$$

8. Glossary of the Equation Terms: Here  $\sigma$  represents the volatility of the asset,  $\xi_k$ 's are draws from independent random variables each with zero mean and unit variance, and the permanent impact function  $g(v)$  is a function of the *average rate* of trading

$$v = \frac{n_k}{\tau}$$

during the interval  $t_{k-1}$  to  $t_k$ .

9. Lack of Explicit Drift Term: In the above equation there is no drift term. Almgren and Chriss (2000) indicate that this is due to the assumption that they have no information about the direction of the future price movements.
10. Trading Term Horizons under Consideration: Over long term investment time scales, or in extremely volatile markets, it is important to consider *geometric* rather than arithmetic Brownian motion – this corresponds to letting  $\sigma$  in

$$S_k = S_{k-1} + \sigma\sqrt{\tau}\xi_k - \tau g\left(\frac{n_k}{\tau}\right)$$

scale with  $S$ . But over short term “trading” horizons of interest, the total fractional price changes are small, and the differences between arithmetic and geometric Brownian motions are negligible.



## Temporary Market Impact

1. Intuition behind the Temporary Market Impact: The intuition behind the temporary market impact is that a trader plans to sell a certain number of units  $n_k$  between times  $t_k$  and  $t_{k-1}$ , but may work the order in several smaller sizes to locate optimal points of liquidity.
2. Liquidity Reduction Impact on Price: If the total number of units  $n_k$  is sufficiently large, the execution price may steadily decrease between  $t_{k-1}$  and  $t_k$  in part due to the exhaustion of the supply of liquidity at each successive price level. This effect is assumed to be short-lived, and in particular, liquidity is assumed to return back after each period, and a new equilibrium price is established.
3. The Temporary Price Impact Function: This effect is modeled by introducing a temporary price impact function  $h(v)$ , the temporary drop in the average price per share caused by trading at an average rate  $v$  during one time interval.
4. Net Price Received at Execution: Give this, the actual price per share received on sale  $k$  is

$$\tilde{S}_k = S_{k-1} - h\left(\frac{n_k}{\tau}\right)$$

but the effect of  $h(v)$  does not appear in the next “market” price  $S_k$ .

5. Choice of Market Microstructure: The functions  $g(v)$  in

$$S_k = S_{k-1} + \sigma\sqrt{\tau}\xi_k - \tau g\left(\frac{n_k}{\tau}\right)$$

and  $h(v)$  in

$$\tilde{S}_k = S_{k-1} - h\left(\frac{n_k}{\tau}\right)$$





may be chosen to reflect any preferred model of market microstructure, subject only to certain natural convexity conditions.

## Capture and Cost of Trading Trajectories

1. Capture across a Trading Trajectory: Almgren and Chriss (2000) then discuss the profits resulting from trading along a certain trajectory. They define the *capture* of a trajectory to be the full trading revenue upon completion of all trades. Due to the short term horizons that they consider, they do not include any notion of carry or time value of money in their discussions.
2. Full Trading Revenue across Execution: Thus, the capture is the sum of the product of the number of units  $n_k$  sold in each time interval times the effective price per share  $\tilde{S}_k$  received on that sale. It is readily computed as

$$\sum_{k=1}^N n_k \tilde{S}_k = XS_0 + \sum_{k=1}^N \left[ \sigma \sqrt{\tau} \xi_k - \tau g\left(\frac{n_k}{\tau}\right) \right] x_k + \sum_{k=1}^N n_k h\left(\frac{n_k}{\tau}\right)$$

3. Decomposition of the Capture Components: The first term on the RHS above is the initial market value of the position; each additional term represents a gain or a loss due to a specific market factor.
4. The Volatility Price Impact Term: The first term  $\sigma \sqrt{\tau} \xi_k x_k$  represents the total impact from the volatility.
5. The Permanent Market Impact Term: The permanent market impact term  $-\tau x_k g\left(\frac{n_k}{\tau}\right)$  represents the loss in the value of the position caused by a permanent price drop associated with selling a small piece of the position.
6. The Temporary Market Impact Term: And the temporary market impact term  $n_k h\left(\frac{n_k}{\tau}\right)$  is the price drop due to selling, acting only on the units sold during the  $k^{th}$  period.



7. The Total Cost of Trading: The *total cost of trading* is the difference  $XS_0 - \sum_{k=1}^N n_k \tilde{S}_k$  between the initial book value and the capture. This is the standard *ex-post* measure of the performance costs used in performance evaluations, and is essentially what Perold (1988) calls *implementation shortfall*.
8. Estimation of Implementation Short-fall: In this model, prior to trading, the implementation short-fall is a random variable. Write  $\mathbb{E}[X]$  for the expected short-fall and  $\mathbb{V}[X]$  for the variance of the short-fall.
9. Implementation Short-fall Mean/Variance: Given the simple nature of price dynamics, Almgren and Chriss (2000) readily compute

$$\mathbb{E}[X] = \sum_{k=1}^N \tau x_k g\left(\frac{n_k}{\tau}\right) + \sum_{k=1}^N n_k h\left(\frac{n_k}{\tau}\right)$$

$$\mathbb{V}[X] = \sigma^2 \sum_{k=1}^N \tau x_k^2$$

The units of  $\mathbb{E}[X]$  are in dollars, and the units of  $\mathbb{V}[X]$  are dollars squared.

10. Distribution of Implementation Short-fall: The distribution of the short-fall is Gaussian if  $\xi_k$  is Gaussian, in any case if  $N$  is large, it is very nearly Gaussian.
11. Almgren and Chriss Minimizer Utility: Almgren and Chriss (2000) devote much of their paper to finding trajectories that minimize  $\mathbb{E}[X] + \lambda \mathbb{V}[X]$  for various values of  $\lambda$ . They demonstrate that for each value of  $\lambda$  there corresponds a unique trading trajectory  $x$  such that  $\mathbb{E}[X] + \lambda \mathbb{V}[X]$  is minimal.

## Linear Impact Functions

1. Linear Temporary/Permanent Market Impact: Although Almgren and Chriss (2000) formulation does not require it, computing optimal trajectories is significantly easier



if one takes the permanent and temporary impact functions to be *linear* in the rate of trading.

2. Linear Permanent Impact Market Function: For linear permanent impact,  $g(v)$  has the form

$$g(v) = \gamma v$$

in which the constant  $\gamma$  has units of (\$/share)/share.

3. Corresponding Execution Time Security Price: With this form, each  $n$  units sold depresses the price per share by  $\gamma n$  regardless of the time taken to sell  $n$  units.

$$S_k = S_{k-1} + \sigma\sqrt{\tau}\xi_k - \gamma g\left(\frac{n_k}{\tau}\right)$$

readily yields

$$S_k = S_0 + \sigma \sum_{j=1}^k \sqrt{\tau_j} \xi_j - \tau \gamma (X - x_k)$$

4. Permanent Implementation Short-fall Mean: Then summing by parts, the permanent impact term in

$$\mathbb{E}[X] = \sum_{k=1}^N \tau x_k g\left(\frac{n_k}{\tau}\right) + \sum_{k=1}^N n_k h\left(\frac{n_k}{\tau}\right)$$

becomes



$$\begin{aligned}\sum_{k=1}^N \tau x_k g\left(\frac{n_k}{\tau}\right) &= \gamma \sum_{k=1}^N x_k n_k = \gamma \sum_{k=1}^N x_k (x_k - x_{k-1}) \\ &= \frac{1}{2} \gamma^2 \sum_{k=1}^N [x_{k-1}^2 - x_k^2 - (x_k - x_{k-1})^2] = \frac{1}{2} \gamma X^2 - \frac{1}{2} \gamma \sum_{k=1}^N n_k^2\end{aligned}$$

5. Linear Temporary Impact Market Function: Similarly, for the temporary impact we take

$$h\left(\frac{n_k}{\tau}\right) = \epsilon \operatorname{sgn}(n_k) + \frac{\eta}{\tau} n_k$$

where  $\operatorname{sgn}$  is the sign function.

6. Estimating the Fixed Costs of Execution: The units of  $\epsilon$  are \$/share, and those of  $\eta$  are (\$/share)/(share/time). A reasonable estimate for  $\epsilon$  is the fixed cost of selling, such as half of bid-ask spread plus premium.
7. Estimating the Linear Impact Coefficient: It is more difficult to estimate  $\eta$  since it depends on the internal and the transient aspects of the market microstructure. It is in this term that one would expect the on-linear terms to be most important, and the approximation

$$h\left(\frac{n_k}{\tau}\right) = \epsilon \operatorname{sgn}(n_k) + \frac{\eta}{\tau} n_k$$

to be most doubtful.

8. Total Temporary Impact Function: The linear model

$$h\left(\frac{n_k}{\tau}\right) = \epsilon \operatorname{sgn}(n_k) + \frac{\eta}{\tau} n_k$$

is often called a *quadratic* cost because the total costs incurred by buying or selling  $n$  units in a single unit of time is



$$nh\left(\frac{n}{\tau}\right) = \epsilon|n| + \frac{\eta}{\tau}n^2$$

9. Temporary Implementation Short-fall Mean: With both linear cost models

$$g(v) = \gamma v$$

and

$$h\left(\frac{n_k}{\tau}\right) = \epsilon \operatorname{sgn}(n_k) + \frac{\eta}{\tau}n_k$$

the expectation of the impact costs

$$\mathbb{E}[X] = \sum_{k=1}^N \tau x_k g\left(\frac{n_k}{\tau}\right) + \sum_{k=1}^N n_k h\left(\frac{n_k}{\tau}\right)$$

becomes

$$\mathbb{E}[X] = \frac{1}{2}\gamma X^2 + \epsilon \sum_{k=1}^N |n_k| + \frac{\tilde{\eta}}{\tau} \sum_{k=1}^N n_k^2$$

in which

$$\tilde{\eta} = \eta - \frac{1}{2}\gamma\tau$$

10. Strictly Convex Nature of  $\mathbb{E}[X]$ : Clearly  $\mathbb{E}[X]$  is a strictly convex function as long as

$$\tilde{\eta} > 0$$



Note that if  $n_k$  all have the same sign, as would be the case for a pure sell program or a pure buy program, then

$$\sum_{k=1}^N |n_k| = |X|$$

11.  $\mathbb{E}[X]$  and  $\mathbb{V}[X]$  Computation Illustration: To illustrate, Almgren and Chriss (2000) compute  $\mathbb{E}[X]$  and  $\mathbb{V}[X]$  for linear impact functions for two of trajectory schemes at the opposite extremes: sell at a constant rate, and sell to maximize variance without regard to transaction costs.
12. Minimum Impact: Constant Execution Rate: The most obvious trajectory is to sell at a constant rate over the entire liquidation period. Thus one takes each

$$n_k = \frac{X}{N}$$

and

$$x_k = (N - k) \frac{X}{N}$$

$$k = 1, \dots, N$$

13. Minimum Impact  $\mathbb{E}[X]$  and  $\mathbb{V}[X]$ : From

$$\mathbb{E}[X] = \sum_{k=1}^N \tau x_k g\left(\frac{n_k}{\tau}\right) + \sum_{k=1}^N n_k h\left(\frac{n_k}{\tau}\right)$$

and



$$\mathbb{E}[X] = \frac{1}{2}\gamma X^2 + \epsilon \sum_{k=1}^N |n_k| + \frac{\tilde{\eta}}{\tau} \sum_{k=1}^N n_k^2$$

one has

$$\mathbb{E}[X] = \frac{1}{2}XTg\left(\frac{X}{T}\right)\left(1 - \frac{1}{N}\right) + Xh\left(\frac{X}{T}\right) = \frac{1}{2}\gamma X^2 + \epsilon X + \tilde{\eta} \frac{X^2}{T}$$

and from

$$\mathbb{V}[X] = \sigma^2 \sum_{k=1}^N \tau x_k^2$$

$$\mathbb{V}[X] = \frac{1}{3}\sigma^2 X^2 T \left(1 - \frac{1}{N}\right) \left(1 - \frac{1}{2N}\right)$$

14. Minimum Impact  $N/T$  Limits: The trajectory minimizes total expected costs, but the variance may be large if the period  $T$  is long. As the number of trading periods

$$N \rightarrow \infty$$

$$v = \frac{X}{T}$$

remains finite, and  $\mathbb{E}[X]$  and  $\mathbb{V}[X]$  have finite limits.

15. Minimum Variance: One Step Execution: The other extreme is to execute the entire position in the first time step. One then takes

$$n_1 = X$$



$$n_2 = \dots = n_N = 0$$

$$x_1 = \dots = x_N = 0$$

which results in

$$\mathbb{E}[X] = Xh\left(\frac{X}{\tau}\right) = \epsilon X + \eta \frac{X^2}{\tau}$$

and

$$\mathbb{V}[X] = 0$$

16. Minimum Variance  $N/T$  Limits: The trajectory has the smallest possible variance – equal to zero – because of the way time has been discretized in the model above. If  $N$  is large and hence  $\tau$  is short, then on the full initial portfolio, one takes a price hit that can be arbitrarily large.
17. Trajectory between the Two Extremes: Almgren and Chriss (2000) show how to effectively compute trajectories that lie between the two extremes.

## **The Efficient Frontier of Optimal Execution**

1. Computing the Optimal Execution Trajectories: Almgren and Chriss (2000) define and compute optimal execution trajectories and use that to later demonstrate a precise relationship between risk aversion and the definition of optimality.
2. Uniqueness of Optimal Execution Strategy: In particular, they show that each level of risk aversion there is a uniquely determined optimal execution strategy.





## The Definition of the Frontier

1. Minimization of Expected Short-fall: The rational trader will always seek to minimize the expectation of short-fall for a given level of variance of the short-fall. Naturally a trader will prefer a strategy that provides minimum error in its estimate of expected costs.
2. Efficient Optimal Trading Strategy Definition: Thus a strategy is *efficient* or *optimal* if there is no other strategy that has lower variance for the same or a lower variance of the expected transaction costs, or, equivalently, no strategy which has no lower expected transaction costs for the same or lower level of variance.
3. Static vs. Dynamic Strategy Optimality: This definition of optimality of a strategy is the same whether the strategy is static or dynamic. It will be established later that under this definition and the price dynamics already stated, optimal strategies are in fact static.
4. Efficient Strategies - Constrained Optimization Formulation: One may construct efficient strategies by solving the constrained optimization problem

$$\min_{x: \mathbb{V}[x] \leq V_*} \mathbb{E}[x]$$

That is, for a given maximum level of variance

$$V_* \geq 0$$

one finds a strategy that has the minimum expected levels of transaction costs.

5. Convex Objective Function and Domain: Since  $\mathbb{V}[x]$  is convex, the set

$$\{\mathbb{V}[x] \leq V_*\}$$



is convex – it is a sphere – and since  $\mathbb{E}[x]$  is strictly convex, there is a unique minimizer  $x_*(V_*)$ .

6. Sub-Optimal Trajectory Variance Cost: Regardless of the preferred balance of risk and return, every other solution  $x$  which has

$$\mathbb{V}[x] \leq V_*$$

has higher expected costs than  $x_*(V_*)$  for the same or lower variance, and can never be more efficient.

7. Efficient Frontier of Optimal Strategies: Thus the family of all possible efficient (optimal) strategies is parametrized by a single variable  $V_*$  representing all possible maximum levels of variance in transaction costs. This family is referred to as *the efficient frontier of optimal trading strategies*.
8. Introducing KKT Type Constraint Multipliers: The constrained optimization problem

$$\min_{x: \mathbb{V}[x] \leq V_*} \mathbb{E}[x]$$

is solved by introducing a constraint multiplier  $\lambda$ , thereby solving the unconstrained problem

$$\min_x (\mathbb{E}[x] + \lambda \mathbb{V}[x])$$

9. Frontier as a Function of  $\lambda$ : If

$$\lambda > 0$$

$\mathbb{E}[x] + \lambda \mathbb{V}[x]$  is strictly convex, and the above minimizer has a unique solution  $x^*(\lambda)$ . As  $\lambda$  varies,  $x^*(\lambda)$  sweeps out the same one parameter family, and thus traces out an efficient frontier.



10.  $\lambda$  as a Risk Aversion Parameter: The Parameter  $\lambda$  has a direct financial interpretation.

It is already apparent from

$$\min_x (\mathbb{E}[x] + \lambda \mathbb{V}[x])$$

that  $\lambda$  is a measure of risk aversion, that is, how much the variance is penalized relative to the cost.

11.  $\lambda$  as an Efficient Frontier Curvature: In fact,  $\lambda$  is the curvature – second derivative – of a smooth utility function, as will be made more precise eventually.

12. Solution given  $h(v)$  and  $g(v)$ : For given values of the parameters, problem

$$\min_x (\mathbb{E}[x] + \lambda \mathbb{V}[x])$$

can be solved by various numerical techniques depending on the functional forms chosen for  $h(v)$  and  $g(v)$ . In the special case that these are *linear* functions, we may write the solution explicitly and gain a great deal of insight into the trading strategies.

## Explicit Construction of Optimal Strategies

1. Optimal Solution in Trajectory Space: With  $\mathbb{E}[x]$  from

$$\mathbb{E}[X] = \frac{1}{2} \gamma X^2 + \epsilon \sum_{k=1}^N |n_k| + \frac{\tilde{\eta}}{\tau} \sum_{k=1}^N n_k^2$$

and  $\mathbb{V}[x]$  from



$$\mathbb{V}[X] = \sigma^2 \sum_{k=1}^N \tau x_k^2$$

and assuming that  $n_j$  does not change sign, the combination

$$\mathbb{U}[x] = \mathbb{E}[x] + \lambda \mathbb{V}[x]$$

is a quadratic function of the control parameters  $x_1, \dots, x_{N-1}$ ; it is strictly convex for

$$\lambda \geq 0$$

2. Finding the Unique Global Minima: Therefore one determines the unique global minimum by setting its partial derivatives to zero. One readily calculates

$$\frac{\partial \mathbb{U}[x]}{\partial x_j} = 2\tau \left( \lambda \sigma^2 x_j - \tilde{\eta} \frac{x_{j-1} - 2x_j + x_{j+1}}{\tau^2} \right)$$

for

$$j = 1, \dots, N - 1$$

3. Combinations of Linear Difference Equations: Then

$$\frac{\partial \mathbb{U}[x]}{\partial x_j} = 0$$

is equivalent to

$$\frac{x_{j-1} - 2x_j + x_{j+1}}{\tau^2} = \tilde{\kappa}^2 x_j$$



with

$$\tilde{\kappa}^2 = \frac{\lambda\sigma^2}{\tilde{\eta}} = \frac{\lambda\sigma^2}{\eta \left(1 - \frac{\gamma\tau}{2\eta}\right)}$$

4.  $\tau$  Abstracted and Re-factored Parameter Set: Note that

$$\frac{x_{j-1} - 2x_j + x_{j+1}}{\tau^2} = \tilde{\kappa}^2 x_j$$

is a linear difference equation whose solution may be written as a combination of the exponentials  $e^{\pm\kappa t_j}$  where  $\kappa$  satisfies

$$\frac{2}{\tau^2} [\cosh(\kappa\tau) - 1] = \tilde{\kappa}^2$$

The tilde's on  $\tilde{\eta}$  and  $\tilde{\kappa}$  denote an  $\mathcal{O}(\tau)$  correction; as

$$\tau \rightarrow 0$$

one has

$$\tilde{\eta} \rightarrow \eta$$

and

$$\tilde{\kappa} \rightarrow \kappa$$

5. Trading Trajectory/Trade List Solutions: The specific solution with



$$x_0 = X$$

and

$$x_N = 0$$

is a trading trajectory of the form

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X$$

$$j = 0, \dots, N$$

and the associated trade list is

$$n_j = \frac{2 \sinh\left(\frac{1}{2}\kappa T\right)}{\sinh(\kappa T)} \cosh\left(\kappa\left(T - t_{j-\frac{1}{2}}\right)\right) X$$

$$j = 1, \dots, N$$

where  $\sinh$  and  $\cosh$  are the hyperbolic sine and cosine functions, and

$$t_{j-\frac{1}{2}} = \left(j - \frac{1}{2}\right) \tau$$

These solutions – although not the efficient frontier – have been constructed previously by Grinold and Kahn (1999).

6. Monotonicity of the Trading Trajectory: One has



$$n_j > 0$$

as long as

$$X > 0$$

Thus for a program of selling a large initial long position, the solution decreases *monotonically* from its initial value to zero at the rate determined by the parameter  $\kappa$ .

7. Consequence of Monotonic Trading Trajectories: For example, the optimal execution of a sell program never involves buying of securities – although this ceases to be true if there is drift or serial correlation in price movements.
8. Approximation under Small Time Step: For a small time step  $\tau$  one has the approximate expression

$$\kappa \sim \tilde{\kappa} + \mathcal{O}(\tau^2) \sim \sqrt{\frac{\lambda \sigma^2}{\eta \left(1 - \frac{\gamma \tau}{2\eta}\right)}} + \mathcal{O}(\tau)$$

$$\tau \rightarrow 0$$

Thus if the trading intervals are short  $\kappa^2$  is essentially the ratio of the product of volatility and the risk-intolerance to the temporary transaction cost parameter.

9. Optimal Strategy Expected Cost/Variance: The expectation and the variance of the optimal strategy for a given initial portfolio size  $X$  are then

$$\mathbb{E}[X] = \frac{1}{2} \gamma X^2 + \epsilon X + \tilde{\eta} X^2 \frac{\tanh\left(\frac{1}{2} \kappa \tau\right) [\tau \sinh(2\kappa T) + 2T \sinh(\kappa \tau)]}{2\tau^2 [\sinh(\kappa \tau)]^2}$$

and



$$\mathbb{V}[X] = \frac{1}{2} \sigma^2 X^2 \frac{\tau \sinh(\kappa T) \cosh(\kappa(T - \tau)) - T \sinh(\kappa \tau)}{[\sinh(\kappa T)]^2 \sinh(\kappa \tau)}$$

which reduce to

$$\mathbb{E}[X] = \frac{1}{2} X T g\left(\frac{X}{T}\right) \left(1 - \frac{1}{N}\right) + X h\left(\frac{X}{T}\right) = \frac{1}{2} \gamma X^2 + \epsilon X + \tilde{\eta} \frac{X^2}{T}$$

$$\mathbb{V}[X] = \frac{1}{3} \sigma^2 X^2 T \left(1 - \frac{1}{N}\right) \left(1 - \frac{1}{2N}\right)$$

$$n_1 = X$$

$$n_2 = \dots = n_N = 0$$

$$x_1 = \dots = x_N = 0$$

$$\mathbb{E}[X] = X h\left(\frac{X}{\tau}\right) = \epsilon X + \eta \frac{X^2}{\tau}$$

$$\mathbb{V}[X] = 0$$

in the limits

$$\kappa \rightarrow 0, \infty$$

## The Half-Life of a Trade

### 1. Definition of the Half-Life: Defining





$$\theta = \frac{1}{\kappa}$$

the trade's "half-life", and using the discussion above, it can be seen that the larger the value of  $\kappa$  and smaller the value of  $\theta$ , the more rapidly the trade list will be depleted. The value  $\theta$  is exactly the amount of time it takes to deplete the holdings by a factor of  $e$ .

2. Half-Life Different from  $T$ : The definition of  $\theta$  is independent of the exogenously specified execution time  $T$ ; it is determined only by the security price dynamics and the market impact factors. If the risk aversion  $\lambda$  is greater than zero, i.e., if the trader is risk-averse, then  $\theta$  is finite and independent of  $T$ .
3. Timeless Initial Portfolio Liquidation Rate: Thus, in the absence of any external time constraint, i.e.

$$T \rightarrow \infty$$

the trader will still liquidate his position on a time scale  $\theta$ . The half-life  $\theta$  is the intrinsic time scale of the trade.

4. Half Life Smaller than  $T$ : For a given  $T$  the ratio

$$\kappa T = \frac{T}{\theta}$$

tells us what factors constrain the trade. If

$$T \gg \theta$$

then the intrinsic half-life  $\theta$  of the trade is small compared to the imposed time  $T$ ; this happens because temporary costs are very small, because volatility is very large, or because of high risk aversion.



5. Impact of Small Half-Life: In this case the bulk of the trading will be done well in advance of the time  $T$ . Viewed on a time scale  $T$  the trajectory will look like a minimum variance solution

$$n_1 = X$$

$$n_2 = \dots = n_N = 0$$

$$x_1 = \dots = x_N = 0$$

6. Very High Half Life Limit: Conversely if

$$T \ll \theta$$

then the trade is highly constrained, and is dominated by temporary market impact costs. In the limit

$$\frac{T}{\theta} \rightarrow 0$$

one approaches the straight line minimum cost strategy

$$n_k = \frac{X}{N}$$

$$x_k = (N - k) \frac{X}{N}$$

$$k = 1, \dots, N$$



7. Trade Size Independent Execution Strategy: A consequence of this analysis is that different sized baskets of the same security will be liquidated in exactly the same fashion, on the same scale, provided the risk aversion parameter  $\lambda$  is held constant.
8. Basket Size Based Liquidity Dependence: This may seem contrary to the expectation that large baskets are effectively less liquid, and should hence be liquidated less rapidly than smaller baskets.
9. Reasons for the Counter-Intuitiveness: This is a consequence of the linear market impact assumption which has the *mathematical* consequence that both variance and market impact scale quadratically with respect to the portfolio size.
10. Higher Order Temporary Impact Function: For large portfolios it may be more reasonable to assume that the temporary impact cost function has higher-order terms, so that such costs increase *super-linearly* with the trade size. With non-linear impact functions, the general framework used here still applies, but one does not obtain explicit exponential solutions as in the linear impact case.
11. Size Dependent Temporary Impact Parameter: A simple practical solution to this problem is to choose different values of  $\eta$  - the temporary impact parameter – depending up on the overall problem size being considered, recognizing that the model is at best only approximate.

## Structure of the Frontier

1. Efficient Frontier and the Corresponding Trajectories: Using a specific choice for the parameters explained below, Almgren and Chriss (2000) produce a sample plot of the efficient frontier – each point on the frontier represents a distinct strategy for optimally liquidating the same basket. Their tangent line represents the optimal solution for a specified risk parameter

$$\lambda = 10^{-6}$$



They also illustrate the trajectories corresponding to a few sample points on the frontier.

2. Trajectory corresponding to Positive  $\lambda$ : Their first trajectory has

$$\lambda = 2 \times 10^{-6}$$

– this would be chosen by a risk-averse trader who wishes to sell quickly to reduce exposure to volatility risk, despite the trading costs incurred in doing so.

3. Trajectory corresponding to Zero  $\lambda$ : Their second trajectory has

$$\lambda = 0$$

They refer to this as the naïve strategy since this represents an optimal strategy corresponding to simply minimizing expected transaction costs without regard to variance.

4. Linear Reduction of the Holdings: For a security with zero drift and linear transaction costs as defined above

$$\lambda = 0$$

corresponds to a simple linear reduction of holdings over the trading period. Since drift is generally not significant over short trading horizons, the naïve strategy is very close to the linear strategy.

5. Sub Optimality of the Strategy: As Almgren and Chriss (2000) demonstrate later, in a certain sense this is *never* an optimal strategy because one can obtain substantial reductions in variance for a relatively small increase in transaction costs.
6. Trajectory corresponding to Negative  $\lambda$ : Finally their trajectory  $C$  has

$$\lambda = -2 \times 10^{-6}$$



it would only be chosen by a trader who likes risk. He postpones execution, thus incurring higher costs both due to rapid sales at the end, and higher variance during the extended period that he holds the security for.

## The Utility Function

1. The Risk-Reward Trade-off: Almgren and Chriss (2000) offer an interpretation of the efficient frontier of optimal strategies in terms of the utility function of the seller. They do this in two ways – by direct analogy with modern portfolio theory employing a utility function, and by a novel approach: Value-at-risk. This eventually leads to some general observations regarding the importance of utility in forming execution strategies.
2. Utility of Risk-Averse Functions: Suppose on measure utility by a smooth convex function  $u(w)$  where  $w$  is the total wealth. This function may be characterized by its risk-aversion coefficient

$$\lambda_u = -\frac{u''(w)}{u'(w)}$$

3. Approximation in Estimating the  $\lambda$ : If the initial portfolio is fully owned, then as the transfer of assets happens from the risky stock into the alternative riskless investment,  $w$  remains roughly constant, and one may take  $\lambda_u$  to be a constant throughout the trading period. If the initial portfolio is highly leveraged, then the assumption of constant  $\lambda$  is an approximate one.
4. Formulation of the Optimal Execution Strategy: For short time horizons and small changes in  $w$  the higher derivatives of  $u(w)$  may be neglected. Thus choosing an optimal execution strategy is equivalent to minimizing the scalar function

$$\mathbb{U}_{UTIL}[x] = \lambda_u \mathbb{V}[x] + \mathbb{E}[x]$$



The units of  $\lambda_u$  are  $\$^{-1}$ ; one is willing to accept an extra square \$ of variance if it reduces the expected cost by  $\$ \lambda_u$ .

5. Constructing Family of Optimal Paths: The combination  $\lambda V[x] + \mathbb{E}[x]$  is precisely the one used to construct the efficient frontier seen earlier; the parameter  $\lambda$ , introduced as a Lagrange multiplier, has a precise definition as a measure of aversion to risk. Thus, the methodology above used to construct the efficient frontier likewise produces a family of optimal paths, one for each level of risk aversion.
6. Static Nature of Optimal Path: Returning now to an important point raised earlier, the computation of optimal strategies by minimizing  $\lambda V[x] + \mathbb{E}[x]$  as measured at the initial trading time is equivalent to maximizing the utility at the outset of trading. As one trades, information arrives that could potentially alter the optimal path. The following theorem eliminates that possibility.
7. Time Homogenous Quadratic Utility Theorem: For a fixed quadratic utility function, the static strategies computed above are “time homogenous”. More precisely given a strategy that begins at a time

$$t = 0$$

and ends at a time

$$t = T$$

the optimal strategy computed at

$$t = t_k$$

is simply a continuation from

$$t = t_k$$



to

$$t = T$$

of the optimal strategy computed at time

$$t = 0$$

8. Proof Steps: General/Specific Functions: The proof may be seen in two ways – by the algebraic computations based on the specific solutions above, and by general valid for generic non-linear impact functions.
9. Proof Steps: Function Time Shift: First suppose that at time  $k$ , where

$$k = 0, \dots, N - 1$$

one were to compute a new optimal strategy. The new strategy would precisely be

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X$$

$$j = 0, \dots, N$$

with  $X$  replaced by  $x_k$ ,  $T$  replaced by  $T - t_k$ , and  $t_j$  replaced by  $t_j - t_k$ . Using the subscript  $(k)$  to denote the strategy computed at time  $k$  one would have

$$x_j^{(k)} = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa(T - t_k))} x_k$$

$$j = k, \dots, N$$



and the trade lists

$$n_j^{(k)} = \frac{2 \sinh\left(\frac{1}{2}\kappa\tau\right)}{\sinh(\kappa(T - t_k))} \cosh\left(\kappa\left(T - t_{j-\frac{1}{2}}\right)\right) X$$

$$j = k + 1, \dots, N$$

10. Proof Step: Recovering Optimal Solutions: It is then apparent that if  $x_k$  is the optimal solution from

$$x_j = \frac{\sinh\left(\kappa(T - t_j)\right)}{\sinh(\kappa T)} X$$

$$j = 0, \dots, N$$

with

$$j \mapsto k$$

then

$$x_j^{(k)} = x_j^0$$

and

$$n_j^{(k)} = n_j^0$$

where





$$x_j^0 = x_j$$

and

$$n_j^0 = n_j$$

are the strategies from

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X$$

$$j = 0, \dots, N$$

and

$$n_j = \frac{2 \sinh\left(\frac{1}{2}\kappa T\right)}{\sinh(\kappa T)} \cosh\left(\kappa\left(T - t_{j-\frac{1}{2}}\right)\right) X$$

$$j = 1, \dots, N$$

11. Proof Step: Non-linear Impact: For general non-linear impact functions  $g(v)$  and  $h(v)$  the optimality condition

$$\frac{x_{j-1} - 2x_j + x_{j+1}}{\tau^2} = \tilde{\kappa}^2 x_j$$

is replaced by a second-order *non-linear* difference relation. The solution  $x_j^{(k)}$  beginning at a given time is determined by the two boundary values  $x_k$  and



$$x_N = 0$$

It is then apparent that the solution does not change if we re-evaluate it at later times.

12. Origin of Time Stable Solutions: More fundamentally, the solutions are time stable because in the absence of serial correlations in the asset price movements, there is no more information about the price changes at later times than there is at the initial time.
13. Optimality over each Sub-interval: Thus, the solution which was determined to be optimal over the entire time interval is optimal as a solution over each sub-interval. This general phenomenon is well known in the theory of optimal control (Bertsekas (1976)).

## Value at Risk

1. Motivation behind Value at Risk: The concept of value at risk is traditionally used to measure the greatest amount of money – maximum profit or loss - a portfolio will sustain over a given period of time under “normal circumstances”, where “normal” is defined by a confidence level.
2. Trading Value at Risk Definition: Given a trading strategy

$$x = (x_1, \dots, x_N)$$

the value-at-risk of  $x$  defined  $Var_p[x]$  is defined to be the level of transaction costs by the trading strategy  $x$  that will not be exceeded  $p$  percent of the time. Put another way, it is the  $p^{th}$  percentile level of transaction costs for total costs of trading  $x$ .

3. Trading Value at Risk Expression: Under the arithmetic Brownian motion assumption, the total costs – the market value minus capture – are normally distributed with known mean and variance. Thus the confidence level is determined by the number of standard deviations  $\lambda_v$  from the mean of the inverse of the



cumulative normal distribution function, and the value at risk for the strategy  $x$  is given by

$$Var_p[x] = \lambda_v \sqrt{V[x]} + \mathbb{E}[x]$$

4. Relation to Implementation Short-fall: That is, with a probability  $p$  the trading strategy will not lose more than  $Var_p[x]$  of its market value in trading. Borrowing from the language of Period (1988), the implementation shortfall of execution will not exceed  $Var_p[x]$  more than a fraction  $p$  of the time. A strategy  $x$  is efficient if it has the minimum possible value at risk for the confidence level  $p$ .
5. Execution Trajectory Optimized for VaR: Note that  $Var_p[x]$  is a complicated non-linear function of  $x_j$  composing  $x$ ; it can be easily evaluated for any given trajectory, but finding the minimizing trajectory directly is difficult.
6. Single Parameter Efficient Frontier Solution: But once the one-parameter family of solutions that form the efficient frontier is obtained, one only needs to solve a one-dimensional problem to find the optimal solutions for the value at risk model, that is, to find the value of  $\lambda_u$  corresponding to a given value of  $\lambda_v$ . Alternatively one may characterize the solutions by a simple graphical procedure, or may read off the confidence levels corresponding to any particular point on the curve.
7. Almgren-Chriss Optimal VaR Illustration: Almgren and Chriss (2000) produce an illustration of the above, using the square root of variance in the  $x$ -axis as opposed to the variance in itself. In this co-ordinate system lines of optimal VaR have a constant slope, and for a given value of  $\lambda_v$  they simply find a tangent to the curve where the slope is  $\lambda_v$ .
8. Interim Optimal Execution Re-evaluation: The question of re-evaluation of the strategy is more complicated and subtle. If one re-evaluates the strategy half-way through the execution process, they will choose a new optimal strategy that is not the same as the original optimal one. The reason is that since  $\lambda_v$  is now held constant,  $\lambda_u$  necessarily changes.



9. General Challenges with the VaR Approach: Value at risk has many flaws from a mathematical point of view, as recognized by Artzner, Delbaen, Eber, and Heath (1997). The particular issue encountered here would occur in any problem in which the time of measurement is a fixed date, rather than maintained at a fixed distance in the future. It is an open issue to formulate suitable measures of risk for general time-dependent problems.
10. Liquidity Adjusted Value at Risk: Despite this shortcoming, Almgren and Chriss (2000) use the smallest possible value of  $Var_p[x]$  as an informative measure of the possible loss associated with the initial position, in the presence of liquidity effects. This value, which they call L-VaR for Liquidity Adjusted Value at Risk, depends on the time to liquidation and the confidence level chosen, in addition to the market parameters such as the impact coefficient (Almgren and Chriss (1999)).
11. Advantages of the L-VaR Approach: The optimal trajectories determined by minimizing the value at risk do *not* have the counter-intuitive scaling behavior seen earlier; even for linear impact functions, large portfolios will be traded closer to the straight line trajectory.
12. Using L-VaR for Large Portfolios: This is because the cost assigned to uncertainty scales *linearly* with the portfolio size, while the temporary impact cost scales *quadratically* as before. Thus the latter is more important for large portfolios.

## **The Role of Utility in Execution**

1. General Observations on Optimal Execution: Almgren and Chriss (2000) use the structure of the efficient frontier in the framework that they have developed to make some general observations concerning optimal executions.
2. The Naïve Strategy Benchmark: They first restrict themselves to the situation where the trader has no directional view on the security being traded. Recall that in this case, the naïve strategy is the simple straight line strategy in which the trader breaks the blocks being executed into equal sized blocks to be sold over equal time intervals.



They use this strategy as a benchmark for comparison with the other strategies used throughout here.

3. Convex  $\mathbb{E}[x]$  to  $\mathbb{V}[x]$  Mapping: A crucial insight is that the curve defining the efficient frontier is a smooth convex function  $\mathbb{E}[\mathbb{V}]$  mapping the levels of variance  $\mathbb{V}$  to the corresponding minimum mean transaction cost levels.
4. Region around the Naïve Strategy: Write  $(\mathbb{E}_0, \mathbb{V}_0)$  for the mean and variance around the naïve strategy. Regarding  $(\mathbb{E}_0, \mathbb{V}_0)$  as a point on the smooth curve  $\mathbb{E}[\mathbb{V}]$  defined by the frontier,  $\frac{\partial \mathbb{E}}{\partial \mathbb{V}}$  evaluated at  $(\mathbb{E}_0, \mathbb{V}_0)$  is equal to zero. Thus for  $(\mathbb{E}, \mathbb{V})$  near  $(\mathbb{E}_0, \mathbb{V}_0)$  one has

$$\mathbb{E} - \mathbb{E}_0 = \frac{1}{2}(\mathbb{V} - \mathbb{V}_0)^2 \left. \frac{\partial^2 \mathbb{E}}{\partial \mathbb{V}^2} \right|_{\mathbb{V}=\mathbb{V}_0}$$

where

$$\left. \frac{\partial^2 \mathbb{E}}{\partial \mathbb{V}^2} \right|_{\mathbb{V}=\mathbb{V}_0}$$

is positive is positive by the convexity of the frontier at the naïve strategy.

5. Special Feature of the Naïve Strategy: By definition, the naïve strategy has the property that any strategy with lower variance in cost has a greater expected cost. However a special feature of the naïve strategy is that a first-order decrease in variance can be obtained – in the sense of finding a strategy with a lower variance – while only incurring a second order increase in cost.
6. Disadvantages of Risk Neutral Strategy: From the above it follows that for small increases in variance, one can obtain much larger reductions in cost. Thus unless the trader is risk-neutral it is always advantageous to execute a strategy that is at least to some degree “to the left” of the naïve strategy. Thus one concludes that, in this framework, from a theoretical standpoint, it never makes sense to trade a strictly risk-neutral strategy.



7. The Role of a Security's Liquidity: An intuitive proposition is that with all things being equal, a trader will execute a more liquid basket more rapidly than a less liquid one. In the extreme this is particularly clear. A broker given a small order to execute over the course of the day will execute the entire order almost immediately.
8. Executing the Highly Liquid Security: How does one explain this? The answer is that the market impact cost attributable to rapid trading is negligible compared with the opportunity cost incurred in breaking up the order over an entire day. Thus, even if the expected return on a security over the day is zero, the perception is that the risk of waiting is outweighed by any small cost of immediacy.
9. Absence of Risk Reduction Premium: Now if the trader were truly risk neutral, in the absence of any views, he would always use the naïve strategy and employ the allotted time fully. This would make sense because any price to pay for trading immediately is worthless if one places no premium on risk reduction.
10. Limitation of Risk Neutral Approach: It follows that any model that proposes optimal trading behavior should predict that more liquid baskets are traded more rapidly than less liquid ones. A model that only considers the minimization of transaction costs, like that of Bertsimas and Lo (1998), is essentially a model that excludes utility.
11. Optimal Execution Independent of Liquidity: In such a model, and under Almgren and Chriss (2000) basic assumptions, traders will trade all baskets at the same rate irrespective of the liquidity, that is unless they have an explicit directional view on the security, or the security possesses extreme serial correlation in its price movements.
12. Super Linear Market Impact Functions: Almgren and Chriss (2000) do note that their model in the case of linear transaction costs does not predict a more rapid trading for smaller versus larger baskets of the same security. However, this is a consequence of choosing linear temporary impact functions and the problem goes away when one considers more realistic super-linear functions.
13. Risk Neutral Execution Half Life: Another way of looking at this is that the half-life of all black executions, under the assumption of risk-neutral preferences, is infinite.



## Choice of Parameters

1. The Asset Intrinsic Dynamics Parameters: Almgren and Chriss (2000) compute some numerical examples for the purposes of exploring the qualitative properties of the efficient frontier. Throughout the examples they consider a single stock with the current market price of

$$S_0 = 50$$

and that they initially have one million shares, for an initial portfolio size of \$50 million. The stock will have 30% annual volatility, 10% expected annual rate of return, a bid-ask spread of  $\frac{1}{8}$ , and a median daily trading volume of 5 million shares.

2. Stock Asset Daily Return/Volatility: With a trading year of 250 days this gives a daily volatility of

$$\frac{0.3}{250} = 0.019$$

and expected fractional return of

$$\frac{0.1}{250} = 4 \times 10^{-4}$$

To obtain our absolute parameters  $\sigma$  and  $\alpha$  one must scale it by the price, so

$$\sigma = 0.019 \times 50 = 0.95$$

and



$$\alpha = (4 \times 10^{-4}) \times 50 = 0.02$$

The table below summarizes the information.

3. Parameter Values for the Test Case:

Parameter Description	Parameter Symbol	Parameter Value
Initial Stock Price	$S_0$	\$50/share
Initial Holdings	$X$	$10^6$ shares
Liquidation Time	$T$	5 days
Number of Time Periods	$N$	5
30% Annual Volatility	$\sigma$	$0.95 (\$/share)/day^{\frac{1}{2}}$
10% Annual Growth	$\alpha$	$0.02 (\$/share)/day$
Bid Ask Spread $\frac{1}{8}$	$\epsilon$	$\$0.0625/share$
Daily Volume 5 million shares	$\gamma$	$2.5 \times 10^{-7} \$/share^2$
Impact at 1% of market	$\eta$	$2.5 \times 10^{-6} (\$/share) / (share / day)$
Static Holdings 11,000 shares	$\lambda_u$	$10^{-6} / \$$
VaR Confidence $p = 95\%$	$\lambda_v$	1.645

4. Incremental and Total Execution Times: Suppose that one wants to liquidate this position in one week so that

$$T = 5 \text{ days}$$

This is divided into daily trades such that  $\tau$  is 1 *day* and

$$N = 5$$





5. Standard Deviation of the Trajectory: Over this period, if one holds the original position with no trading, the fluctuations in the stock value will be Gaussian with a standard deviation of

$$\sigma\sqrt{T} = 2.12 (\$/share)$$

and the fluctuations in this value will have an absolute standard deviation of

$$\sqrt{V} = \$2.12M$$

As expected this is precisely the value of  $\sqrt{V}$  for the lowest point in the efficient frontier, since that point corresponds selling along a linear trajectory rather than holding a constant amount.

6. Temporary Cost Function Parameter -  $\epsilon$ : One then chooses the parameters for the temporary cost function

$$h\left(\frac{n_k}{\tau}\right) = \epsilon \operatorname{sgn}(n_k) + \frac{\eta}{\tau} n_k$$

Almgren and Chriss (2000) set

$$\epsilon = \frac{1}{16}$$

that is, the fixed part of the temporary costs will be one-half the bid-ask spread.

7. Temporary Cost Function Parameter -  $\eta$ : For  $\eta$  they suppose that for each 1% of the daily volume traded they incur a price impact equal to one bid-ask spread. For example trading at a rate of 5% daily volume incurs a one-time cost on each trade of  $\frac{5}{8}$ . Under this assumption



$$\eta = \frac{\frac{1}{8}}{0.01 \times 5 \times 10^6} = 2.5 \times 10^{-6}$$

8. Permanent Cost Function Parameter -  $\gamma$ : For permanent costs, the common rule of thumb is that price effects become significant when 10% of the daily volume is sold. Assuming that “significant” means that the price depression is one bid-ask spread, and that the effect is linear for both smaller and larger trading rates, one has

$$\gamma = \frac{\frac{1}{8}}{0.1 \times 5 \times 10^6} = 2.5 \times 10^{-7}$$

Recall that this parameter gives a fixed cost independent of the path.

9. The Risk Aversion Parameter -  $\lambda$ : Almgren and Chriss (2000) have chosen

$$\lambda = \lambda_u = 10^{-6}$$

For these parameters, from

$$\kappa \sim \tilde{\kappa} + \mathcal{O}(\tau^2) \sim \sqrt{\frac{\lambda \sigma^2}{\eta \left(1 - \frac{\gamma \tau}{2\eta}\right)}} + \mathcal{O}(\tau)$$

$$\tau \rightarrow 0$$

one has for the optimal strategy that

$$\kappa \approx 0.61 \text{ day}$$

so that



$$\kappa T \approx 3$$

Since this value is near 1 in magnitude, the behavior is an interesting intermediate in-between the naïve extremes.

10.  $\lambda_v$  at 95% Confidence Level: For the value at risk representation, as assumed 95% confidence level gives

$$\lambda_v = 1.645$$

## The Value of Information

1. Zero Drift Random Walk Assumption: The discussion carried out so far assumed that the price dynamics followed an arithmetic random walk with zero drift. Since past price paths provide no extra information on future price movements, the conclusion was that the optimal trajectories can be statically determined. There are three ways by which a random walk with zero drift may fail to represent the price process.
2. Non-zero Drift in Dynamics: First the price process may have drift. For example, if the trader has a strong directional view, the trader may want to incorporate this view into the liquidation strategy.
3. Cross Period Serial Correlation Impact: Second, the price process may exhibit serial correlation. The presence of first order serial correlation for example, implies that the price moves in a given period provide non-trivial information concerning the next period movement of the asset.
4. Incorporation of the Investor's Private Information: Bertsimas and Lo (1998) study a general form of this assumption, wherein an investor possesses possibly private information of a serially correlated information vector that acts as a linear factor in the asset returns.



5. Exogenously Induced Material Parameter Shift: Lastly, at the start of trading, it may be known that at some specific point in time, an event will take place whose outcome will cause a material shift in the parameters governing the price process.
6. Literature Survey on Exogenous Events: Such event induced parameter shifts include quarterly and annual earnings announcements, dividend announcements, and share repurchases. Event studies documenting these parameter shifts and providing theoretical grounding for their existence include Beaver (1968), Fama, Fisher, Jensen, and Roll (1969), Dann (1981), Patell, and Wolfson (1984), Kalay and Loewentstein (1985), Kim and Verrecchia (1991), Campbell, Lo, and MacKinlay (1997), Easterwood and Nutt (1999), and Ramaswami (1999).
7. Temporary Shifts on Dynamic Parameters: For example, Brown, Harlow, and Tinic (1988) show that events cause temporary shifts in both the risk and returns of individual securities, and the extent of these shifts depends on the outcome of the event. In general, securities react more strongly to bad news than good news.
8. Probabilistic Event Outcomes/Parameter Shifts: Almgren and Chriss (2000) study a stylized version of the events in which a known event at a known time – e.g., an earnings announcement – has several possible outcomes. The probability of each outcome is known, and the impact that a given outcome will have on the parameters of the price is also known. Clearly, optimal strategies must explicitly use this information, and Almgren and Chriss (2000) develop methods to incorporate event-specific information into their risk-reward framework.
9. Back-to-Back Static Strategies: The upshot is a piece-wise strategy that trades statically up to the event, and then reacts explicitly to the outcome of the event. Thus the burden is on the trader to determine which of the possible outcomes occurred and then trade accordingly.

## Drift



1. Drift as a Directional View: It is convenient to regard the drift parameter in the price process as a directional view of price movements. For example, the trader charged with liquidating a single security may believe that this security is likely to rise. Intuitively it makes more sense to trade this issue more slowly to take advantage of this view.
2. Incorporating Drift into Price Dynamics: To incorporate drift into the price dynamics Almgren and Chriss (2000) modify

$$S_k = S_{k-1} + \sigma\sqrt{\tau}\xi_k - \gamma g\left(\frac{n_k}{\tau}\right)$$

to

$$S_k = S_{k-1} + \sigma\sqrt{\tau}\xi_k + \alpha\tau - \gamma g\left(\frac{n_k}{\tau}\right)$$

where  $\alpha$  is an expected drift term. If the trading proceeds are invested in an interest bearing account, then  $\alpha$  should be taken as the *excess* rate of return of the risky asset.

3. Price Expectation over Time Period: One can readily write the modified version of

$$\mathbb{E}[X] = \frac{1}{2}\gamma X^2 + \epsilon \sum_{k=1}^N |n_k| + \frac{\tilde{\eta}}{\tau} \sum_{k=1}^N n_k^2$$

as

$$\mathbb{E}[X] = \frac{1}{2}\gamma X^2 - \alpha \sum_{k=1}^N \tau x_k + \epsilon \sum_{k=1}^N |n_k| + \frac{\tilde{\eta}}{\tau} \sum_{k=1}^N n_k^2$$

4. Updated Objective Function Optimality Condition: The variance is still given by



$$\mathbb{V}[X] = \sigma^2 \sum_{k=1}^N \tau x_k^2$$

The optimality condition

$$\frac{x_{j-1} - 2x_j + x_{j+1}}{\tau^2} = \tilde{\kappa}^2 x_j$$

becomes

$$\frac{x_{j-1} - 2x_j + x_{j+1}}{\tau^2} = \tilde{\kappa}^2 (x_j - \bar{x})$$

in which the new parameter

$$\bar{x} = \frac{\alpha}{2\lambda\sigma^2}$$

is the optimal level of security holding for a time independent portfolio optimization problem.

5. Drift Based Updated Execution Slice: For example, the parameters used in the example above give approximately

$$\bar{x} = 1,100 \text{ shares}$$

or 0.11% of our initial portfolio. One expects this fraction to be very small, since, by hypothesis, the eventual aim is complete liquidation.

6. Drift Based Updated Optimal Solution: The optimal solution

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X$$



$$j = 0, \dots, N$$

becomes

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X + \left\{ 1 - \frac{\sinh(\kappa(T - t_j)) + \sinh(\kappa t_j)}{\sinh(\kappa T)} \right\} \bar{x}$$

for

$$j = 0, \dots, N$$

with the associated trades

$$\begin{aligned} n_j = & \frac{2 \sinh\left(\frac{1}{2}\kappa\tau\right)}{\sinh(\kappa T)} \cosh\left(\kappa\left(T - t_{j-\frac{1}{2}}\right)\right) X \\ & + \frac{2 \sinh\left(\frac{1}{2}\kappa\tau\right)}{\sinh(\kappa T)} \left[ \cosh\left(\kappa t_{j-\frac{1}{2}}\right) - \cosh\left(\kappa\left(T - t_{j-\frac{1}{2}}\right)\right) \right] \bar{x} \end{aligned}$$

7. Initial Position Independent Trajectory Correction: This trading trajectory is a sum of two distinct trajectories – the zero-drift solution as computed before, plus a “correction” which profits by capturing a piece of the predictable drift component. The size of this correction term is proportional to  $\bar{x}$ , and thus to  $\alpha$ : it is independent of the initial portfolio size  $X$ .
8. Practical Incorporation into Program Trading: To place this in an institutional framework, consider a program trading desk that sits in front of customer flow. If this desk were to explicitly generate alphas on all securities that flow through the desk in an attempt to, say, hold securities with high alphas and sell securities with low alphas more rapidly, the profit would not scale in proportion to the average size of the



programs. Rather it would only scale with the number of securities that flow through the desk. An even stronger conclusion is that since the optimal strategy disconnects into a static strategy unrelated to the drift term, and a second strategy related to the drift term, there is no particular advantage to restricting trading in securities which the desk currently holds the positions in.

9. Comparison: Highly Liquid Markets Scenario: The difference between this solution and the no-drift solution in

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X$$

$$j = 0, \dots, N$$

may be understood by considering the case

$$\kappa T \gg 1$$

corresponding to highly liquid markets. Whereas the previous one relaxed from  $X$  to  $\frac{X}{e}$  in a time scale of

$$\theta = \frac{1}{\kappa}$$

this one relaxes instead to the optimal static portfolio size  $\bar{x}$ . Near the end of the trading period the trader sells the remaining holdings to achieve

$$x_N = 0$$

at





$$t = T$$

10. Caveat: Buy-Sell Symmetry Breaking: In this case, one requires

$$0 \leq \bar{x} \leq X$$

in order for all trades to be in the same direction. This breaks the symmetry between a buy program and a sell program, if one wanted to consider buy programs it would be more logical to set

$$\alpha = 0$$

## Gain due to Drift

1. Gain from Drift – Calculation Motivation: Now suppose that the price dynamics is given by

$$S_k = S_{k-1} + \sigma\sqrt{\tau}\xi_k + \alpha\tau - \gamma g\left(\frac{n_k}{\tau}\right)$$

with

$$\alpha > 0$$

but one chooses to determine the solution as though

$$\alpha = 0$$



The situation may arise, for example, in case where the trader is trading a security with non-zero drift, but *unknowingly* assumes that the security has no drift. Almgren and Chriss (2000) explicitly calculate the loss associated with ignoring the drift term.

2. Gain adjusted  $\mathbb{E}[x]$  and  $\mathbb{V}[x]$ : Write  $x_j^*$  for the optimal solution

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X + \left\{ 1 - \frac{\sinh(\kappa(T - t_j)) + \sinh(\kappa t_j)}{\sinh(\kappa T)} \right\} \bar{x}$$

with

$$\alpha > 0$$

$x_j^0$  for the sub-optimal solution

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X$$

$$j = 0, \dots, N$$

or

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X + \left\{ 1 - \frac{\sinh(\kappa(T - t_j)) + \sinh(\kappa t_j)}{\sinh(\kappa T)} \right\} \bar{x}$$

with

$$\alpha = 0$$



Also write  $\mathbb{E}^*[x]$  and  $\mathbb{V}^*[x]$  for the optimal expected cost and its variance measured by

$$\mathbb{E}[X] = \frac{1}{2}\gamma X^2 - \alpha \sum_{k=1}^N \tau x_k + \epsilon \sum_{k=1}^N |n_k| + \frac{\tilde{\eta}}{\tau} \sum_{k=1}^N n_k^2$$

and

$$\mathbb{V}[X] = \sigma^2 \sum_{k=1}^N \tau x_k^2$$

with

$$x_j = x_j^*$$

and write  $\mathbb{E}^0[x]$  and  $\mathbb{V}^0[x]$  for the sub-optimal values of

$$\mathbb{E}[X] = \frac{1}{2}\gamma X^2 - \alpha \sum_{k=1}^N \tau x_k + \epsilon \sum_{k=1}^N |n_k| + \frac{\tilde{\eta}}{\tau} \sum_{k=1}^N n_k^2$$

and

$$\mathbb{V}[X] = \sigma^2 \sum_{k=1}^N \tau x_k^2$$

evaluated with

$$x_j = x_j^0$$



3. Objective Function Gain from Drift: The corresponding objective functions are

$$\mathbb{U}^*[X] = \mathbb{E}^*[X] + \lambda \mathbb{V}^*[X]$$

and

$$\mathbb{U}^0[X] = \mathbb{E}^0[X] + \lambda \mathbb{V}^0[X]$$

One can then define the *gain due to drift* to be the difference  $\mathbb{U}^0[X] - \mathbb{U}^*[X]$ ; this is the reduction in the cost and the variance by being aware of and taking into account of the drift term. Clearly

$$\mathbb{U}^0[X] - \mathbb{U}^*[X] \geq 0$$

since  $x^*$  is the unique optimal strategy for the model with

$$\alpha > 0$$

4. Upper Bound for the Gain: Now the value of the terms in  $\mathbb{U}^0[X]$  that come from

$$\mathbb{E}[X] = \frac{1}{2}\gamma X^2 - \alpha \sum_{k=1}^N \tau x_k + \epsilon \sum_{k=1}^N |n_k| + \frac{\tilde{\eta}}{\tau} \sum_{k=1}^N n_k^2$$

and

$$\mathbb{V}[X] = \sigma^2 \sum_{k=1}^N \tau x_k^2$$



is only *increased* by going from  $x^0$  to  $x^*$  since  $x^0$  and not  $x^*$  was the optimum strategy with

$$\alpha = 0$$

Therefore an *upper bound* for the gain is

$$\mathbb{U}^0[X] - \mathbb{U}^*[X] \geq \alpha\tau \sum_{k=1}^N (x_k^* - x_k^0)$$

5. Adjustment Applied to the Holdings: That is, in response to positive drift, one should increase the holdings throughout the trading. This reduces the net cost by the amount of the increase in the asset price one captures, at the expense of slightly increasing the transaction costs and the volatility exposure. An upper bound for the possible benefit is the amount of increase one captures.
6. Explicit Expression for the Bound: But  $x_k^* - x_k^0$  is just the term in the square brackets in

$$x_j = \frac{\sinh(\kappa(T - t_j))}{\sinh(\kappa T)} X + \left\{ 1 - \frac{\sinh(\kappa(T - t_j)) + \sinh(\kappa t_j)}{\sinh(\kappa T)} \right\} \bar{x}$$

times  $\bar{x}$ , which is clearly independent of  $X$ . Indeed this can be explicitly evaluated to get

$$\alpha\tau \sum_{k=1}^N (x_k^* - x_k^0) = \alpha\bar{x}T \left[ 1 - \frac{\tau \tanh\left(\frac{1}{2}\kappa T\right)}{T \tanh\left(\frac{1}{2}\kappa\tau\right)} \right]$$



7. Gain Comparison against Execution Cost: Since  $\frac{\tanh x}{x}$  is a positive decreasingly function, this quantity is positive and bounded above by  $\alpha \bar{x}T$ , the amount one would gain by holding  $\bar{x}$  for a time  $T$ . Any reasonable estimates for the parameters show that this quantity is negligible compared to the impact costs incurred in liquidating an institutional sized portfolio over a short period.

## Serial Correlation

1. Prior Period Price Increment Component: Now one supposes that the asset prices exhibit serial correlation, so that at each period one discovers a component of predictability of the asset price in the next period.
2. Methodology behind the Price Increment Estimation: In the model

$$S_k = S_{k-1} + \sigma\sqrt{\tau}\xi_k - \gamma g\left(\frac{n_k}{\tau}\right)$$

with a drift

$$\alpha = 0$$

one now supposes that the  $\xi_k$  are serially correlated with period-to-period correlation  $\rho$

$$|\rho| < 1$$

One can determine  $\xi_k$  at time  $k$  based on the obtained  $S_k - S_{k-1}$  and sale  $n_k$

3. Optimal Strategy no more Static: With serial correlation the optimal trajectory is no longer a static trajectory determined in advance of trading; since each price



movement gives some information about the immediate future price movements, the optimal trade list can be determined only one period at a time.

4. Estimation of the Realized Gain: Thus a full optimal solution requires the use of dynamic programming methods. However since the information is still roughly local in time, one can estimate the optimal gain attainable by an optimal strategy.
5. Almgren and Chriss (2000) Conclusions: Almgren and Chriss (2000) state their conclusion in advance of their estimation. The value of information contained in pure movements due to serial correlations is independent of the size of the portfolios being traded. The calculation demonstrated below lends intuition to this counter-intuitive statement.
6. Per Period Price Change Impact: Consider two consecutive periods during which the base strategy has the trader trading the same number of shares  $n$  in each period. With a linear impact price model, in each period price changes by  $\left[\epsilon + \eta \frac{n}{\tau}\right]$  dollars/share. The trader pays this cost in each of the  $n$  shares, so the total cost due of market impact per period is  $\left[\epsilon + \eta \frac{n}{\tau}\right] n$
7. Price Change from Serial Correlation: Suppose one has some price information due to serial correlations. If one knows  $\xi_k$  at the previous period, then the predictable component of the price change is roughly  $\rho\sigma\sqrt{\tau}\Delta n$ .
8. Incremental Cost of the Adapted Strategy: But this adaptation increases the impact costs. After the shift in the first period the price change is  $\epsilon + \eta \frac{n-\Delta n}{\tau}$  while in the second period  $\epsilon + \eta \frac{n+\Delta n}{\tau}$ . These costs are paid on  $n - \Delta n$  and  $n + \Delta n$  shares respectively, so the market impact per period is now

$$\left[ \frac{1}{2} \left( \epsilon + \eta \frac{n - \Delta n}{\tau} \right) (n - \Delta n) + \frac{1}{2} \left( \epsilon + \eta \frac{n + \Delta n}{\tau} \right) (n + \Delta n) \right] = \left[ \epsilon + \eta \frac{n}{\tau} \right] n + \frac{n}{\tau} \Delta n^2$$

9. Optimal Per-Period Execution Shift: To determine how many shares one should shift, one solves the quadratic optimization problem



$$\max_{\Delta n} \left[ \rho \sigma \sqrt{\tau} \Delta n - \frac{n}{\tau} \Delta n^2 \right]$$

The optimal  $\Delta n$  is readily found as

$$\Delta n^* = \frac{\rho \sigma \tau^{\frac{3}{2}}}{2\eta}$$

and the maximum possible gain per period is  $\frac{\rho^2 \sigma^2 \tau^2}{4\eta}$ . This heuristic can be confirmed by a detailed dynamic programming computation that accounts for optimal shifts across multiple periods.

10. Limitation of Optimal Gain Execution: Almgren and Chriss (2000) also explain briefly the limitation of the above approximation. When  $\rho$  is close to zero, clearly this approximation is extremely close to accurate, because the persistence of the serial correlation effect dies down very quickly after the first period. When  $|\rho|$  is too large to ignore, the approximation is too small for

$$\rho > 0$$

That is,  $\frac{\rho^2 \sigma^2 \tau^2}{4\eta}$  understates the possible gains over ignoring serial correlation.

Conversely when

$$\rho < 0$$

$\frac{\rho^2 \sigma^2 \tau^2}{4\eta}$  overstates the possible gains due to serial correlation. As

$$\rho > 0$$





is more frequently the case Almgren and Chriss (2000) assert that  $\frac{\rho^2 \sigma^2 \tau^2}{4\eta}$  is useful for bounding the possible gains in most situations available from serial correlations.

11. Position Independence of Gain/Cost: Note that both the size of the adaptation, and the resulting gain, are independent of the amount of shares  $n$  that would be sold under an unadapted strategy. That is they are also independent of the size of the initial portfolio.
12. Gain/Cost Liquidity/Correlation Dependence: Instead the binding constraint is the liquidity of the security being traded, and the magnitude of the correlation coefficient. The more information available due to correlation and the more liquid the security, the more overall gain that is available due to adapting the strategy to the correlations.
13. Higher Order Impact Function Optimality: The results above are especially simple because of the assumption of linear impact functions. Almgren and Chriss (2000) also show briefly what happens in the more general case of nonlinear market impact functions

$$h(v) = h\left(\frac{n}{\tau}\right)$$

The cost per period due to market impact is

$$\begin{aligned} & \left[ \frac{1}{2} h\left(\frac{n - \Delta n}{\tau}\right) (n - \Delta n) + \frac{1}{2} h\left(\frac{n + \Delta n}{\tau}\right) (n + \Delta n) \right] \\ & \approx h\left(\frac{n}{\tau}\right) n + \left[ \frac{1}{2} h''\left(\frac{n}{\tau}\right) \frac{n}{\tau} + h'\left(\frac{n}{\tau}\right) \right] \frac{\Delta n^2}{\tau} \end{aligned}$$

for small  $\Delta n$ . Now the optimal shift and the maximal gain are given by

$$\Delta n^* = \frac{\rho \sigma \tau^{\frac{3}{2}}}{v h'' + 2 h'}$$



and  $\frac{\rho^2 \sigma^2 \tau^2}{2(vh'' + 2h')}$  respectively, where  $h'$  and  $h''$  are evaluated at the base execution rate of

$$v = \frac{n}{\tau}$$

The linear case is recovered by setting

$$h(v) = \epsilon + \eta v$$

This has the special property that  $h'$  is independent of  $v$  and

$$h'' = 0$$

14. Optimality Dependence on Impact Exponent: In general suppose

$$h(v) \sim \mathcal{O}(v^{\varpi})$$

as

$$v \rightarrow \infty$$

$$\varpi > 0$$

is required so that  $h(v)$  is increasing; selling the share always pushes the price down more. The marginal cost is

$$h'(v) \sim \mathcal{O}(v^{\varpi-1})$$

$$\varpi > 1$$



corresponds to an increasing marginal impact, and

$$\varpi < 1$$

corresponds to a decreasing marginal impact. Then the per-period cost one pays on the base strategy is

$$\sim \mathcal{O}(v^{\varpi+1})$$

for large initial portfolios, and hence large rates of execution. The marginal gain from adapting to evolution is

$$\sim \mathcal{O}(v^{\varpi-1})$$

in the same limit.

## Parameter Shifts

1. Price Dynamics Parameter Set Shift: Almgren and Chriss (2000) discuss the impact on optimal execution of scheduled news earnings such as earnings and dividend announcements. Such events have two features that make them an important object of study. First the outcome of the event determines the shift in the parameters governing the price dynamics – see Brown, Harlow, and Tinic (1988), Easterwood and Nutt (1999), and Ramaswami (1999).
2. Determining an Event' Full Impact: Second, the fact that they are scheduled increases the likelihood that one can detect what the true outcome of the event is. This situation is formalized below, and explicit formulas are given for price trajectories before and after the event takes place.



3. Scheduled Event Occurrence Time  $T_*$ : Suppose at some time  $T_*$  between now and the specified final time  $T$  an event will occur, the outcome of which may or may not cause a shift in the parameters of price dynamics.
4. New Regime Shifted Parameter Set: The term *regime set* or *parameter set* refers to the collection

$$R = \{\sigma, \eta, \dots\}$$

of the parameters that govern the dynamics at any particular time, and the events of interest are those that have the possibility of causing *parameter shifts*.

5. Initial to Final Regime Shift: Let

$$R_0 = \{\sigma_0, \eta_0, \dots\}$$

be the parameters of price dynamics at the time the execution begins. Suppose the market can shift to one of possible new sets of parameters  $p$  so that  $R_1, \dots, R_p$  is characterized by parameters  $\sigma_j, \eta_j, \dots$  for

$$j = 1, \dots, p$$

6. Probability of a Regime Switch: One also supposes that probabilities can be assigned to these possible new states, so that  $p_j$  is the probability that regime  $R_j$  occurs. The probabilities are *independent* of the short term market fluctuations represented by  $\xi_k$ . Of course it is possible that some  $R_j$  has the same values as  $R_0$  in which case  $p_j$  is the probability that no change occurs.
7. Globally Optimal Dynamic Trading Strategy: Almgren and Chriss (2000) consider a dynamic trading strategy the yields globally optimal strategies in the presence of a parameter shift at time  $T_*$ . Taking

$$T_* = t_s = s\tau$$



one pre-computes an initial trajectory

$$x^0 = \{x_0^0, \dots, x_s^0\}$$

with

$$x_0^0 = X$$

Denote

$$X_* = x_s^0$$

8. Landscape of Switchable Trajectories: They also compute a family of trajectories

$$x^j = \{x_0^j, \dots, x_s^j\}$$

for

$$j = 1, \dots, p$$

all of which have

$$x_s^j = X_*$$

and

$$x_N^j = 0$$



They follow the trajectory  $x^0$  until the time of the shift. Once the shift occurs they assume they can quickly identify the outcome of the event and the new set of parameters governing the price dynamics. With this settled, the complete trading using the corresponding trajectory  $x^j$  is determined.

9. Key Almgren and Chriss (2000) Results: Almgren and Chriss (2000) show that it is possible to determine each trajectory using static optimization; although one cannot choose which one to use until the event occurs. Also the starting trajectory  $x^0$  will *not be the same* as the trajectory one would use if they believed the regime  $R_0$  would hold through the entire time  $T$ .
10. Trajectory Conditional on Fixed  $X_*$ : To determine the trajectories  $x^0, x^1, \dots, x^p$  they reason as follows. Suppose that the common value of

$$X_* = x_s^0 = x_s^j$$

is fixed. Then by virtue of the independence of the regime shift in itself from the security motions, the optimal trajectories conditional on the values of  $X_*$  are simply those that have already been computed with a small modification to include the given non-zero final value.

11. Sequential Pair of Static Strategies: One can immediately write

$$x_k^0 = \frac{\sinh(\kappa_0(T_* - t_k))}{\sinh(\kappa_0 T_*)} X + \frac{\sinh(\kappa_0 t_k)}{\sinh(\kappa_0 T_*)} X_*$$

$$k = 0, \dots, s$$

where  $\kappa_0$  is determined from  $\sigma_0, \eta_0, \dots$ . The trajectory is determined the same way as seen before; it is the unique combination of the exponentials  $x^{\pm \kappa_0 t}$  that has

$$x_0^0 = X$$



and

$$x_s^0 = X_*$$

Similarly

$$x_k^j = \frac{\sinh(\kappa_j(T - t_k))}{\sinh(\kappa_j(T - T_*))} X_*$$

$$k = s, \dots, N$$

$$j = 1, \dots, p$$

Thus one only needs to determine  $X_*$ .

12. Principle behind the Estimation of  $X_*$ : To determine  $X_*$  one needs to determine the expected loss and the variance of the combined strategy. Let  $\mathbb{E}_0$  and  $\mathbb{V}_0$  denote the expectation and the loss incurred by the trajectory  $x^0$  on the first segment

$$k = 0, \dots, s$$

The quantities can be determined readily using

$$\mathbb{E}[X] = \frac{1}{2} \gamma X^2 + \epsilon \sum_{k=1}^N |n_k| + \frac{\tilde{\eta}}{\tau} \sum_{k=1}^N n_k^2$$

and

$$\mathbb{V}[X] = \sigma^2 \sum_{k=1}^N \tau x_k^2$$



13. Mean Variance of the Compound Strategy: Then by virtue of the regime shift and the security motion's independence, the expected loss of the compound strategy is

$$\mathbb{E} = \mathbb{E}_0 + \mathbb{P}_1 \mathbb{E}_1 + \cdots + \mathbb{P}_p \mathbb{E}_p$$

and its variance is

$$\mathbb{V} = \mathbb{V}_0 + \mathbb{P}_1 \mathbb{V}_1 + \cdots + \mathbb{P}_p \mathbb{V}_p + \frac{1}{2} \sum_{i,j=1}^{p0} \mathbb{P}_i \mathbb{P}_j (\mathbb{E}_i - \mathbb{E}_j)^2$$

One can now do a one-variable optimization in  $X_*$  to maximize  $\mathbb{E} + \lambda \mathbb{V}$ . Almgren and Chriss (2000) provide a pictorial representation of the above.

## Conclusions and Further Extensions

1. Efficient Frontier of Transaction Costs: The central feature of the Almgren and Chriss (2000) analysis has been to construct an *efficient frontier* in a two-dimensional plane whose axes are the expectation of the total cost and its variance.
2. Linear Impact Functions Analytical Solutions: Regardless of an individual's tolerance to risk, the only strategies which are candidates for being optimal solutions are found in this one-parameter set. For linear impact functions, they give complete analytical solutions for the strategies in this set.
3. Efficient Frontier Optimal Operating Characteristic: Then, considering the details of risk aversion, they have shown how to select an optimal point on the frontier either by classical mean-variance optimization, or by the concept of value at risk. These solutions are easily constructed numerically, and interpreted graphically by examining the frontier.





4. First Conclusion: Sub-optimal Strategies: Because the set of attainable strategies, and hence the efficient frontier, are generally *smooth* and *convex*, a trader who is at all risk-averse should never trade according to the naïve strategy of minimizing expected cost. This is because in the neighborhood of that strategy, the first order reduction in the variance is attained at the expense of only a second order increase in the expected cost.
5. Second Conclusion: Custom Risk Optimization: Almgren and Chriss (2000) also observe that this careful analysis of the costs and risks of liquidation can be used to give a more precise characterization of the risk of holding the initial portfolio. As an example, they define a Liquidity-Adjusted VaR (L-VaR) to be, for as given time horizon, the minimum VaR of any static liquidation strategy.
6. Actual Gains of Dynamic Trading: Although it may seem counter-intuitive that the optimal strategies can be determined in advance of trading, Almgren and Chriss (2000) argue that only very small gains can be realized by adapting the strategy to the information as it is needed.
7. First Extension: Continuous Time Trading: The limit

$$\tau \rightarrow 0$$

is immediate in all of their solutions. Their trading strategy is characterized by a holdings function  $x(t)$  and a *trading rate*

$$x(t) = \lim_{\tau \rightarrow 0} \frac{n_k}{\tau}$$

Almgren and Chriss (2000) minimum variance strategy has infinite cost, but the optimal strategies for finite  $\lambda$  have finite cost and variance. However, this limit is at best a mathematical convenience, as the market model is implicitly a “coarse-grained” description of the real dynamics.



8. Second Extension: Nonlinear Cost: The conceptual framework outlined by Almgren and Chriss (2000) is not limited to the linear permanent and temporary impact functions

$$g(v) = \gamma v$$

and

$$h(v) = \epsilon \operatorname{sgn}(n_k) + \frac{\eta}{\tau} n_k$$

though the exact exponential/hyperbolic solutions are specific to that case. For nonlinear functions  $g(v)$  and  $h(v)$  that satisfy suitable convexity conditions, optimal risk-averse trajectories are found by solving a non-quadratic optimization problem; the difficulty of the problem depends on the specific functional forms chosen.

9. Third Extension Time Varying Coefficients: Almgren and Chriss (2000) framework also covers the case in which the volatility, the market impact parameters, and perhaps the expected drift are all time-dependent; finding the optimal strategy entails solving a linear system of size equal to the number of time periods (times the number of assets, for a portfolio problem). One example in which this is useful is if the price is expected to jump up or down on a known future date – say, an earnings announcement – as long as one has a good estimate of the expected *size* of this jump.

## Numerical Optimal Trajectory Generation

1. Varying Time Interval Cost Distribution:

$$\mathbb{E}[x] = \sum_{k=1}^N \tau_k x_k g\left(\frac{n_k}{\tau_k}\right) + \sum_{k=1}^N n_k h\left(\frac{n_k}{\tau_k}\right)$$



$$\mathbb{V}[x] = \sum_{k=1}^N \tau_k \sigma_k^2 x_k^2$$

$$\tau_k = t_k - t_{k-1}$$

$$n_k = x_k - x_{k-1}$$

2. Time Varying Interval Linear Impact:

$$\mathbb{E}[x] = \frac{1}{2} \gamma X^2 + \epsilon \sum_{k=1}^N |n_k| + \eta \sum_{k=1}^N \frac{n_k^2}{\tau_k} - \frac{1}{2} \gamma \sum_{k=1}^N n_k^2$$

$$\mathbb{V}[x] = \sum_{k=1}^N \tau_k \sigma_k^2 x_k^2$$

$$\tau_k = t_k - t_{k-1}$$

$$n_k = x_k - x_{k-1}$$

3. Varying Interval Linear Impact Objective:

$$\mathbb{U}[x] = \mathbb{E}[x] + \lambda \mathbb{V}[x]$$

implies

$$\mathbb{U}[x] = \frac{1}{2} \gamma X^2 + \epsilon \sum_{k=1}^N |n_k| + \eta \sum_{k=1}^N \frac{n_k^2}{\tau_k} - \frac{1}{2} \gamma \sum_{k=1}^N n_k^2 + \lambda \sum_{k=1}^N \tau_k \sigma_k^2 x_k^2$$



4. Varying Time Interval Linear Impact Jacobian:

$$\frac{\partial \mathbb{U}[x]}{\partial x_j} = 2 \left\{ \lambda \tau_j \sigma_j^2 x_j - \tilde{\eta} \left[ \frac{x_{j+1}}{\tau_{j+1}} - \frac{x_{j-1}}{\tau_j} - x_j \left( \frac{1}{\tau_j} + \frac{1}{\tau_{j+1}} \right) \right] \right\} + \frac{1}{2} \gamma [x_{j-1} - 2x_j + x_{j+1}]$$

Extrema requires that

$$\frac{\partial \mathbb{U}[x]}{\partial x_j} = 0 \quad \forall j = 1, \dots, N - 1$$

5. Estimation Quantities for Numerical Optimization: To carry out the numerical optimization, one needs the Jacobian (i.e., gradient) and the Hessian of the optimizer objective function in terms of

$$x_j \quad \forall j = 1, \dots, N - 1$$

This has to be computed for each of the following quantities:

- a. Trajectory Slice Permanent Impact Function Expectation Left Holdings
- b. Trajectory Slice Permanent Impact Function Expectation Right Holdings
- c. Trajectory Slice Permanent Impact Function Expectation Cross Holdings  
Jacobian
- d. Trajectory Slice Temporary Impact Function Expectation Left Holdings
- e. Trajectory Slice Temporary Impact Function Expectation Right Holdings
- f. Trajectory Slice Temporary Impact Function Expectation Cross Holdings  
Jacobian
- g. Trajectory Slice Permanent Impact Function Variance Left Holdings
- h. Trajectory Slice Permanent Impact Function Variance Right Holdings
- i. Trajectory Slice Permanent Impact Function Variance Cross Holdings  
Jacobian
- j. Trajectory Slice Temporary Impact Function Variance Left Holdings



- k. Trajectory Slice Temporary Impact Function Variance Right Holdings
- l. Trajectory Slice Temporary Impact Function Variance Cross Holdings  
Jacobian
- m. Trajectory Slice Core Market Function Expectation Left Holdings
- n. Trajectory Slice Core Market Function Expectation Right Holdings
- o. Trajectory Slice Core Market Function Expectation Cross Holdings Jacobian
- p. Trajectory Slice Core Market Function Variance Left Holdings
- q. Trajectory Slice Core Market Function Variance Right Holdings
- r. Trajectory Slice Core Market Function Variance Cross Holdings Jacobian
- s. Trajectory Permanent Impact Function Expectation Left Holdings
- t. Trajectory Permanent Impact Function Expectation Right Holdings
- u. Trajectory Permanent Impact Function Expectation Cross Holdings Jacobian
- v. Trajectory Temporary Impact Function Expectation Left Holdings
- w. Trajectory Temporary Impact Function Expectation Right Holdings
- x. Trajectory Temporary Impact Function Expectation Cross Holdings Jacobian
- y. Trajectory Permanent Impact Function Variance Left Holdings
- z. Trajectory Permanent Impact Function Variance Right Holdings
- aa. Trajectory Permanent Impact Function Variance Cross Holdings Jacobian
- bb. Trajectory Temporary Impact Function Variance Left Holdings
- cc. Trajectory Temporary Impact Function Variance Right Holdings
- dd. Trajectory Temporary Impact Function Variance Cross Holdings Jacobian
- ee. Trajectory Core Market Function Expectation Left Holdings
- ff. Trajectory Core Market Function Expectation Right Holdings
- gg. Trajectory Core Market Function Expectation Cross Holdings Jacobian
- hh. Trajectory Core Market Function Variance Left Holdings
- ii. Trajectory Core Market Function Variance Right Holdings
- jj. Trajectory Core Market Function Variance Cross Holdings Jacobian
- kk. Objective Utility Function Permanent Impact Function Expectation Left  
Holdings



- ll. Objective Utility Function Permanent Impact Function Expectation Right Holdings
- mm. Objective Utility Function Permanent Impact Function Expectation Cross Holdings Jacobian
- nn. Objective Utility Function Temporary Impact Function Expectation Left Holdings
- oo. Objective Utility Function Temporary Impact Function Expectation Right Holdings
- pp. Objective Utility Function Temporary Impact Function Expectation Cross Holdings Jacobian
- qq. Objective Utility Function Permanent Impact Function Variance Left Holdings
- rr. Objective Utility Function Permanent Impact Function Variance Right Holdings
- ss. Objective Utility Function Permanent Impact Function Variance Cross Holdings Jacobian
- tt. Objective Utility Function Temporary Impact Function Variance Left Holdings
- uu. Objective Utility Function Temporary Impact Function Variance Right Holdings
- vv. Objective Utility Function Temporary Impact Function Variance Cross Holdings Jacobian
- ww. Objective Utility Function Core Market Function Expectation Left Holdings
- xx. Objective Utility Function Core Market Function Expectation Right Holdings
- yy. Objective Utility Function Core Market Function Expectation Cross Holdings Jacobian
- zz. Objective Utility Function Core Market Function Variance Left Holdings
- aaa. Objective Utility Function Core Market Function Variance Right Holdings
- bbb. Trajectory Slice Core Market Function Variance Cross Holdings Jacobian



6. Permanent Impact Expectation Left Sensitivity:

$$\mathbb{E}_{P,k} = s\tau_k x_k g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)$$

$$\frac{\partial \mathbb{E}_{P,k}}{\partial x_{k-1}} = s\tau_k x_k \frac{\partial g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_{k-1}}$$

$$\frac{\partial^2 \mathbb{E}_{P,k}}{\partial x_{k-1}^2} = s\tau_k x_k \frac{\partial^2 g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_{k-1}^2}$$

$$s = \text{sign}\left(\frac{x_k - x_{k-1}}{\tau_k}\right)$$

7. Permanent Impact Expectation Right Sensitivity:

$$\mathbb{E}_{P,k} = s\tau_k x_k g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)$$

$$\frac{\partial \mathbb{E}_{P,k}}{\partial x_k} = s\tau_k g\left(\frac{x_k - x_{k-1}}{\tau_k}\right) + s\tau_k x_k \frac{\partial g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_k}$$

$$\frac{\partial^2 \mathbb{E}_{P,k}}{\partial x_k^2} = 2s\tau_k \frac{\partial g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_k} + s\tau_k x_k \frac{\partial^2 g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_k^2}$$

8. Permanent Impact Expectation Cross Jacobian:

$$\mathbb{E}_{P,k} = s\tau_k x_k g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)$$



$$\frac{\partial^2 \mathbb{E}_{P,k}}{\partial x_{k-1} \partial x_k} = s\tau_k x_k \frac{\partial^2 g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_{k-1} \partial x_k} + s\tau_k \frac{\partial g\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_{k-1}}$$

9. Temporary Impact Expectation Left Sensitivity:

$$\mathbb{E}_{T,k} = (x_k - x_{k-1})h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)$$

$$\frac{\partial \mathbb{E}_{T,k}}{\partial x_{k-1}} = -h\left(\frac{x_k - x_{k-1}}{\tau_k}\right) + (x_k - x_{k-1}) \frac{\partial h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_{k-1}}$$

$$\frac{\partial^2 \mathbb{E}_{T,k}}{\partial x_{k-1}^2} = -2 \frac{\partial h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_{k-1}} + (x_k - x_{k-1}) \frac{\partial^2 h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_{k-1}^2}$$

10. Temporary Impact Expectation Right Sensitivity:

$$\mathbb{E}_{T,k} = (x_k - x_{k-1})h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)$$

$$\frac{\partial \mathbb{E}_{T,k}}{\partial x_k} = h\left(\frac{x_k - x_{k-1}}{\tau_k}\right) + (x_k - x_{k-1}) \frac{\partial h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_k}$$

$$\frac{\partial^2 \mathbb{E}_{T,k}}{\partial x_k^2} = 2 \frac{\partial h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_k} + (x_k - x_{k-1}) \frac{\partial^2 h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_k^2}$$

11. Temporary Impact Expectation Cross Jacobian:

$$\mathbb{E}_{T,k} = (x_k - x_{k-1})h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)$$





$$\frac{\partial^2 \mathbb{E}_{T,k}}{\partial x_{k-1} \partial x_k} = -\frac{\partial h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_k} + \frac{\partial h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_{k-1}} + (x_k - x_{k-1}) \frac{\partial^2 h\left(\frac{x_k - x_{k-1}}{\tau_k}\right)}{\partial x_k \partial x_{k-1}}$$

12. Trajectory Jacobian and Hessian Computation: In general, the trajectory Jacobian's and the Hessian's may be computed as sequential, aggregate accumulations over the corresponding slices, with one very critical caveat. In the automated sensitivity generation schemes, all sensitivities to the left-most and the right-most nodes must be excluded, since these do not constitute the control nodes.
13. Power Objective Function Rationale/Formulation: A generalization of the mean-variance optimization and the Value-at-risk schemes is the power objective function formulation

$$\mathbb{U}[x] = \mathbb{E}[x] + \lambda(\mathbb{V}[x])^p$$

$$p = 1$$

corresponds to the regular mean-variance optimization scheme, and

$$p = 0.5$$

corresponds to the liquidity based VaR formulation.

14. Liquidity VaR Control Jacobian/Hessian:

$$\mathbb{U}[x] = \mathbb{E}[x] + \lambda(\mathbb{V}[x])^p$$

$$\frac{\partial \mathbb{U}[x]}{\partial x_i} = \frac{\partial \mathbb{E}[x]}{\partial x_i} + \lambda p (\mathbb{V}[x])^{p-1} \frac{\partial \mathbb{V}[x]}{\partial x_i}$$

$$\frac{\partial^2 \mathbb{U}[x]}{\partial x_i \partial x_j} = \frac{\partial^2 \mathbb{E}[x]}{\partial x_i \partial x_j} + \lambda p (p-2) (\mathbb{V}[x])^{p-2} \frac{\partial \mathbb{V}[x]}{\partial x_i} \frac{\partial \mathbb{V}[x]}{\partial x_j} + \lambda p (\mathbb{V}[x])^{p-1} \frac{\partial^2 \mathbb{V}[x]}{\partial x_i \partial x_j}$$



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## Non-linear Impact and Trading-Enhanced Risk

### Abstract

1. Price and Market Impact Volatility: Almgren (2003) determines optimal trading strategies for the liquidation of a large single-asset portfolio to minimize a combination of volatility risks and market impact costs.
2. Power Law Market Impact Function: The market impact cost is taken to be a power law of the trading rate with an arbitrary positive exponent. This includes, for example, the square root law that has been proposed based on market microstructure theory.
3. Holdings Size Dependent Characteristic Time: In analogy with the linear model, a *characteristic time* is defined for optimal trading, which now depends on the initial portfolio size and decreases as the execution proceeds.
4. Trade Size Dependent Liquidity Volatility: Also considered is a model in which the uncertainty of the realized price is increased by demanding rapid execution; it is shown that the optimal trajectories are defined by a *critical portfolio size* above which this effect is dominant and below which this effect may be neglected.

### Introduction

1. Active vs. Passive Execution Strategy: In the execution of large portfolio transactions, a trading strategy must be determined that balances the risk of delayed execution against the cost of rapid execution; the choice is roughly between an *active* and *passive* trading strategy (Hasbrouck and Schwartz (1988), Wagner and Banks (1992)).
2. Construction of Optimal Execution Strategies: Several papers have constructed optimal strategies for the problem (Almgren and Chriss (1999), Grinold and Kahn



(1999), Almgren and Chriss (2000), Konishi and Makimoto (2001) under the assumption that the liquidity costs per share traded are a linear function of trading rate or block size, and that the only source of volatility in execution is the price volatility of the underlying asset.

3. Price Effect of Block Trades: There is an extensive literature studying the effects of block trades on prices – see Kraus and Stoll (1972), Holthausen, Leftwich, and Mayers (1987, 1990), Chan and Lakonishok (1993, 1995), Keim and Madhavan (1995, 1997), and Koski and Michaely (2000).
4. Assumption of Linear Trading Costs: In practice linearity of trading costs is an unrealistic assumption. Perold and Salomon Jr. (1991) have argued that the liquidity premium per share demanded by the market will either be a convex or a concave function of the block size depending on whether the market's perception is that the trader is information driven or liquidity driven, respectively.
5. Barra Market Impact Liquidity Premium: In the Barra Market Impact Model (Loeb (1983), Kahn (1993), Barra (1997), Grinold and Kahn (1999)) it is argued, based upon the detailed analysis of the risk-reward choice faced by the equity market maker that the liquidity premium per share should grow as the square root of the block size traded.
6. Block Size Dependent Liquidity Premium: Electronic trading systems such as Optimark (Rickard and Torre (1999)) have been constructed to allow traders specify precisely what liquidity premium they are willing to pay as a function of the block size, and search for clearing opportunities in the mismatch between profiles of different market participants. These effects can be captured by introducing *nonlinear impact functions* into the cost function which is minimized to determine the optimal trading strategies.
7. Approaches of Nonlinear Models: Although linear models are commonly used in empirical regression analyses for simplicity, nonlinear models can often be emulated by dividing trades into categories by size (Bessembinder and Kaufmann (1997), Huang and Stoll (1997)). In fact, Chakravarthy (2001) argues medium-sized trades have a disproportionately large effect on prices.



8. Handling Non-Deterministic Liquidity Premiums: An additional effect not considered in the theoretical strategies considered in the previous work is that the liquidity premium demanded by the market is not deterministic. In fact the premium will depend on the presence in the market at that instant of participants who are willing to take the other side of the trade.
9. Motivation for Trading Enhanced Risk: Since the presence of these counterparties cannot be predicted in advance, it represents an additional source of risk incurred by the trading profile. That is, a more complete model should include *trading-enhanced risk* representing the increased uncertainty in the execution price incurred by demanding rapid execution of large blocks.
10. Manifestation of Stochastic Liquidity Premiums: Trading-enhanced risk is an implicit feature in the model described in Rickard and Torre (1999). Chordia, Subrahmanyam, and Anshuman (2001) and Hasbrouck and Seppi (2001) argue that liquidity fluctuates due to intrinsic variations in the market activity independent of the trade size. This effect is included in the model by Almgren (2003) via the constant term  $f(0)$  but additional interest is in the *increase* in the execution price uncertainty due to larger block sizes.
11. Nonlinear Block Size Dependence: Thus Almgren (2003) extends the models of Grinold and Kahn (1999) and Almgren and Chriss (2000) in a few important ways. First, the liquidity premium, expressed as an unfavorable motion of the price per share, may be an increasing nonlinear function of the trading rate and the block size – one is considered to be a proxy for the other.
12. Power Law Premium - Closed Form: This cost is reduced by trading slowly, but it must be balanced against the volatility risk incurred by holding the initial portfolio longer than is necessary. In particular, exact solutions are provided in the case this function is a power law with an arbitrary positive exponent, which covers the range of behavior outlined above.
13. Dependence on Initial Portfolio Size: Whereas in the linear case optimal trajectories are characterized by a single *characteristic time* independent of the initial portfolio



size, in the nonlinear case the characteristic time depends upon the initial portfolio size, and scales appropriately as the remaining portfolio diminishes during trading.

14. Comparison with Price Volatility Risk: The realized price per share itself is a random variable, whose variance increases with the increased rate of trading. This introduces an additional source of risk in addition to the volatility. In contrast to the effect of market volatility, this additional risk is *decreased* by trading slowly, submitting small blocks for execution at each time.
15. Volatile Liquidity - Closed Form Solutions: Nearly explicit optimal solutions including this effect can be constructed, and an asymptotic analysis can be used to show that the effect of trading-enhanced risk is most important for large initial portfolios. Indeed for any given set of parameters there is a characteristic portfolio size above which the optimal strategy is determined by the need to reduce trading-enhanced risk, and below which this effect may be ignored.

## The Model

1. Holdings Trade and Liquidation Time: The general framework followed is that from Almgren and Chriss (2000). At time

$$t = 0$$

$X$  shares of an asset are held, which are to be completely liquidated by the time

$$t = T$$

The initial size  $X$  is positive for a sell program and negative for a buy program; in the former case, there is a long exposure to the market until all the holdings have been eliminated, while in the latter case there is short exposure to the market until the purchase to which the trader has committed to at





$$t = 0$$

is completed. The focus here is on the case

$$X > 0$$

In the case of a portfolio trading problem  $X$  may be a vector, but the consideration here is only on a single asset.

2. The Problem Trade List Determination:  $x(t)$  denotes the holdings at time  $t$  with

$$x(0) = X$$

and

$$x(T) = 0$$

The problem is to choose an optimal function  $x(\cdot)$  so as to minimize a chosen cost functional. Later the limit

$$T \rightarrow \infty$$

will be taken in which the natural execution time emerges as a result of the analysis, but for now the consideration is on an exogenously imposed time horizon.

3. Origin of the Static Strategy: It is a rather surprising fact that in the absence of serial correlation in the asset price movements, the optimal price may be determined *statically* at the start of the trading. Unless the market parameters change, observations of price movements in the course of trading do not convey any information that would lead to a change in the strategy.



4. Evenly Spaced Discrete Time Intervals: The analysis starts with the construction of a discrete time model. Thus for a given trading interval

$$\tau > 0$$

$$t_k = k\tau$$

for

$$k = 0, \dots, N$$

with

$$N = \frac{T}{\tau}$$

and let  $x_k$  be the holdings at time  $t_k$  with

$$x_0 = X$$

and

$$x_N = 0$$

The sales between times  $t_k$  and  $t_{k-1}$  are

$$n_k = x_k - x_{k-1}$$

corresponding to the velocity



$$v_k = \frac{n_k}{\tau} \text{ shares per unit time}$$

Thus

$$x_k = X - \sum_{j=1}^k n_j = \sum_{j=k+1}^N n_j$$

$$k = 0, \dots, N$$

5. Generating the Optimal Trade List: In the discrete time model there is no assumption that the shares are traded at a uniform rate *within* each interval. Rather the assumption is that the trader achieves the optimal execution possible subject to the constraint that  $n_k$  shares are to be traded in the next time interval  $\tau$ . The functions introduced below are a model to describe the trader's best efforts.
6. Temporary/Permanent Market Impact Components: On a standard manner (Stoll (1985)) the impact is divided into a permanent and a temporary component. Thus  $S_k$  describes the price per share of the asset that is publically available in the market.
7. Discrete Arithmetic Permanent Impact Component: The price satisfies the arithmetic random walk

$$S_k = S_{k-1} + \sigma \sqrt{\tau_k} \xi_k - \tau_k g\left(\frac{n_k}{\tau_k}\right) = S_0 + \sigma \sum_{j=1}^k \sqrt{\tau_j} \xi_j - \sum_{j=1}^k \tau_j g(v_j)$$

where  $\xi_j$  are independent random variables with zero mean and unit variance,  $\sigma$  is an *absolute* (not percentage) volatility,  $g(v)$  is the *permanent impact function* representing the effect of the share price of the information conveyed by the trade. This effect is generally small, and below  $g(v)$  is taken to be a linear function, in which case it will have no effect on determining the optimal strategy.



8. Nonlinear Temporary Impact Component: The price that one actually gets on the  $k^{th}$  trade is

$$\tilde{S}_k = S_{k-1} - h\left(\frac{n_k}{\tau_k}\right) + \frac{1}{\sqrt{\tau_k}} f\left(\frac{n_k}{\tau_k}\right) \tilde{\xi}_k$$

$$k = 1, \dots, N$$

Here  $h(v)$  is a nonlinear *temporary impact function* representing the price concession one must accept in order to trade

$$n_k = v_k \tau_k$$

shares in time  $\tau_k$ . The random variables  $\tilde{\xi}_k$  are independent of each other and of  $\xi_k$  with zero mean and unit variance. The new function  $f(v)$  represents the uncertainty of the trade execution as a function of the block size.

9. Liquidity Volatility Term Time Dependence: The factor  $\frac{1}{\sqrt{\tau_k}}$  in the last term of

$$\tilde{S}_k = S_{k-1} - h\left(\frac{n_k}{\tau_k}\right) + \frac{1}{\sqrt{\tau_k}} f\left(\frac{n_k}{\tau_k}\right) \tilde{\xi}_k$$

simply represents a scaling of the parameters if  $\tau_k$  is fixed and finite. When  $\tau_k$  varies, for example when the continuous time

$$\tau_k \rightarrow 0$$

is taken, this factor is necessary to preserve the effect of the trading-enhanced risk.

10. Liquidity Volatility Incremental Time Dependence: If the above term were not present, then breaking a block into several smaller blocks would diversify away the risk due to the uncertainty of each one, regardless of the form of the risk.



11. Capture of the Trade Program: The *capture* of the trade program is the total cash received

$$\sum_{k=1}^N n_k \tilde{S}_k = XS_0 + \sigma \sum_{k=1}^N \sqrt{\tau_k} x_k \xi_k - \sum_{k=1}^N \tau_k x_k g(v_k) + \sum_{k=1}^N \sqrt{\tau_k} v_k f(v_k) \tilde{\xi}_k - \sum_{k=1}^N \tau_k v_k h(v_k)$$

12. The Trade Program Implementation Cost: Discounting is ignore since the trading horizon is short. The *implementation cost* is  $XS_0 - \sum_{k=1}^N n_k \tilde{S}_k$  - a random variable due to uncertainties in price movements and realized prices.
13. Components of the Implementation Cost: Note that the implementation cost includes both the costs of finite liquidity and price uncertainty due to delayed execution. This is the *implementation shortfall* of Perold (1988) – see also Jones and Lipson (1999).
14. Implementation Cost Mean and Variance: Its expectation and variance at

$$t = 0$$

depend on the free parameters  $x_1, \dots, x_{N-1}$  of the trade strategy:

$$\mathbb{E}[x_1, \dots, x_{N-1}] = \sum_{k=1}^N \tau_k x_k g(v_k) + \sum_{k=1}^N \tau_k v_k h(v_k)$$

$$\mathbb{V}[x_1, \dots, x_{N-1}] = \sum_{k=1}^N \tau_k \sigma_k^2 x_k^2 + \sum_{k=1}^N \tau_k v_k^2 f^2(v_k)$$

15. Mean Variance Optimal Static Strategies: A rational trader will construct his or her own strategies to minimize some combination of  $\mathbb{E}[x]$  and  $\mathbb{V}[x]$ . As  $t$  advances the values of  $\mathbb{E}[x]$  and  $\mathbb{V}[x]$  change, but if  $\mathbb{E}[x]$  and  $\mathbb{V}[x]$  are constructed using a classic



mean-variance approach, the optimal strategy continues to be the one determined initially (Almgren and Chriss (2000), Huberman and Stanzl (2005)).

16. Continuous Time Limit Trading Strategy: Now, for analytical convenience, the continuous time limit

$$\tau \rightarrow 0$$

is taken. The trade strategy becomes a continuous path  $x(t)$  and the block sizes  $n_k$  are assumed to be well-behaved so that

$$v_k \rightarrow v(\tau_k k)$$

with

$$v(t) = -\dot{x}(t)$$

17. Continuous Time Mean and Variance: The above expressions have finite limits

$$\mathbb{E}[x] = \int_0^T [x(t)g(v(t)) + v(t)h(v(t))]dt$$

$$\mathbb{V}[x] = \int_0^T [\sigma^2 x^2(t) + v^2(t)f^2(v(t))]dt$$

where the square brackets indicate that these are *functionals* of the entire continuous-time path  $x(t)$ .

18. Caveat behind Continuous Time Analytics: It needs to be emphasized that the continuous time limit is simply an analytical device for obtaining solutions when  $\tau_k$  is



reasonably small; in reality the discreteness of the trading intervals must be taken into account in order to correctly describe trading-enhanced risk.

19. Mean Variance Optimization Objective Function: Introducing the risk-aversion parameter  $\lambda$ , the combined quantity

$$\mathbb{U}[x] = \mathbb{E}[x] + \lambda \mathbb{V}[x]$$

is minimized. Whether or not mean variance optimization is appropriate for a particular case,  $\lambda$  may be considered to be a Lagrange/KKT multiplier for the constrained problem of minimizing  $\mathbb{E}[x]$  for a given  $\mathbb{V}[x]$  and used to construct an efficient frontier in the space of trading trajectories.

20. VaR Based Optimization Objective Functions: More general weightings of risk, including Value-at-Risk, present thorny conceptual problems for time-dependent strategies (Artzner, Delbaen, Eber, and Heath (1999), Basak and Shapiro (2001)).
21. The Calculus of Variations Approach: Minimizing  $\mathbb{U}[x]$  is a standard problem in the calculus of variations:

$$\min_{x(t)} \mathbb{U}[x(t)] = \min_{x(t)} \int_0^T F(x(t), -\dot{x}(t)) dt$$

with

$$F(x, v) = xg(v) + vh(v) + \lambda\sigma^2 x^2 + \lambda v^2 f^2(v)$$

22. Perturbation Stationarity: Euler-Lagrange Equation: Stationarity to small perturbations requires that the optimal  $x(t)$  solve the Euler-Lagrange equation



$$\begin{aligned}
 0 &= \frac{\partial F(x(t), -\dot{x}(t))}{\partial x(t)} + \frac{d}{dt} \left[ \frac{\partial F(x(t), -\dot{x}(t))}{\partial v(t)} \right] \\
 &= \frac{\partial F(x(t), -\dot{x}(t))}{\partial x(t)} + \dot{x}(t) \frac{\partial^2 F(x(t), -\dot{x}(t))}{\partial x(t) \partial v(t)} \\
 &\quad - \ddot{x}(t) \frac{\partial^2 F(x(t), -\dot{x}(t))}{\partial v^2(t)}
 \end{aligned}$$

– a second order ordinary differential equation to be solved with respect to the given endpoints  $x(0)$  and  $x(T)$

23. Integration into the First Order Form: Since  $F(x(t), -\dot{x}(t))$  does not depend explicitly on  $t$  multiplying throughout by  $\dot{x}(t)$  and integrating results in the first-order equation

$$F(x(t), -\dot{x}(t)) + \dot{x}(t) \frac{\partial F(x(t), -\dot{x}(t))}{\partial v(t)} = \text{constant}$$

24. Application to Optimal Trajectory Determination: In the current case one obtains

$$P(-\dot{x}(t)) - P(v_0) = x[g(-\dot{x}(t)) + \dot{x}(t)g'(-\dot{x}(t))] + \lambda \sigma^2 x^2$$

with

$$P(v) = v^2 \frac{\partial h(v)}{\partial v} + \lambda v^2 \left[ f^2(v) + 2vf(v) \frac{\partial f(v)}{\partial v} \right] = v^2 \frac{\partial [h(v) + \lambda v f^2(v)]}{\partial v}$$

25. Properties of the Almgren “P” Function: The constant of integration

$$v_0 = -\dot{x}(t)|_{x=0}$$

is the velocity with which  $x(t)$  hits





$$x = 0$$

For a sell program with

$$X > 0$$

$$v_0 \geq 0$$

and conversely for a buy program. Note that

$$P(0) = 0$$

additional assumption is that  $P(v)$  is always an *increasing* function of  $v$  and hence invertible.

26. Explicit Solutions - Key Simplifying Assumptions: Almgren (2001) makes two simplifying assumptions to obtain explicit solutions.

- a. Permanent impact is linear in the trading rate.
- b. The imposed time horizon is infinite.

27. Linear Permanent Market Impact Function: A linear cost function

$$g(v) = \gamma v$$

gives a total cost  $\gamma X$  independent of the path  $x(t)$ . The first term on the right side of

$$P(-\dot{x}(t)) - P(v_0) = x[g(-\dot{x}(t)) + \dot{x}(t)g'(-\dot{x}(t))] + \lambda\sigma^2 x^2$$

vanishes, and then since  $\dot{x}(t)$  appears only on the left side and  $x$  itself appears only on the right side, the general solution can be written in the quadrature form as



$$\int_{x(t)}^x \frac{dt}{P^{-1}[\lambda\sigma^2x^2 + P(v_0)]} = t$$

28. Bid Ask Permanent Linear Absent: The constant  $v_0$  is to be chosen so that

$$x = 0$$

corresponds to

$$T = 0$$

Note also that any constant in  $h$  disappears; the bid-ask spread does not affect the optimal strategy.

29. No Extraneously Specified Liquidation Time: Since  $P(\cdot)$  is an increasing function, so is  $P^{-1}(\cdot)$ . It is thus clear that as  $v_0$  decreases towards zero, the liquidation time  $T$  increases.

30. Invoking Longest Possible Liquidation Time: If no time horizon is exogenously imposed, the longest possible liquidation time can be obtained by setting

$$v_0 = 0$$

which leads to the quadrature problem

$$\int_{x(t)}^x \frac{dt}{P^{-1}[\lambda\sigma^2x^2]} = t$$

31. Tractability of the above Solution: Often analytic solutions to the above problem can be found when



$$\int_{x(t)}^x \frac{dt}{P^{-1}[\lambda \sigma^2 x^2 + P(v_0)]} = t$$

with

$$v_0 \neq 0$$

would be too intractable. These solutions will still give nearly complete liquidations in finite time determined by market parameters.

## Nonlinear Cost Functions

1. Power Law Temporary Impact Functions: Restricting the attention to the sell program, with

$$v \geq 0$$

the temporary impact functions are taken to be

$$h(v) = \eta v^k$$

$$f(v) = 0$$

with

$$k > 0$$



- for a buy program the signs will be changed in an obvious way. The linear case corresponds to

$$k = 1$$

2. Temporary Impact Almgren “P” Function: As noted above a possible constant in  $h$  corresponding to the bid-ask spread has been neglected. Then

$$P(v) = \eta k v^{k+1}$$

which, for the case of a general finite time horizon with

$$v_0 \geq 0$$

leads to the quadrature problem

$$\int_{x(t)}^x \left( \frac{\lambda \sigma^2}{\eta k} x^2 + v_0^{k+1} \right)^{-\frac{1}{k+1}} dx = t$$

3. Longest Optimal Trajectory Explicit Solution: Taking

$$v_0 \geq 0$$

explicit solutions for the longest optimal trajectories can be obtained:



$$\frac{x(t)}{X} = \begin{cases} \left(1 + \frac{1-k}{1+k} \frac{t}{T_*}\right)^{\frac{1+k}{1-k}} & 0 < k < 1 \\ e^{-\frac{t}{T_*}} & k = 1 \\ \left(1 - \frac{k-1}{k+1} \frac{t}{T_*}\right)^{\frac{k+1}{k-1}} & k > 1 \end{cases}$$

4. Characteristic Time for Optimal Execution: Here the *characteristic time* is

$$T_* = \left( \frac{k\eta X^{k-1}}{\lambda\sigma^2} \right)^{\frac{1}{k+1}}$$

This is the analog of the *half-life* in the linear case. Only in the linear case

$$k = 1$$

is  $T_*$  independent of the initial portfolio size  $X$ . For

$$k \neq 1$$

the characteristic time depends on the initial size as

$$T_* \sim X^{\frac{k-1}{k+1}}$$

5. Sub Linear Power Law Exponent: For

$$k < 1$$



rapid trading is *under*-penalized relative to the linear case. As the portfolio size increases, volatility risk dominates the trading costs, and the optimal trading time *decreases* since the exponent is negative.

6. Supra Linear Power Law Exponent: For

$$k > 1$$

rapid trading is *over*-penalized relative to the linear case. As the portfolio size increases, the trading cost dominates the volatility risk, and the optimal trading time *increases*, since the exponent is positive. For example, if

$$k = 3$$

then

$$T_* \sim \sqrt{X}$$

7. Characteristic Time vs Half Life: As the portfolio size decreases to zero, reconciliation of the optimal trajectory would use a different starting value  $X$  and hence a different time  $T_*$ . The meaning of  $T_*$  is thus a little less fundamental than in the linear case. However,  $T_*$  scales in exactly the right way to make  $x(t)$  still a static solution.
8. Intuition behind the Characteristic Time: For more intuition, note that the initial rate of selling is

$$-\dot{x}(0) = \frac{X}{T_*}$$

and  $T_*$  is the solution to the relation



$$\lambda \sigma^2 X^2 T = k \eta \left( \frac{X}{T} \right)^k X$$

9. Characteristic Time as a Cost Balance: The left side is the risk penalty associated with holding  $X$  shares for a time  $T$ , and the right side, up to a factor  $k$ , is  $Xh\left(\frac{X}{T}\right)$ , the impact cost associated with selling  $X$  shares over a time  $T$  (without the constant term representing the bid-ask spread, which does not impact the optimal solution).
10. The Longest Optimal Execution Time: For

$$k > 1$$

the trajectory reaches

$$x = 0$$

with

$$v = 0$$

at a finite time

$$T_{MAX} = \frac{k+1}{k-1} T_*$$

Thus these trajectories are the solution for finite imposed time  $T$  if

$$T > T_{MAX}$$

the trajectory reaches 0 at  $T_{MAX}$  and stays there till  $T$



11. Self-Similar Scaling Trajectory Form: Almgren (2003) contains a graphical illustration of the optimal trajectories generated from

$$\frac{x(t)}{X} = \begin{cases} \left(1 + \frac{1-k}{1+k} \frac{t}{T_*}\right)^{\frac{1+k}{1-k}} & 0 < k < 1 \\ e^{-\frac{t}{T_*}} & k = 1 \\ \left(1 - \frac{k-1}{k+1} \frac{t}{T_*}\right)^{\frac{k+1}{k-1}} & k > 1 \end{cases}$$

The form of the portfolio is independent of a particular choice of time scale  $T_*$  and initial portfolio size  $X$ ; these solutions may be easily scaled to any case.

12. Time Realization of Trajectory Differences: A sense of the differences between the solutions may be gained by noting that for short times, all optimal trajectories are fairly close to each other; but the *tail* of the trajectories are extended for small value of  $k$  which strongly penalize trading at slow rates.
13. Example: Sell-Order Exponent Dependence: For example, as shown by Almgren (2003), at

$$t = T_*$$

the optimal trajectories reduce holdings to 30%, 37%, and 42% of the initial portfolio for

$$k = 2$$

$$k = 1$$

and





$$k = \frac{1}{2}$$

respectively.

14. Example Sell Time Exponent Dependence: Further as demonstrated by Almgren (2003), at

$$\frac{t}{T_*} = 3$$

the trajectory for

$$k = 2$$

has reached

$$x = 0$$

and remains there, the trajectory for

$$k = 1$$

retains 5% of its initial holdings, and the trajectory for

$$k = 2$$

retains 12.5% of the initial holdings. The relative differences become even more pronounced as time continues.

## Objective Function



1. Determination of  $\mathbb{E}[x]$  and  $\mathbb{V}[x]$ :  $\mathbb{E}[x]$  and  $\mathbb{V}[x]$  can be explicitly computed for these solutions from

$$\mathbb{E}[x] = \int_0^T [x(t)g(v(t)) + v(t)h(v(t))]dt$$

$$\mathbb{V}[x] = \int_0^T [\sigma^2 x^2(t) + v^2(t)f^2(v(t))]dt$$

and hence the frontier can be drawn. In doing this the contributions from  $g(v)$  and the term  $\epsilon X$  in  $\mathbb{E}[x]$  are neglected.

2. Closed Form for  $\mathbb{E}_\lambda[x]$  and  $\mathbb{V}_\lambda[x]$ : Then for a general  $k$

$$\mathbb{E}_\lambda[x] = \frac{k+1}{3k+1} \eta \left( \frac{X}{T_*} \right)^{k+1} T_* = \frac{k+1}{3k+1} \eta \left( \frac{\eta \sigma^{2k} X^{3k+1}}{k^k} \lambda^k \right)^{\frac{1}{k+1}} T_*$$

$$\mathbb{V}_\lambda[x] = \frac{k+1}{3k+1} \sigma^2 T_* X^2 = \frac{k+1}{3k+1} \left( \frac{k \eta \sigma^{2k} X^{3k+1}}{\lambda} \right)^{\frac{1}{k+1}}$$

3. The  $(\mathbb{E}, \mathbb{V})$  Efficient Frontier Curve: As  $\lambda$  varies  $(\mathbb{E}, \mathbb{V})$  moves along the hyperboloid-like curve

$$\mathbb{E}_\lambda[x](\mathbb{V}_\lambda[x])^k = \left( \frac{k+1}{3k+1} \right)^{k+1} \eta \sigma^{2k} X^{3k+1}$$

For any positive  $\lambda$  there is a unique solution.

4. Asymptotics of  $\lambda \rightarrow 0$  and  $\lambda \rightarrow \infty$ : As



$$\lambda \rightarrow 0$$

one gets

$$T_* \rightarrow \infty$$

$$\mathbb{E}_\lambda[x] \rightarrow 0$$

and

$$\mathbb{V}_\lambda[x] \rightarrow \infty$$

i.e., optimizing expected cost without regard to variance leads to use of all available time. As

$$\lambda \rightarrow \infty$$

it can be seen that

$$T_* \rightarrow 0$$

$$\mathbb{E}_\lambda[x] \rightarrow \infty$$

and

$$\mathbb{V}_\lambda[x] \rightarrow 0$$

i.e., uncertainty is minimized regardless of the cost.



## Almgren (2003) Example

1. Reference Trading Rate/Market Depth: Almgren (2003) provides a sample methodology for the estimation of the parameters. The first is to choose a representative level of trading rate  $v_{REF}$ . If a specific time period  $\tau$  is chosen  $v_{REF}$  is equivalent to a certain block size

$$n_{REF} = \tau v_{REF}$$

traded in the time period; it may be interpreted as the market *depth* in the sense of Kyle (1985) or Bondarenko (2001).

2. Choice of Reference Trading Rate: The examples below consider stocks that trade one million shares a day, and  $v_{REF}$  is taken to be 10% of that rate, or

$$v_{REF} = 100,000 \text{ share/day}$$

For time period

$$\tau = 1 \text{ hour}$$

with 6.5 *periods per day* this rate is equivalent to trading a block of approximately 15,300 shares in each hour.

3. The Corresponding Temporary Price Impact: Next the price impact  $h_{REF}$  which would be incurred by the steady trading at the reference rate  $v_{REF}$  would be chosen. The share price is assumed to be \$50/*share* and the assumption is that trading

$$v_{REF} = 100,000 \text{ shares/day}$$

incurs a price impact of 1% or \$0.50/*share*



4. Choosing the Exponent - The Rationale: Finally a choice for the value of the exponent  $k$  is made that best fits the belief of how the price impact would depend upon the trading rate for rates smaller or larger than  $v_{REF}$ .
5. Reminder Trading Rate  $k$  Dependence: The choice

$$k = 1$$

corresponds to the linear dependence of price impact on rate;

$$k > 1$$

means that *large* trading rates or block sizes have a disproportionately *large* effect on price; while

$$k < 1$$

means that large trading rates or block sizes have a relatively *smaller* impact.

6.  $h_{REF}/v_{REF}$  Based Impact Model: This impact model is then written as

$$h(v) = h_{REF} \left( \frac{v}{v_{REF}} \right)^k$$

or

$$\eta = \frac{h_{REF}}{v_{REF}^k}$$

7. Daily Volatility and Initial Portfolio: It is also supposed that the stock has an annual volatility of 32% for the daily price change of



$$\sigma = \$1/\text{share} \cdot \sqrt{\text{day}}$$

A portfolio of initial size

$$X = 100,000$$

is considered, equal to  $\frac{1}{10}$  <sup>th</sup> of the daily volume.

8. Construction of the Efficient Frontier: There is now enough information to construct the efficient frontier

$$\mathbb{E}_\lambda[x] = \frac{k+1}{3k+1} \eta \left( \frac{X}{T_*} \right)^{k+1} T_* = \frac{k+1}{3k+1} \eta \left( \frac{\eta \sigma^{2k} X^{3k+1}}{k^k} \lambda^k \right)^{\frac{1}{k+1}} T_*$$

$$\mathbb{V}_\lambda[x] = \frac{k+1}{3k+1} \sigma^2 T_* X^2 = \frac{k+1}{3k+1} \left( \frac{k \eta \sigma^{2k} X^{3k+1}}{\lambda} \right)^{\frac{1}{k+1}}$$

from  $\mathbb{E}_\lambda[x]$  and  $\mathbb{V}_\lambda[x]$  for any chosen  $k$  describing the family of solutions as the risk aversion parameter  $\lambda$  ranges over all the possible values

$$0 < \lambda < \infty$$

To construct particular optimal solutions a specific value for  $\lambda$  needs to be set.

9. Variance/Cost Dependence on  $\lambda$ : The results are shown numerically in the table below. For any value of  $k$  the natural liquidation time  $T_*$  increases with the *risk tolerance* parameter  $\frac{1}{\lambda}$ ; as both increase the expected cost decreases and the variance increases.
10.  $\lambda$  Impact:  $T_*, \mathbb{E}_\lambda[x], \sqrt{\mathbb{V}_\lambda[x]}$ : The table below shows that the optimal time scale  $T_*$ , the expected cost  $\mathbb{E}_\lambda[x]$ , and the standard deviation of the cost  $\sqrt{\mathbb{V}_\lambda[x]}$  as functions of the



risk tolerance parameter  $\frac{1}{\lambda}$  and the temporary impact exponent  $k$ . Market and portfolio parameters are as given in the treatment above (the initial portfolio value is \$5 million). As  $k$  is varied, the reference values  $h_{REF}$  and  $v_{REF}$  are held constant; thus the coefficient  $\eta$  varies as in

$$h(v) = h_{REF} \left( \frac{v}{v_{REF}} \right)^k$$

or

$$\eta = \frac{h_{REF}}{v_{REF}^k}$$

Time  $T_*$  is measured in days;  $\frac{1}{\lambda}$ ,  $\mathbb{E}_\lambda[x]$ , and  $\sqrt{\mathbb{V}_\lambda[x]}$  are in thousands of dollars.

11. Table of  $T_*$ ,  $\mathbb{E}_\lambda[x]$ ,  $\sqrt{\mathbb{V}_\lambda[x]}$ :

	$\frac{1}{\lambda}$	$k = \frac{1}{2}$	$k = 1$	$k = 2$
$T_*$	1	0.02	0.07	0.22
	10	0.09	0.22	0.46
	100	0.40	0.71	1.00
	1000	1.84	2.24	2.15
	10000	8.55	7.07	4.64
$\mathbb{E}_\lambda[x]$	1	221	354	462
	10	103	112	99
	100	48	35	21
	1000	22	11	5
	10000	10	4	1
$\sqrt{\mathbb{V}_\lambda[x]}$	1	11	19	30
	10	23	33	45



	100	49	59	65
	1000	105	106	96
	10000	226	188	141

12. Large  $\lambda$  Execution Time Dependence: For large values of  $\lambda$ , optimal trajectories all execute rapidly, to reduce the volatility risk associated with the portfolio. When the trading rate is larger than  $v_{REF}$  costs *increase* with increasing  $k$  so larger  $k$  leads to slower trading.
13.  $\lambda$  and  $k$  Combination Impact: Conversely for small  $\lambda$  generally trading proceeds *more slowly* than  $v_{REF}$  in order to minimize the total expected cost. In this regime *smaller*  $k$  is more expensive and leads to relatively slower trading.
14. Cross-Over  $\lambda$  Execution Time: In the intermediate parameter regime the trajectories cross-over from one behavior to the other; larger  $k$  suggests slower trading at the beginning when the rate is large, then relatively more rapid in the tail.
15. Characteristic Time Reference Rate Dependence: Note that

$$T_* = \left( \frac{k\eta X^{k-1}}{\lambda\sigma^2} \right)^{\frac{1}{k+1}}$$

may be re-written as

$$T_* = \left( \frac{kh_{REF}}{\lambda\sigma^2 X} \right)^{\frac{1}{k+1}} \left( \frac{X}{v_{REF}} \right)^{\frac{k}{k+1}}$$

from which it is clear that

$$T_* \rightarrow \frac{X}{v_{REF}}$$

as





$$k \rightarrow \infty$$

regardless of the values of the other parameters.

16. Trade Speed vs. Cost Balance: In this limit, trading more rapidly than the reference rate is very strongly penalized, while trading more slowly is almost without cost, so the optimal strategy is to always trade exactly at the critical rate.
17.  $\lambda$  Estimation from Reference Parameters: Finally since  $\lambda$  is a difficult parameter to select in practice, it may be observed that it can be estimated if a time scale  $T_*$  is chosen from

$$T_* = \left( \frac{k\eta X^{k-1}}{\lambda\sigma^2} \right)^{\frac{1}{k+1}}$$

and

$$h(v) = h_{REF} \left( \frac{v}{v_{REF}} \right)^k$$

or

$$\eta = \frac{h_{REF}}{v_{REF}^k}$$

- it can be found that

$$\lambda = k \frac{h_{REF} \left( \frac{X/T_*}{v_{REF}} \right)^k X}{\sigma^2 T_* X^2}$$



18. Trading Cost vs. Variance Balance: The numerator is the price concession per share for trading at a concession rate  $\frac{X}{T_*}$  multiplied by the total number of shares  $X$  to get the expected cost; the denominator is the variance that would be incurred by holding  $X$  shares for time  $T_*$ . This ratio is multiplied by  $k$  to correct for nonlinearities which are ignored by this simple description.

## Trading-Enhanced Risk

1. Liquidity Volatility: Functional Form Considered: Now the following functional form is taken for a sell program with

$$v \geq 0$$

$$h(v) = \eta v$$

$$f(v) = \alpha + \beta v$$

The deterministic part of the temporary impact is the linear case

$$k = 1$$

of the previous section.

2. Trading Rate Independent Volatility Component: The constant term in  $f(v)$ , with coefficient  $\alpha$ , represents a constant uncertainty in the realized sale price independent of the rate of selling and of the underlying process. The total risk associated with this term is minimized by splitting the sale into as many parts as possible; thus this term pushes towards the linear trajectory.



3. Trading Rate Dependent Volatility Component: The linear term, with coefficient  $\beta$ , represents the increase in variance caused by non-zero amounts of selling. This term can even more strongly push toward the linear trajectory.
4. Liquidity Volatility Almgren “P” Function: Then with

$$\dot{x} = -v \leq 0$$

$$P(-\dot{x}(t)) - P(v_0) = x[g(-\dot{x}(t)) + \dot{x}(t)g'(-\dot{x}(t))] + \lambda\sigma^2 x^2$$

becomes

$$P(v) = (\eta + \lambda\alpha^2)v^2 + 4\lambda\alpha\beta v^3 + 3\lambda\beta^2 v^4$$

5. Behavior of the Almgren “P” Function: The polynomial  $P(v)$  has

$$P(0) = 0$$

and is increasing for

$$v \geq 0$$

so the graph of the trajectory is always convex, and the inverse of  $P^{-1}$  is well-defined. For a buy program with

$$x \geq 0$$

the sign of the odd term in  $P(v)$  is reversed.

6. No Hard Maximum Execution Time: Since

$$P(v) \sim \mathcal{O}(v^2)$$



for  $v$  near zero, the integrand appearing in the quadrature formulation

$$\int_{x(t)}^x \frac{dt}{P^{-1}[\lambda \sigma^2 x^2 + P(v_0)]} = t$$

behaves as  $\mathcal{O}(x^{-1})$  as

$$x \rightarrow 0$$

for

$$v_0 = 0$$

and there is no “hard” maximum time as was found above for

$$k > 1$$

## Constant Enhanced Risk

1. Analytical Solution for  $\beta = 0$  Case: Two special cases are considered for obtaining analytical solution. The first is

$$\beta = 0$$

With this assumption the price uncertainty on each trade is independent of the size of the trade.

2. Trading Trajectory and Execution Time: A solution can then be found for



$$v_0 = 0$$

$$x(t) = X e^{-\frac{t}{T_*}}$$

$$T_* = \sqrt{\frac{\eta + \lambda \alpha^2}{\lambda \sigma^2}}$$

3. Comparison with  $f(v) = 0, k = 1$  Case: This is a pure exponential solution, except that the time constant has been increased by adding the additional variance per transaction to the impact coefficient

$$\eta \mapsto \eta + \lambda \alpha^2$$

4. Expressions for  $\mathbb{E}_\lambda[x]$  and  $\mathbb{V}_\lambda[x]$ : The value functions are

$$\mathbb{E}_\lambda[x] = \frac{1}{2} \eta \frac{X^2}{T_*} = \frac{1}{2} X^2 \sqrt{\frac{\lambda \eta^2 \sigma^2}{\eta + \lambda \alpha^2}}$$

$$\mathbb{V}_\lambda[x] = \frac{1}{2} X^2 \sigma^2 T_* \left( 1 + \frac{\alpha^2}{\sigma^2 T_*} \right) = \frac{1}{2} X^2 \frac{\sigma}{\sqrt{\lambda}} \sqrt{\frac{\eta + 2\lambda \alpha^2}{\eta + \lambda \alpha^2}}$$

5.  $\lambda \rightarrow 0$   $\mathbb{E}_\lambda[x]$  and  $\mathbb{V}_\lambda[x]$  Behavior: The optimal value functions change in a more complicated way than the trajectory. As

$$\lambda \rightarrow 0$$

the behavior is the same as that found earlier;



$$\mathbb{E}_\lambda[x] \rightarrow 0$$

and

$$\mathbb{V}_\lambda[x] \rightarrow \infty$$

since there is less care about the enhanced risk.

6.  $\lambda \rightarrow 0$   $\mathbb{E}_\lambda[x]$   $T_*$   $\mathbb{V}_\lambda[x]$  Behavior: In contrast as

$$\lambda \rightarrow \infty$$

all quantities have finite limits;

$$T_* \rightarrow \frac{\sigma}{\alpha}$$

$$\mathbb{E}_\lambda[x] \rightarrow \frac{1}{2} \eta \frac{X^2}{T_*}$$

and

$$\mathbb{V}_\lambda[x] \rightarrow \alpha \sigma X^2$$

Since trading itself introduces risk, risk-aversion and cost reduction both encourage spreading the trade over several periods; the minimum variance solution takes finite time and has finite cost.

## Linear Enhanced Risk

1. Analytical Solutions for the  $\alpha = 0$  Case: The next special case is



$$\alpha = 0$$

and

$$P(v) = 0$$

becomes

$$P(v) = \eta v^2 + 3\lambda\beta^2 v^4$$

and thus

$$P^{-1}(\omega) = \sqrt{\frac{\sqrt{\eta^2 + 12\lambda\beta^2\omega} - \eta}{6\lambda\beta^2}}$$

2. Trading Trajectory and Characteristic Fields: This can be integrated to obtain

$$\frac{t}{T_*} = F\left(\frac{X}{X_*}\right) - F\left(\frac{x}{X_*}\right)$$

in which the characteristic time and the characteristic share level are

$$T_* = \sqrt{\frac{\eta}{\lambda\sigma^2}}$$

$$X_* = \frac{1}{\sqrt{3}} \frac{\eta}{\lambda\sigma\beta} = \frac{1}{\sqrt{3}} \frac{\sigma T_*^2}{\beta}$$

and the nonlinear function is



$$F(u) = 2z - \coth^{-1} z$$

where

$$z = \sqrt{\frac{1}{2} \left( 1 + \sqrt{1 + 4u^2} \right)}$$

3. Intuition behind the Characteristic Size: The characteristic time is the same as in the earlier section for

$$k = 1$$

and does not depend on the new coefficient  $\beta$ . To understand the characteristic level  $X_*$  note that

$$\sqrt{3}\beta \frac{X_*}{T_*} \frac{1}{\sqrt{T_*}} = \sigma \sqrt{T_*}$$

4. Trading Enhanced Market Volatility Balance: In this expression the left side is the trading induced variance in the share price given by the model

$$\tilde{S}_k = S_{k-1} - h \left( \frac{n_k}{\tau_k} \right) + \frac{1}{\sqrt{\tau_k}} f \left( \frac{n_k}{\tau_k} \right) \xi_k$$

$$k = 1, \dots, N$$

if an initial portfolio of size  $X_*$  were sold in a single period  $T_*$ . The right side is the variance in the share price due to the volatility in the same time interval; at the characteristic share level these two quantities are of comparable size.





5.  $X_*$  much bigger than  $x, X$ : To compare with the previous results note that

$$F(u) \sim \log u + \text{constant} + \mathcal{O}(u^2)$$

$$u \rightarrow 0$$

If this limit is attained by taking a limit of the *parameters* so that

$$\frac{X_*}{X} \rightarrow \infty$$

so that

$$F(u) \sim \log u + \text{constant} + \mathcal{O}(u^2)$$

is valid uniformly over  $x$ , since

$$0 \leq x \leq X$$

- a pure exponential solution results

$$\frac{t}{T_*} = \log \frac{X}{x(t)} + \mathcal{O} \left[ \left( \frac{\lambda \alpha \beta}{\eta} \right)^2 \right]$$

$$\frac{\lambda \alpha \beta}{\eta} \rightarrow 0$$

which, in particular, recovers the previous result with

$$k = 1$$



in the limit

$$\beta \rightarrow 0$$

6. Behavior Towards  $x \rightarrow 0$ ; Trajectory Tail: And for any fixed value of the parameters

$$F(u) \sim \log u + \text{constant} + \mathcal{O}(u^2)$$

$$u \rightarrow 0$$

describes the tail of the solution as

$$x \rightarrow 0$$

the time constant of the decay is not affected by the addition of  $\beta$ .

7.  $X_*$  much smaller than  $x, X$ : For

$$x \gg X_*$$

i.e., the initial behavior when

$$X \gg X_*$$

using the expansion

$$F(u) \sim 2\sqrt{u} - \mathcal{O}\left(\frac{1}{\sqrt{u}}\right)$$

$$u \rightarrow \infty$$



gives

$$x(t) \sim X_* \left( C - \frac{1}{2} \frac{t}{T_*} \right)^2$$

$$x \gg X_*$$

with

$$C = \frac{1}{2} F(1)$$

This is the same solution constructed in the earlier Section with

$$k = 3$$

with

$$\eta = \lambda \beta^2$$

8. Almgren (2003) Asymptotic Solution Illustration:

$$\frac{t}{T_*} = F\left(\frac{X}{X_*}\right) - F\left(\frac{x}{X_*}\right)$$

together with

$$\frac{t}{T_*} = \log \frac{X}{x(t)} + \mathcal{O}\left[\left(\frac{\lambda \alpha \beta}{\eta}\right)^2\right]$$



$$\frac{\lambda\alpha\beta}{\eta} \rightarrow 0$$

and

$$x(t) \sim X_* \left( C - \frac{1}{2} \frac{t}{T_*} \right)^2$$

$$x \gg X_*$$

are illustrated in elaborate figures in Almgren (2003) Figure 5.

9. Strategy Construction Approach: Starting Trajectory: Thus the optimal strategy for construction would be as follows. Assuming

$$x > X_*$$

the initial trades are done using the trajectories of the temporary impact power law with

$$k = 3$$

with

$$\eta = \lambda\beta^2$$

That is, the volatility due to trading completely dominates the intrinsic volatility  $\sigma$

10. Strategy Construction Approach: Tail Trajectory: As  $x(t)$  reaches the level  $X_*$  switch is done to the optimal solution in the linear case

$$k = 1$$



with the other parameters taking their market values. In the tail trading-enhanced risk is a negligible quantity compared to the volatility.

### **Almgren (2003) Nonlinear Example Sample**

1. Working out the  $\alpha = 0$  Case: In this case the focus is on the previous section in which

$$\alpha = 0$$

and

$$\beta \neq 0$$

so that trading enhanced risk increases linearly with block size with no constant term.

2. The Corresponding Discrete Price Equation: To estimate the coefficients, one starts with the discrete time model. With

$$h(v) = \eta v$$

and

$$f(v) = \beta v$$

the price model

$$\tilde{S}_k = S_{k-1} - h\left(\frac{n_k}{\tau_k}\right) + \frac{1}{\sqrt{\tau_k}} f\left(\frac{n_k}{\tau_k}\right) \tilde{\xi}_k$$



$$k = 1, \dots, N$$

becomes

$$\tilde{S}_k = S_{k-1} - \eta \frac{n_k}{\tau_k} + \beta n_k \tau_k^{-\frac{3}{2}} \tilde{\xi}_k$$

3. Liquidity Risk as Price Volatility Fraction: Assuming that for a particular choice of the trading interval  $\tau$  the standard deviation of price concession associated with trading-enhanced risk is a fraction  $\varrho$  of the deterministic impact – a plausible assumption since both quantities are linearly proportional to the block size.
4. The Corresponding Characteristic Price: That is

$$\beta n_k \tau_k^{-\frac{3}{2}} = \varrho \eta \frac{n_k}{\tau_k}$$

or

$$\beta = \varrho \eta \sqrt{\tau}$$

which gives

$$X_* = \frac{1}{\sqrt{3}\varrho} \frac{1}{\lambda \sigma \sqrt{\tau}}$$

5.  $X_*$  Dependence on Risk Aversion: At this portfolio size, the volatility risk of holding the portfolio roughly balances the risk of selling along the optimal trajectory. Although both of these quantities are risks,  $X_*$  involves  $\lambda$  through its influence on trading time  $T_*$ .



6. Choice of  $\lambda, \tau, \varrho$ : The market parameters are taken to be the same as in the earlier section, with

$$\frac{1}{\lambda} = \$10,000$$

corresponding to the case where the liquidation is one a day. The trading is divided into one hour time intervals, so

$$\tau = \frac{2}{13} \text{ days}$$

and

$$\varrho = \frac{1}{2}$$

7. Estimate of  $\beta$  and  $X_*$ : One obtains

$$\beta = 10^{-6} \$ \cdot \text{day}^{\frac{3}{2}} \cdot \text{share}^{-2}$$

and

$$X_* = 30,000 \text{ shares}$$

corresponding to a portfolio size of \$1.5m. A liquidation problem with initial value greater than will begin in the large  $x$  regime where trading-enhanced risk is dominant and end in the small  $x$  regime where it is negligible.

## Conclusions: Summary and Extensions



1. Summary: Power Law Temporary Component: The treatment seen above obtains explicit analytical solutions for certain cases of the impact model. First, it neglects the effects of trading-enhanced risk, and takes the impact function to be a simple power law. The solutions in this case are straightforward nonlinear extensions of Almgren and Chriss (2000); the exponential solutions obtained there are a particular dividing case of these power law solutions.
2. Summary: Constant Trading-Enhanced Risk: With trading-enhanced risk, two particular cases with linear impact functions were considered. If the price uncertainty per transaction is independent of the transaction size, then the optimal trajectories are given by the previous results, simply augmenting the impact coefficient by the additional variance. A risk-averse trader lengthens his trade program, diversifying some variance away by spreading the execution over more different transactions at the expense of slightly higher volatility risk.
3. Summary: Linear Trading-Enhanced Risk: If price uncertainty per transaction is linearly proportional to the transaction size, then a characteristic portfolio size emerges, above which reduction of the added variance is the dominant effect. In this regime trade trajectories are equivalent to the previous power law solutions with exponent equal to 3. For portfolios smaller than this size the new effect may be neglected compared to the deterministic impact costs and volatility.
4. Extension #1: Optimal Numerical Trajectories: Throughout this treatment, the focus has been on obtaining explicit solutions for the sake of analytical insight. Numerical solutions would be quite straightforward, and allow lifting the restrictions described above, and consideration of a more general class of models.
5. Extension #2: Linear Impact Portfolios: Portfolios of assets are an interesting extension. Already in the linear case (Almgren and Chriss (2000)), to obtain explicit solutions it is necessary to make simplifying assumptions about cross-impacts, for example, that trading in each asset affects only the price of that asset.
6. Extension #3: Nonlinear Impact Portfolios: Even with that assumption, the nonlinear formulation opens a wide class of possible models; for example, should the exponent





be the same for each asset? Determination and characterization of optimal trajectories in this case is a topic for future work.

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## Market Impact Function/Parameters Estimation

### Introduction, Overview, and Background

1. Power Law Temporary Impact Function: The impact of large trades on prices is very important and widely discussed, but rarely measured. Using a large data set from a major bank and a simple but theoretical model, Almgren, Thum, Hauptmann, and Li (2005) propose that the impact is a  $\frac{3}{5}$  law of the block size, with specific dependence on trade duration, daily volume, volatility, and shares outstanding.
2. Incorporation into Scheduling/Cost Estimation Algorithms: The results can be directly incorporated into an optimal trade scheduling algorithms and into pre- and post-trade estimation systems.
3. Performance Impact of Transaction Costs: Transaction costs are widely recognized as an important determinant of investment performance (see, for example, Freyre-Sanders, Guobuzaitė, and Byrne (2004)). Not only do they affect the realized results of an active investment strategy, they also control how rapidly assets can be converted into cash should the need arise.
4. Direct Fixed Transaction Cost Component: Such costs generally fall into two categories. First are the direct costs such as commissions and fees that are explicitly stated and easily measured. These are important and should be minimized, but are not the focus here.
5. Indirect Controllable Transaction Cost Component: Indirect costs are not explicitly stated. For large trades the most important component of these is the impact of the traders' own actions on the market. These costs are notoriously difficult to measure but they are most amenable to careful trade management and execution.
6. Calibration of Market Impact Costs: Almgren, Thum, Hauptmann, and Li (2005) present a quantitative analysis of the market impact costs based on a large of



Citigroup US brokerage executions. A simple theoretical model that brings in the very important role of execution is used.

7. Out-of-Sample Cross Validation: The model and its calibration are constructed to satisfy two criteria. First, the predicted costs are quantitatively accurate, as determined by direct fit and out-of-sample back testing, as well as extensive consultations with the traders and the other market participants.
8. Deployability with External Execution Schedulers: The results may be directly used as an input into optimal portfolio scheduling systems, although the scheduling algorithm itself may be non-trivial.
9. Use in Citigroup's BECS System: The results of this study have been incorporated into Citigroup's Best Execution Consulting Services (BECS) software for use internally at all desks as well as the clients of the equity division. While this work has focused on US markets, it has been extended to global equities. BECS is the delivery platform for Citigroup's next generation of trading analytic tools, both pre- and post-execution.
10. Extension to the Standard Trading Model: This pre-trade analyzer is an extension to the market standard existing model that has been delivered through the Stock Facts Pro software for the past 25 years (Sorensen, Price, Miller, Cox, and Birnbaum (1998)).
11. Solid Empiricals and Real-Data Verifications: This model is based on better developed empirical foundations; it is based on real trading data taking time into consideration while verifying the results through post-trade analysis. The table below summarizes some of the advantages/disadvantages of this approach.
12. Distinguishing Features of the Model:
  - a. Advantages
    - i. Calibrated from Real Data
    - ii. Includes Time Component
    - iii. Incorporates Intra-day Profiles
    - iv. Uses non-linear Impact Functions
    - v. Confidence Levels for Coefficients



- b. Disadvantages
  - i. Based only on Citigroup Data
  - ii. Little Data for Small-Cap Stocks
  - iii. Little Data for very large Trades
- 13. Academic Industrial Market Data Quantification: Much work in both the academic and industrial communities has been devoted to understanding and quantifying market impact costs. Many academic studies have only worked with publically available data in Trade and Quote (TAQ) tick-record from the New York Stock Exchange (NYSE).
- 14. Buy-Sell Market Imbalance Analysis: Breen, Hodrick, and Korajczyk (2002) regress the net markets movements over five-minute and half-hour time periods against a net buy-sell impact during the same period, using a linear impact model. A similar model is developed in Kissell and Glantz (2003).
- 15. Impact Cost Function Dependence Analysis: Rydberg and Shephard (2003) develop a rich econometric foundation for describing price motions; Dufour and Engle (2000) investigate the key role of waiting period between successive trades. Using techniques from statistical physics, Lillo, Farmer, and Mantegna (2003) look for a power law scaling in the impact cost function, and find significant dependence on total market capitalization as well as daily volume, and Bouchaud, Gefen, Potters, and Wyart (2004) discover non-trivial serial correlation in volume and price data.
- 16. Limitations of Public Data Sets: The publically available data sets lack the reliable classification of individual trades as buyer- or seller- initiated. Even more significantly, each transaction exists in isolation; there is no information on the sequence of trades that form part of the larger transaction.
- 17. Transaction Trade Sequence Incorporation Studies: Some academic studies have used limited data sets made available by asset managers that do have this information, where the date, but not the time duration of the trade is known (Holthausen, Leftwich, and Mayers (1990), Chan and Lakonishok (1995), and Keim and Madhavan (1996)).
- 18. Comparable Studies on Smaller Samples: No other study is known to have carried out this fit explicitly, although various models in use in the industry are based on



regressions of smaller samples (Weisberger and Kreichman (1999), Alba (2002), and de Ternay (2002)).

19. Permanent and Temporary Impact Costs: The transaction cost model embedded in this analysis is based on the model presented by Almgren and Chriss (2000) with non-linear extensions from Almgren (2003). The essential features of this model, as described below, is that it explicitly divides the market impact costs into a permanent component associated with information and a temporary component arising from the liquidity demands made by the execution in a short time.

## **Data Description and Filtering Rules**

1. Data Generation Period and Universe: The data on which the analysis was based on contains, before filtering, almost 700,000 US stock orders executed by the Citigroup equity trading desks for a 19-month period from December 2001 to June 2003.
2. Orders, Transactions, and Resulting Executions: Each order is broken down into one or more transactions, each of which may generate one or more executions. The information presented below is available for each order.
3. Symbol, Size, and Order Type: The stock symbol, the requested order size, and the sign (buy/sell) of the entire order – the client information is removed.
4. Order Submission Time and Method: The times and the methods by which the transaction was submitted by the Citigroup trader to the market. The time  $t_0$  of the first transaction is taken to be the start of the order. Some of the transactions are sent as market orders, some as limit order, and some are submitted to the Citigroup's automated VWAP server. Except for the starting time and except to exclude the VWAP orders, no use is made of this transaction information.
5. Execution Times, Sizes, and Prices: The times, the prices, and the sizes corresponding to the execution of each transaction is used. Some transactions are cancelled or inly partly executed; only completed sizes and prices are used. The execution times re denoted by  $t_1, \dots, t_n$ , sizes by  $x_1, \dots, x_n$ , and prices by  $S_1, \dots, S_n$ .



6. Order Completion Finish Time Frame: All orders are completed within one day, though not necessarily filled.
7. Additional Types of Information Available: In addition, various additional pieces of information – such as instructions given by the client to the trader for the order – e.g., ‘market on close’, ‘market on open’, ‘over the day’, VWAP or blank – are available.
8. Sample Subset Filtering Criteria: the total sample contains 682,582 orders, but only a subset is used for the data analytics.
9. S & P 500 Constituent Stocks Only: To exclude small and thinly traded stocks, only orders on the Standard and Poor’s Index are considered, which represent about half of the total number of orders, but a large majority of the dollar value. Even within this universe there is enough diversity to explore the dependence on the market capitalization, as there are both NYSE and OTC stocks.
10. Exclusion of Highly Volatile Stocks: Also excluded are approximately 400 orders for which the stocks exhibit more than 12.5% daily volatility – 200% annual volatility.
11. Orders that Match the Analysis Objectives: Furthermore, only those orders that are reasonably representative of the actual scheduling strategies that are the ultimate goal are considered.
12. Excluding Market-on-Open/Close: The orders for which the client requested market-on-open or market-on-close executions are excluded. These orders are likely to be executed with strongly non-linear profiles that do not satisfy the modeling assumption – there are only a few hundred of these.
13. Excluding Client Requested VWAP Orders: The orders for which the client requested VWAP execution are excluded. These orders have consistently long execution times and represent very small rates of trading relative to the market volume. These are about 16% of the total number of orders.
14. Excluding Later-in-the-Day Transactions: Also excluded are orders for which any executions are recorded after 16:10 EST, approximately 10% of the total. In many cases these use Citigroup’s block desk for some or all of the transactions, and the fills are reported sometime after the order is completed. Therefore the time information is not reliable.





15. Caveat - Impact of Orders Exclusion: This exclusion, together with the use of fill size in place of originally requested size, could be a source of significant bias. For example, if clients and traders consistently used limit orders, orders may be filled only if the prices moved in a favorable direction. Analysis of the data set suggests that this effect is not significant – for example the same coefficients are obtained with or without partially filled orders – and informal discussions with the traders confirm the belief that partial fills are not the result of a limit order strategy.
16. Other Minimum Cut off Criteria: Most significantly, small order are excluded since the goal is to estimate transaction costs in the range where they are significant. Specifically only the following orders are included:
- The order has at least two completed transactions.
  - Orders are at least 1,000 shares.
  - Orders are at least 0.25% of average daily volume in that stock.
17. Range of Execution Sizes/Times: The results of the model are reasonably stable to changes in the above criteria. After this filtering there are 29,509 orders in the data set; the largest number of executions for any order is 548, and the median is around 5. The median time is around 5 minutes.
18. Order/Volume Ratio Range: The table below shows some descriptive statistics for the sample. Most of the orders constitute only a few percent of the typical market volume, and the model is designed to work within this range of values. Orders greater than a few percent of daily volume have substantial sources of uncertainty that are not modeled here, and the model does not represent them.

19. Summary Statistics of the Sample Orders:

	<b>Mean</b>	<b>Minimum</b>	<b>Q1</b>	<b>Median</b>	<b>Q3</b>	<b>Maximum</b>
Total Cost %	0.04	-3.74	-0.11	0.03	0.19	3.55
Permanent Cost % <i>I</i>	0.01	-3.95	-0.17	0.01	0.19	2.66
Temporary Cost % <i>J</i>	0.03	-3.57	-0.11	0.02	0.17	2.33
Shares/ADV % $ X $	1.51	0.25	0.38	0.62	1.36	88.62
Time Days	0.39	0.00	0.10	0.32	0.65	1.01
Daily Volatility %	2.68	0.70	1.70	2.20	3.00	12.50



Mean Spread %	0.14	0.03	0.03	0.11	0.16	2.37
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## Data Model - Variables

1. Market Impact Input Dependence Estimation: The goal of the study is to determine the market impact in terms of a small number of input variables. Below is a list of precisely which market impacts are measured, and what primary and auxiliary variables will be used to model them.
2. Pre- and Post- Market Prices: Let  $S(t)$  be the price of the asset being traded. For each order the following price points of interest are defined:  $S_0$  is the market price before this order begins executing;  $S_{POST}$  is the market price after this order is completed; and  $\bar{S}$  is the average realized price on the order.
3. The Transaction Weighted Average Price: The realized price

$$\bar{S} = \frac{\sum_{j=1}^N x_j S_j}{\sum_{j=1}^N x_j}$$

is calculated from the transaction data set. The market price  $S_0$  and  $S_{POST}$  are the bid-ask mid points from *TAQ*.

4. First Transaction Pre- Trade Price: The pre-trade price  $S_0$  is the price before the impact on the trade begins to be felt (this is an approximation, since some information may leak before any record enters the system).  $S_0$  is computed from the latest quote just preceding the first transaction.
5. Post-trade Price Capture - Caveat: The post-trade price  $S_{POST}$  should capture the permanent effects of the trade program. That is, it should be long enough after the last execution that any effects of temporary liquidity have dissipated.
6. Accounting for the Permanent Impact: In reportedly performing the fits, Almgren, Thum, Hauptmann, and Li (2005) have found that 30 minutes after the last execution



is enough to achieve this. For shorter time intervals, the regressed values depend on the time lag, and about this level the variation stops. That is, they define

$$t_{POST} = t_n + 30 \text{ minutes}$$

7.  $t_{POST}$  Delay Date Roll Over: The price  $S_{POST}$  is taken from the first quote following  $t_{POST}$ . If  $t_{POST}$  is after the market close, it carries over to the next morning. This risks distorting the results by including excessive overnight volatility, but Almgren, Thum, Hauptmann, and Li (2005) have found this to give more consistent results than truncating at the market close.
8. Permanent Realized Impact Variables Definition: Based on these prices the following dimensionless impact variables are defined. The dimensionless permanent impact is

$$I = \frac{S_{POST} - S_0}{S_0}$$

and the dimensionless realized impact is

$$I = \frac{\bar{S} - S_0}{S_0}$$

9. Conversion into Observed Market Impacts: The “effective dimensionless impact  $J$  is the quantity of most interest, since it specifies the actual cash spent or received on the trade. In the model below the temporary impact will be defined to be  $J$  minus a suitable fraction of  $I$  and this temporary impact will be the quantity described by the theory.
10. Signs of the Impact Variables: On any individual order, the signs of  $I, J$  can be positive or negative. In fact since volatility is a very large contributor to either values, they are almost likely to have either sign. They are defined so that positive cost is experienced if  $I, J$  have the same sign as the total order  $X$ ; for a buy order with



$$X > 0$$

positive cost means that the price  $S(t)$  moves upwards. The average values of  $I, J$  taken across many orders is expected to have the same sign as  $X$ .

11. Intra-day Volume Weighted Time: The level of market activity is known to vary substantially and consistently over different periods of the trading day; this intra-day variation affects both the volume profile and the variance of prices. To capture this effect, all computations are performed in volume time  $\tau$  which represents the fraction of the average day's volume that has executed up to the time  $t$ .
12. Intra-day Volume Weighted Trajectory: Thus a constant rate trajectory in the  $\tau$  variable corresponds to a VWAP execution in real time. The relationship between  $t$  and  $\tau$  is independent of the daily trading volume; it is scaled so that

$$\tau = 0$$

at market open and

$$\tau = 1$$

at market close.

13. Intra-day Volume Weighted Times: Each of the clock times  $\tau_0, \dots, \tau_n$  in the data set is mapped to the corresponding volume time  $t_0, \dots, t_n$ . Since the stocks in the sample are heavily traded a non-parametric estimator that directly measures the differences in  $\tau$  is used; the shares traded during the period correspond to the execution of each order.
14. Time Volume vs. Price Volatility: Almgren, Thum, Hauptmann, and Li (2005) display an illustration of the empirical profiles. The fluctuations in each time period in these illustrations correspond to the approximate size of statistical error in the



volume calculation for a 15-minute trade; these errors are typically less than 5%, and are smaller for longer periods.

15. The “Dimensional” Parametric Explanatory Variables: The impacts  $I$  and  $J$  are to be described in terms of the following quantities.

a. Total executed size in shares

$$X = \sum_{j=1}^N x_j$$

b. Volume Duration of Active Trading:

$$T = \tau_n - \tau_0$$

c. Volume Duration of the Impact:

$$T_{POST} = \tau_{POST} - \tau_0$$

16. Caveats around the Explanatory Variables: As noted above,  $X$  is positive for a buy order, and negative for a sell order. Explored defining  $T$  using a size weighted average of execution times, but the results are not substantially different. The intermediate execution times  $\tau_1, \dots, \tau_{n-1}$  are not used, and the execution sizes are not used either except in calculating the order size and the mean realized prices.

17. Fixed Trade - Optimal Time Nodes: In the eventual application for trajectory optimization, the size  $X$  will be assumed given, and the execution schedule here represented by  $T$  will be optimized.

18. Execution Time as Optimizing Parameter: In general the solution will be a complicated time dependent trajectory parametrized by a time scale  $T$ . For the purposes of data modeling the trajectory optimization is ignored and the schedules are taken to be determined only by a single number  $T$ .



19. Market Core Empirical Parametric Inputs: Although the goal is to explain the dependence of the impact costs  $I, J$  on order size  $X$  and trade time  $T$ , other market variables will influence the solution. The most important of these are:  $V$  – which is the average daily volume in shares, and  $\sigma$  – the daily volatility.
20. Daily Volume/Volatility “Wander” Scale:  $V$  is a 10 day moving average. For volatility, an intra-day estimator that makes use of every transaction in the day is used. It is important to track changes in these variables not only between different stocks but also across time for the same stock.
21. Order Size/Daily Volume Normalization: These values serve primarily to “normalize” the active variables across the stocks with widely varying properties. It seems natural that order size  $X$  should be measured as a fraction of the average daily volume  $V$ :  $\frac{X}{V}$  is a more natural variable than  $V$  itself.
22. Intrinsic Notion of Volume Time: In the model presented below, the order size as a fraction of the average volume traded during the time of execution will also be seen to be important.  $VT$  is estimated directly by taking the average volume that executed between the times  $t_0$  and  $t_n$  over the previous 10 days. In fact, since in the model the trade duration  $T$  appears only in the combination  $VT$  this avoids the need to measure  $T$  directly.
23. “Wander” Scale of Market Impact: The volatility is used to scale the impacts – a certain level of participation in the daily volume should cause a certain level of participation in the ‘normal’ motion of the stock. Empirical investigation by Almgren, Thum, Hauptmann, and Li (2005) shows that volatility is the most important scale factor for cost impact.

## **Trajectory Cost Model**

1. Constant Volume Time Trading Rate: The model used is based on the framework developed by Almgren and Chriss (2000), and Almgren (2003), with simplifications made to facilitate data fitting. The main simplification is that the rate of trading is



constant (in volume time). In addition cross impact is neglected, since the data has no information about the effect of trading one stock on the price of the other.

2. The Permanent Impact Market Component: The price impact is decomposed into two components. First is a permanent component that reflects the information transmitted to the market by the buy/sell imbalance. This component is believed to be roughly independent of trade scheduling; ‘stealth’ trading is not admitted by this construction. In the data fit this component will be independent of the execution time  $T$ .
3. The Temporary Market Impact Component: A temporary component reflects the price concession needed to attract counterparties within a specified short time interval. This component is highly sensitive to trade scheduling; here it will strongly depend on  $T$ .
4. Other Elaborate Market Impact Frameworks: More detailed conceptual frameworks have been developed (Bouchaud, Geffen, Potters, and Wyart (2004)), but this easily understood model has become standard in industry and academic literature (Madhavan (2000)).
5. Decomposition of the Realized Market Impact: The realized price impact is a combination of the above two effects. In terms of the realized and the permanent impact defined above and observed from the data, the model may be summarized as

$$Realized = Permanent + Temporary + Noise$$

with suitable coefficients and scaling depending upon  $T$ . Thus the temporary impact is obtained as a difference between the permanent impact and the realized impact; it is not directly observed, although there is a direct model for it.

6. Uniform Rate of Order Liquidation: The starting point is the initial order demand of  $X$  shares. This is assumed to be completed by a uniform rate of trading over a volume interval  $T$ . That is, the trade rate in volume units is

$$v = \frac{X}{T}$$



and is held constant until the program is completed.

7. Sign of the Trade Rate: Constant rate in these units is equivalent to VWAP execution during the time of execution. Note that  $v$  has the same sign as  $X$ ; thus

$$v > 0$$

for a buy order and

$$v < 0$$

for a sell order. Market impact will move the price in the same direction as  $v$ .

## Permanent Impact

1. Volatility/Permanent Impact Price Change: The model postulates that the asset price  $S(\tau)$  follows an arithmetic Brownian motion with a drift term that depends on the trade rate term  $v$ . That is

$$\Delta S = S_0 g(v) \Delta \tau + S_0 \sigma \Delta B(\tau)$$

where  $B(\tau)$  is a standard Brownian motion (or a Bachelier process); and  $g(v)$  is the permanent impact function; the only assumptions made are that  $g(v)$  is increasing and has

$$g(0) = 0$$

2. Integrated Form of Price Change: As noted above,  $\tau$  is volume time, representing the fraction of an average day's volume that has executed so far. This expression can be integrated in time taking  $v$  to equal  $\frac{X}{T}$  for





$$0 \leq \tau \leq T$$

to obtain the permanent impact

$$I = Tg\left(\frac{X}{T}\right) + \sigma\sqrt{T_{POST}}\xi$$

where

$$\xi \sim \mathcal{N}(0, 1)$$

is a standard Gaussian variable.

3. Linearity of the Permanent Impact Function: Note that if  $g(v)$  is a linear function, then the accumulated drift at time  $\tau$  is equal to  $\frac{X\tau}{T}$ , the number of shares executed to time  $\tau$ , and the permanent impact  $I$  is proportional to the total order size  $X$  independently of the time scale  $T$ .

## Temporary Impact

1. Temporary Impact Price Change Realization: The actual price received from the trade is

$$\tilde{S}(\tau) = S(\tau) + S_0 h\left(\frac{X}{T}\right)$$

where  $h(v)$  is the temporary impact function. For convenience, it has been scaled by the market price at the start of trading, since the time intervals involved are all less than one day.



2. Discretization of the Price Impact: This expression is a continuous time approximation to a discrete process. A more accurate description would be to imagine that the time intervals would be broken down into intervals such as, say, one hour or 30 minute intervals. Within each interval the average price realized on the trade during that interval would be less favorable than the average price that an unbiased observer would measure during that time interval.
3. Unbiased Price Plus Liquidity Concession: The unbiased price is affected by the previous trades that have been executed before this interval (as well as the volatility) but not on their timing. The additional concession during this time interval is strongly dependent on the number of shares executed in this interval.
4. Closed Form Temporary Impact Expression: At a constant liquidation rate, calculating the time average of the execution price gives the temporary impact expression

$$J - \frac{I}{2} = h\left(\frac{X}{T}\right) + \sigma \left[ \sqrt{\frac{T}{12} \left(4 - 3 \frac{T}{T_{POST}}\right)} \chi - \frac{T_{POST} - T}{2\sqrt{T_{POST}}} \xi \right]$$

where

$$\chi \sim \mathcal{N}(0, 1)$$

is independent of  $\xi$ . The term  $\frac{I}{2}$  reflects the effect on the later execution prices of permanent impact caused by the earlier parts of the program.

5. Estimate of the Heteroscedastic Corrections: The rather complicated error expression reflects the fluctuations on the middle part of the Brownian motion on  $[0, T]$  relative to the end point at  $T_{POST}$ . It is only used for the heteroscedastic corrections for the regression fits below.
6. Fluctuations and Error Residuals Estimation: The equations and provide explicit expressions for the permanent and the temporary impact components  $I, J$  in terms of



the values of the functions  $g$  and  $h$  at known trade rates, together with the estimates of the magnitude of the error coming from the volatility.

7. Regression Based Impact Form Estimation: The data fitting procedure above is in principle straightforward, the impacts  $I$  and  $J$  are computed from the transaction data, and those values are regressed against order sizes and times as indicated to directly extract the functions  $g(v)$  and  $h(v)$ .

## Choice of the Functional Form

1. Permanent/Temporary Impact Function Structure: The next question that needs to be addressed is what should the structure of the permanent impact function  $g(v)$  and the temporary impact function  $h(v)$  be. Even with a large sample it is not possible to extract these functions purely from data, so a hypothesis must be made about their structure.
2. Power Law Impact Functional Forms: The postulate is that these functions are power laws, that is, that:

$$g(v) = \pm\gamma|v|^\alpha$$

and

$$h(v) = \pm\eta|v|^\beta$$

where the numerical values of the dimensionless coefficients  $\gamma$  and  $\eta$  and the exponents  $\alpha$  and  $\beta$  are to be determined by linear and non-linear regressions on the data. The sign is to be chosen so that  $g(v)$  and  $h(v)$  have the same sign as  $v$ .

3. Range of Power Law Representation: This class of power law is extremely broad. It includes concave functions (exponent  $< 1$ ), convex functions (exponent  $> 1$ ), and linear functions (exponent  $= 1$ ). It is the functional form that is implicitly assumed by



fitting straight lines on a log-log plot as is very common in physics, and has been used in this context, for example, by Lillo, Farmer, and Mantegna (2003).

4. Order Type/Exchange Parameter Independence: The same coefficients are taken for buy orders

$$v > 0$$

and sell orders

$$v < 0$$

It would be a trivial modification to introduce different coefficients  $\gamma_{\pm}$  and  $\eta_{\pm}$  for the two sides, but the exploratory analysis by Almgren, Thum, Hauptmann, and Li (2005) has not indicated a string need for this. Similarly it would be possible to use different coefficients for stocks traded on different exchanges, but this does not appear to be necessary either.

5. Quasi Arbitrage Permanent Impact Elimination: There is reason to be specific in the choice of the exponents. For the permanent impact function there is a strong reason to prefer the linear model with

$$\alpha = 1$$

This is the only value for which the model is free from quasi-arbitrage (Huberman and Stanzl (2004)).

6. Linearity of the Permanent Impact: Furthermore, the linear function is the only one for which the permanent price impact is independent of the trading time. Of course this substantial conceptual simplification must be supported by the data.
7. Concave Nature of the Temporary Exponents: For temporary impacts, there is ample evidence indicating that the function should be concave, that is



$$0 < \beta < 1$$

This evidence dates back to Loeb (1983) and is strongly demonstrated by the fits in Lillo, Farmer, and Mantegna (2003). In particular theoretical arguments (Barra (1997)) suggest that the particular value of

$$\beta = \frac{1}{2}$$

is especially plausible, resulting in a square root impact function.

8. Verification of Power Exponent Values: The approach is then as follows.

Unprejudiced fits to the power law functions shall be made to the entire data set to determine the best estimates for the exponents  $\alpha$  and  $\beta$ . The validity of the values

$$\alpha = 1$$

and

$$\beta = \frac{1}{2}$$

will then be tested to validate the linear and the square root candidate functional forms.

9. Determination of the Impact Coefficients: Once the exponents have been selected, simple linear regression is adequate to determine the coefficients. In this regression heteroscedastic weightings are used, with the error magnitudes from

$$I = Tg\left(\frac{X}{T}\right) + \sigma\sqrt{T_{POST}}\xi$$

and



$$J - \frac{I}{2} = h\left(\frac{X}{T}\right) + \sigma \left[ \sqrt{\frac{T}{12} \left(4 - 3 \frac{T}{T_{POST}}\right)} \chi - \frac{T_{POST} - T}{2\sqrt{T_{POST}}} \xi \right]$$

The result of this regression is not only the values for the coefficients, but also a collection of the error residuals  $\xi$  and  $\chi$  which must be tested for normality as the theory supposes.

## Cross-Sectional Description

1. Motivations for the Properties Normalization: The above analysis has assumed an ‘ideal’ asset, all of whose properties remain constant in time. For any real asset, the parameters that determine the market impact will vary with time. For example one would that the execution of a given number of shares would incur higher impact costs on a day with unusually low volume or unusually high volatility.
2. Basis for the Normalizer Choice: That is, the impact of the cost functions should be expressed in terms of the dimensionless quantity  $\frac{X}{VT}$  rather than  $X$  itself, where  $V$  is the average number of shares per day defined above.
3. Normalization of the Price Moves: Furthermore, the motion of the price should not be given as a raw percentage figure, but it should be expressed as a fraction of ‘normal’ daily motion of the price, as expressed by the volatility  $\sigma$ .
4. Normalized Expressions for  $I, J$ : With these assumptions, the equations

$$I = Tg\left(\frac{X}{T}\right) + \sigma\sqrt{T_{POST}}\xi$$

and



$$J - \frac{I}{2} = h\left(\frac{X}{T}\right) + \sigma \left[ \sqrt{\frac{T}{12} \left(4 - 3 \frac{T}{T_{POST}}\right)} \chi - \frac{T_{POST} - T}{2\sqrt{T_{POST}}} \xi \right]$$

can be modified to

$$I = \sigma T g\left(\frac{X}{T}\right) + \llbracket noise \rrbracket$$

and

$$J - \frac{I}{2} = \sigma h\left(\frac{X}{T}\right) + \llbracket noise \rrbracket$$

respectively, where  $\llbracket noise \rrbracket$  is the error expression depending on the volatility.

5. Dimensionless Permanent Temporary Function Inputs: Now  $g$  and  $h$  are dimensionless functions of a dimensionless variable. They are assumed to be constant in time for a single stock across days when  $\sigma$  and  $V$  vary. The next step is to investigate these functions for their dependence on cross-stock variables.

## Model Determination

1. Specification of Extraneous Model Regressors: To bring the full size of the data into play, one must address the more complex and the less precise question of how the impact functions vary across the stocks, that is, how much they depend variables such as market capitalization, shares outstanding, bid-ask spread, or other quantities. Temporary and permanent impact must be considered separately.
2. Permanent Impact Function Liquidity Regressor: A ‘liquidity factor’  $\mathcal{L}$  is inserted into the permanent cost function  $g(v)$ , where  $\mathcal{L}$  depends on the market parameters



characterizing each stock (in addition to daily volume and liquidity). There are several candidates for inputs into  $\mathcal{L}$ .

3. Liquidity Regressor Candidate - Inverse Turnover: The form of  $\mathcal{L}$  is constrained to be

$$\mathcal{L} = \left[ \frac{\Theta}{V} \right]^\delta$$

where  $\Theta$  is the total number of shares outstanding, and  $\delta$  is the exponent to be determined. The dimensionless quantity  $\frac{\Theta}{V}$  is the inverse of the ‘turnover’ – the fraction of the company’s value traded each day. This is a natural explanatory variable, and has been used in empirical studies such as Breen, Hodrick, and Korajczyk (2002).

4. Liquidity Regressor Candidate – Bid-Ask: Almgren, Thum, Hauptmann, and Li (2005) did not find any consistent dependence on the bid-ask spread across the sample, so it is not included in  $\mathcal{L}$ .
5. Liquidity Regressor Candidate - Market Capitalization: This differs from the shares outstanding by the price per share, so including this factor is equivalent to including a ‘price effect’. The study by Almgren, Thum, Hauptmann, and Li (2005) found that there is a persistent price effect, as also found by Lillo, Farmer, and Mantegna (2003), but that the dependence is weak is enough that it may be neglected in favor of the conceptually simpler quantity  $\frac{\Theta}{V}$ .
6. Temporary Impact Function - Regressor Candidate: In further extensive preliminary exploration, it was found that the temporary cost function  $h(v)$  does not require any stock-specific modification; liquidity costs as a fraction of volatility only depends upon the fraction of the shares traded as a fraction of the average daily volume.
7. Revised  $I, J$  Functional Forms: After assuming the functional form defined above, the model is validated and the exponent  $\delta$  is determined by performing a non-linear regression of the form





$$\frac{I}{\sigma} = \gamma T \operatorname{sgn}(X) \left| \frac{X}{VT} \right|^\alpha \left[ \frac{\Theta}{V} \right]^\delta + \llbracket \text{noise} \rrbracket$$

and

$$\frac{1}{\sigma} \left[ J - \frac{I}{2} \right] = \eta \operatorname{sgn}(X) \left| \frac{X}{VT} \right|^\beta + \llbracket \text{noise} \rrbracket$$

where  $\llbracket \text{noise} \rrbracket$  is the again the heteroscedastic error term from

$$I = T g \left( \frac{X}{T} \right) + \sigma \sqrt{T_{POST}} \xi$$

and  $\operatorname{sgn}$  is the sign function.

8. Estimates and Residuals of Exponents: A modified Gauss-Newton optimization algorithm was used to determine the values of  $\alpha$ ,  $\beta$ , and  $\delta$  that minimized the normalized residuals. The results are:

$$\alpha = 0.891 \pm 0.10$$

$$\delta = 0.267 \pm 0.22$$

$$\beta = 0.600 \pm 0.038$$

9. Errors Represented as One Sigma Amounts: Here, as throughout this chapter, the error bars are expressed with  $\pm$  are one standard deviation, assuming Gaussian error model. Thus the ‘true’ value can be expected to be within this range with 67% probability, and within a range twice as large with 95% probability.
10. Choice of Linear Permanent Impact: From these values the following conclusions can be drawn. First the value



$$\alpha = 1$$

for linear impact cannot be reliably rejected. In view of enormous practical simplification of the linear permanent impact

$$\alpha = 1$$

is chosen.

11. Permanent Impact Liquidity Exponent Estimation: The liquidity factor is very approximately

$$\delta = \frac{1}{4}$$

12. Temporary Impact Power Law Exponent: For temporary impact, the analysis confirms the concavity of the function with  $\beta$  strictly less than one. This confirms the fact that the bigger the trades made by the fund managers on the market, the less additional cost they experience per share traded. At 95% confidence level, the square root model

$$\beta = \frac{1}{2}$$

is rejected. The temporary cost exponent is therefore fixed at

$$\beta = \frac{3}{5}$$

In comparison with the square root model, this gives slightly smaller costs for smaller trades, and slightly larger costs for large trades.

13. Permanent Dependence on Shares Outstanding: Note that because



$$\delta > 0$$

for fixed values of number  $X$  of shares in the order, and the average daily volume  $V$ , the cost increases with  $\Theta$ , the total number of shares outstanding. In effect a large number of outstanding shares means that a smaller fraction of the company is traded each day, so a given fraction of that flow has a greater impact.

14. Linear Permanent Concave Temporary Impact: Therefore the results confirm empirically the theoretical arguments of Huberman and Stanzl (2004) for permanent impact that is linear in the block size, and the concavity of the temporary impact has been widely described in the literature for both theoretical and empirical reasons.

## Determination of the Coefficients

1. Estimation of the Impact Coefficients: After fixing the exponent values, the values of  $\gamma$  and  $\eta$  are determined by linear regression of the models.

$$\frac{I}{\sigma} = \gamma T \text{sgn}(X) \left| \frac{X}{VT} \right|^\alpha \left[ \frac{\Theta}{V} \right]^\delta + \llbracket \text{noise} \rrbracket$$

and

$$\frac{1}{\sigma} \left[ J - \frac{I}{2} \right] = \eta \text{sgn}(X) \left| \frac{X}{VT} \right|^\beta + \llbracket \text{noise} \rrbracket$$

using the heteroscedastic error estimates given in

$$I = T g \left( \frac{X}{T} \right) + \sigma \sqrt{T_{POST}} \xi$$



and

$$J - \frac{I}{2} = h\left(\frac{X}{T}\right) + \sigma \left[ \sqrt{\frac{T}{12} \left(4 - 3 \frac{T}{T_{POST}}\right)} \chi - \frac{T_{POST} - T}{2\sqrt{T_{POST}}} \xi \right]$$

It is found that

$$\gamma = 0.314 \pm 0.041$$

with

$$t = 7.7$$

and

$$\eta = 0.142 \pm 0.0062$$

with

$$t = 23$$

2. Interpretation of the  $t$  statistic: The  $t$  statistic is calculated assuming that the Gaussian model expressed in

$$I = Tg\left(\frac{X}{T}\right) + \sigma\sqrt{T_{POST}}\xi$$

and



$$J - \frac{I}{2} = h\left(\frac{X}{T}\right) + \sigma \left[ \sqrt{\frac{T}{12} \left(4 - 3\frac{T}{T_{POST}}\right)} \chi - \frac{T_{POST} - T}{2\sqrt{T_{POST}}} \xi \right]$$

is valid; the error estimates are the values divided by the  $t$  statistic. Although the actual residuals are fat-tailed as discussed below, these estimates indicate that the coefficient values are highly significant.

3. Permanent Impact Signal Contribution: The  $\mathbb{R}^2$  values are typically less than 1% indicating that only a small part of the dependent variables  $I$  and  $J$  is explained by the model in terms of the independent variables. This is precisely what is expected given the small size of the random impact term relative to the random motion of the price due to the volatility arising from the trade execution.
4. Importance of the Permanent Cost: The permanent persistent cost, though small, is of major importance since it is on the average the cost incurred by the fund managers while trading. Furthermore since most orders are part of large portfolio trades, the volatility costs experienced on the portfolio level is considerably lower than exhibited in the stock-level analysis, increasing the significance of the fraction of the impact cost estimated. As previously mentioned the non-linear optimization of the volatility versus impact cost trade-off would reveal additional profitable strategies.
5. Universal Coefficients of Market Impact: The dimensionless numbers  $\gamma$  and  $\eta$  are the universal coefficients of market impact. According to the model, they apply to every order and every asset in the entire data set.
6. Interpretation Caveat  $I$  vs.  $J$ : To summarize, they are to be inserted into the equations

$$I = \gamma \sigma \frac{X}{V} \left[ \frac{\Theta}{V} \right]^{\frac{1}{4}} + \llbracket noise \rrbracket$$

and

$$J = \frac{I}{2} + \eta \sigma \operatorname{sgn}(X) \left| \frac{X}{VT} \right|^{\frac{3}{5}} + \llbracket noise \rrbracket$$



giving the expectation of the impact costs; in any particular order the realized values will vary greatly due to the volatility. To reiterate,  $I$  does not signify the total cost, but is simply the net price motion from pre-trade to post-trade. The actual cost experienced by the trade is signified by  $J$ .

7. Sub Group Impact Parameters Determination: Almgren, Thum, Hauptmann, and Li (2005) have chosen the simple form above to have a single model that applies reasonably well across the entire data set which consists entirely of large cap stocks in the US market. More detailed models could be constructed to capture more limited data or assets, or to account for variations across global markets. In practice, it is expected that the coefficients, perhaps even the exponents, or maybe even the functional forms, will be continually updated to reflect the most recent data.
8. Example of Impact Cost: The table below shows the impact cost functions and the numerical examples for two large cap stocks when the customer buys 10% of the average daily volume. The permanent cost is independent of the time of execution, the temporary cost depends on the time of execution, but across different asset it is the same fraction of the daily volatility.  $K$  is written as

$$K = J - \frac{I}{2}$$

9. Example of Impact Costs Table:

			<b>IBM</b>	<b>DRI</b>
Average Daily Volume	Million	$V$	6.561	1.929
Shares Outstanding	Million	$\Theta$	1728	168
Inverse Turnover		$\frac{\Theta}{V}$	263	87
Daily Volatility	%	$\sigma$	1.57	2.26
Normalized Trade Rate		$\frac{X}{V}$	0.1	0.1



Normalized Permanent Impact		$\frac{I}{\sigma}$	0.126			0.096		
Permanent Price Impact	bp	$I$	20			22		
Trade Duration	Days	$T$	0.1	0.2	0.5	0.1	0.2	0.5
Normalized Temporary Impact		$\frac{K}{\sigma}$	0.142	0.094	0.054	0.142	0.094	0.054
Temporary Impact Cost	bp	$K$	22	15	8	32	21	12
Realized Cost	bp	$J$	32	25	18	43	32	23

10. Example of Impact Cost – Analysis: In the above example, because DRI turns over  $\frac{1}{87}$  of its float each day, whereas IBM turns over only  $\frac{1}{263}$ , trading 10% of the day's volume causes a permanent price move of only 0.1 times volatility for DRI, but 0.13 times for IBM; half of this is experienced as cost. Because the permanent cost function is linear, the permanent cost numbers are independent of the times of execution.

## Residual Analysis

1. Results of Impact and Market: The results of the above analysis are not simply the values of the coefficients presented. In addition, the error formulation provides specific predictions for the nature of the residuals  $\xi$  and  $\chi$  for the permanent and the temporary impact respectively from

$$I = Tg\left(\frac{X}{T}\right) + \sigma\sqrt{T_{POST}}\xi$$

and



$$J - \frac{I}{2} = h\left(\frac{X}{T}\right) + \sigma \left[ \sqrt{\frac{T}{12} \left(4 - 3 \frac{T}{T_{POST}}\right)} \chi - \frac{T_{POST} - T}{2\sqrt{T_{POST}}} \xi \right]$$

2. Validating the Independence of the “Wanderers”: Under the assumption that the asset price is a Brownian motion with the drift caused by the impact, these two variables should be independent standard Gaussians. This assumption has already been used in heteroscedastic regression, now it needs to be verified.
3. Residual Mean and Covariance: Almgren, Thum, Hauptmann, and Li (2005) demonstrate histograms and  $Q - Q$  plots of  $\xi$  and  $\chi$ . The means are quiet close to zero, the variances a r reasonably close to 1, and the correlation is reasonably small.
4. Fat-Tailed Nature of the Distribution: But the distribution is extremely fat-tailed, as is normal for returns distributions on short-time intervals (see Rydberg (2000)), and hence does not indicate that the model is poorly specified. Nonetheless, the structure of the residuals confirms that the model is close to the best that can be obtained within the Brownian framework.

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## Optimal Execution of Program Trades

### Introduction

1. The Definition of the Program Trade: The program trade involves the sale or the purchase of a basket of stocks that is too large to be traded immediately in the market. When such trades are brokered, they take on of two forms.
2. The Agency Program Trade Type: In the *agency trade* type the broker executes the trade on behalf of the client on a commission basis, and all the risk of the trade is borne by the client.
3. The Principal Program Trade Type: In a *principal trade*, also called a principal basket, principal bid, or risk bid, the broker directly purchases the entire basket for a fixed price, usually expressed as a discount to the fair market value. By design, principal trades transfer all of the risk from the client to the broker in exchange for a single price, which therefore proxies for the risk of the market portfolio.
4. Program Trades Share of NYSE: Program trading represents an increasing percentage of the overall stock market volume. In 2002 program trades averaged over 30% of the New York Stock Exchange trading volume, up from approximately 20% in 1999 and 2000.
5. Share of the Principal Trades: Overall 50% of all trading volume took place in the NYSE, and of this 30-40% was done on a principal basis (NYSE (2002)).
6. Attributes of a Principal Trade: Almgren and Chriss (2003) begin by making two key observations about the program trading business. First the principal trade consists of two attributes – a basket of stocks, and a price.
7. The Basket Components and Price: The basket is determined by the client, but the price – usually expressed as a per share discount to the current market value – is agreed upon by the client and the broker, and the potential profitability of the trade depends upon the precise price that can be secured for trading the basket. Throughout



this chapter, the trade will be treated as the logical unit which consists of both the basket and its price.

8. Corporate Finance View of the Principal Trade: The second observation is that since program trading represents an investment of the firm's capital, the correct way to view performance is on an annualized basis.
9. First Result - The "Optimal" Execution: The treatment here constructs a mathematical framework for pricing and trading of principal baskets, yielding two main results. First it shows that for a broad class of measures of annualized risk-adjusted return there is a unique optimal way to trade the basket.
10. Second Result - The Information Ratio: Second, the measure called the *information ratio* of a trade is introduced, which is the ratio of the annualized expected profit to the annualized standard deviation of the profit.
11. Information Ratio as a Relative Value Metric: Given a proposed trade one can calculate the information ratio from the known information about the basket. Because the information ratio is annualized by the expected time to completion of the liquidation, it provides a way to compute the profitability of trades of different sizes and levels of liquidity. This yields a powerful tool for analyzing principal businesses.
12. Accommodating Various Market Impact Models: One does not need to know all of the constituents of a basket to compute its information ratio – just the volatility, the liquidity, and a proposed price for the basket. In particular, one must know the effect of trading a basket on the prices of its constituents, that is, the market impact. The methods in this treatment fit in with a wide variety of existing models.
13. The "Hurdle Rate" Minimum Price: The information ratio is primarily a pricing tool. By specifying a hurdle rate – a minimum information ratio that every principal basket must exceed – one can determine for a given principal basket what the minimum price will be that exceeds the hurdle rate.
14. Viability of the "Going Price": Alternatively it may be used as an evaluation tool. If one knows the "going price" of a trade, one can compute the information ratio of the trade based on that price to determine whether it is worthwhile to submit a winning bid for the business.



## Efficient Frontier Pricing of Program Trades

1. Ex-Ante Risk Adjusted Return: The program trade is essentially the use of capital by a trading desk. In this treatment, the use of this capital is evaluated using an *ex-ante* risk adjusted return ratio – the ratio of the predicted profit to the standard deviation of the predicted profit. This turns out to be the familiar information ratio, analogous to the familiar Sharpe ratio of the Information Theory.
2. The Investment Horizon Cost/Variance: Almgren and Chriss (2003) argue that for a principal desk engaged in an ongoing business, the correct approach is to *annualize* the cost and the variance, placing them in the context of other investment opportunities.
3. Discount Based Optimal Execution Point: Remarkably for each value of the discount received for trading the basket, there is then a *single* optimal point, independent of the risk preferences. This point corresponds to the single best value for the overall information ratio.
4. “Put Out To Bid” Call: The value of this ratio is therefore a potential tool to be used in evaluating whether to accept a certain piece of business at a certain price. In many situations the program trading business is “put out to bid”. That is, the portfolio manager contacts multiple desks about a particular portfolio.
5. Information Ratio as a Decision Tool: Each business responds with a certain bid – the discount to the fair market value required to do the business. Program trading desks often know the level of bid required to win the business, and therefore the information ratio can be used as a hurdle or an evaluation tool to decide whether or not to bid at a level to win the business.

## The Efficient Frontier Including Discount



1. Incorporating the Execution Discount Premium: This section connects the problem of liquidating a basket to the price of a basket. The aim is to eventually compute the information ratio of liquidating a basket incorporating the value of the discount to the fair value received in the transaction.
2. Units of the Execution Discount: Thus the assumption is that the trader will receive a discount of  $D$  dollars per share for a basket in the principal trade, and explicitly calculate the cash received in trading out the basket and its variance. For example, if the program trading desk were to be able to dump the entire portfolio onto the market without any market impact, it would earn a profit of  $DX$  dollars.
3. Execution Profit Under market Impact: In general, because of the market impact, the total expected profit of a trade would be

$$E = DX - C_{PERM} - C_{TEMP}$$

and the variance is the same as stated in other publications (Almgren and Chriss (2000), Almgren (2003)).

4. Execution Profit Expectation and Variance: The expected profit and its variance can be explicitly calculated as functions of the execution time  $T$ :

$$\mathbb{E}_P[T] = \left(D - \frac{1}{2}\gamma X\right)X - \frac{k+1}{3k+1}\eta\left(\frac{X}{T}\right)^k X$$

$$\mathbb{V}_P[T] = \frac{k+1}{3k+1}\sigma^2 TX^2$$

5. Market Impact Reduction of Profit: Shortly  $\mathbb{E}_P[T]$  and  $\mathbb{V}_P[T]$  will be used to construct the information ratio of a trade, but for now some of its properties are examined. Clearly it is seen that the expected profit of a trade is its total discount  $DX$  reduced by a temporary impact and a permanent impact amount.
6. Difference between the Permanent and the Temporary Impact Costs: The effect of the permanent impact is to reduce the expected profit per share, as reflected in the size of



the discount  $D$ , by an amount equal to the portfolio size, while temporary impact is proportional to a *per share* reduction in the expected profit of  $\left(\frac{X}{T}\right)^k$ .

7. Time Horizon Dependence of Profit: It is worth noting the dependence of  $\mathbb{E}_P[T]$  and  $\mathbb{V}_P[T]$  on  $T$ . Short liquidation times

$$T \rightarrow 0$$

correspond to

$$\mathbb{E}_P[T] \rightarrow -\infty$$

and

$$\mathbb{V}_P[T] \rightarrow 0$$

All profit is dissipated in impact costs, but no variance is incurred.

8. Intuitive Interpretation of Long Times: Long times

$$T \rightarrow \infty$$

correspond to

$$\mathbb{E}_P[T] = \left(D - \frac{1}{2}\gamma X\right)X$$

and

$$\mathbb{V}_P[T] \rightarrow \infty$$



Temporary impact costs are avoided completely by essentially holding the portfolio forever, but at the expense of any certainty of profit.

9. Elimination of Permanent Impact Costs: In principle, if the portfolio were held forever without trading, then the permanent impact costs will also be avoided:

$$T = \infty$$

is not the same as

$$T \rightarrow \infty$$

10. The Zero Net Profit Trade: Assuming that the discount is at least enough to compensate for the permanent impact, there is an intermediate point at which

$$\mathbb{E}_P[T] = 0$$

- the zero profit trade; impact costs are exactly compensated by the discount on average, but risk is taken to achieve this.

11. Applying Customized Mean Variance Objective: The previous work by Almgren and Chriss (2000) focused on various ways to draw the expectation cost expectation/variance combination frontier, in order to maximize either a mean-variance criterion  $\mathbb{E}_P[T] + \lambda_u \mathbb{V}_P[T]$  or a value-at-risk measure  $\mathbb{E}_P[T] + \lambda_v \sqrt{\mathbb{V}_P[T]}$  for a single trade in isolation. The next step is to consider this trade as part of an ongoing business.

## Performance Measures

1. Basket Specific Optimal Liquidation Time: In this section the information ratio of a single trade is determined assuming a given discount of  $D$  dollars a share. First





observe that the above analysis did not take into account the fact that different baskets will have different optimal liquidation times.

2. Comparison across Different Principal Bids: If the principal bids are to be considered in the context of ongoing business in relation to multiple investment opportunities, then the expected profit per trade must be viewed in units that are comparable across different optimal times.
3. Per Basket Annualized Expected Return: This is done by directly annualizing the expected return by the expected amount of time it takes to liquidate substantially all of the basket, as determined by the characteristic time of the trade  $T$ . If a positive profit can be made, i.e., if

$$\mathbb{E}_P[T] > 0$$

then the trader prefers a shorter liquidation time to a longer liquidation time, other things being equal.

## Annualization

1. Characteristic Time as the Investment Horizon: In order to annualize the expected profit and its variance, it is assumed that the entire invested capital becomes available for re-investment after one characteristic time  $T$ .
2. Intermittent Release of Invested Capital: In fact, liquidation is a continuous process; some capital is available immediately, and recovery of the full capital formally requires an infinite amount of time. Nonetheless  $T$  is a reasonable average value, and it is the simplest way to compare different trajectories.
3. Annualized Expected Return and Variance: Assuming that  $T$  is measured in years, annualizing is simply a matter of dividing by  $T$ . The expectation and the variance per year of trading is



$$\frac{\mathbb{E}_P[T]}{T} = \frac{\left(D - \frac{1}{2}\gamma X\right)X}{T} - \frac{k+1}{3k+1}\eta\left(\frac{X}{T}\right)^{k+1}$$

$$\frac{\mathbb{V}_P[T]}{T} = \frac{k+1}{3k+1}\sigma^2 X^2$$

4. Annualization of the Discount and the Permanent Costs: The annualized expectation is composed of two terms. The first term is the average rate at which the discount payment  $D$  is accepted, reduced by the cost of the permanent impact; since this is a fixed amount per portfolio, it is increased by rapidly trading.
5. Annualization of the Temporary Costs: The second term is the impact cost incurred by trading at a constant rate  $\frac{X}{T}$  adjusted by a numerical coefficient to account for the non-linear shape of the trajectory.
6. Annualized Variance Independent of the Liquidation Time: Note that the annualized variance is independent of the liquidation time; this can be interpreted as saying that in the course of repeated execution, one is always invested in the market by the same amount on average.
7. Impact on the Efficient Frontier: This has an important implication. That is that if the efficient frontier is re-cast in terms of annualized expectation and annualized variance, it collapses to a single point.
8. Almgren Chriss (2003) Efficient Frontier Illustration: As illustrated in Almgren and Chriss (2003) the feasible region collapses into a half-infinite vertical line and the frontier itself has collapsed into a single point. This is a direct consequence of the annualized variance being independent of the trading time.
9. The Mandatory Capital Market Line Point: The striking consequence of this is that any measure of risk-adjusted profitability as constructed from the tangent line on the curve, regardless of the functional form or the parameter values, will pass through the highest point on this line.
10. The corresponding Optimal Trading Time: This means that, in particular, there is a unique best way to trade for any reasonable risk-adjusted return measure *regardless*



of any particular risk-reward preferences, and is found simply by finding the value of  $T$  that maximizes  $\frac{\mathbb{E}_P[T]}{T}$ . This gives

$$T_{OPT} = \left[ \frac{(k+1)^2}{3k+1} \right]^{\frac{1}{k}} \frac{\eta^{\frac{1}{k}} X}{\left( D - \frac{1}{2} \gamma X \right)^{\frac{1}{k}}}$$

11. **Quasi Universal Optimal Trading Time:** To emphasize the point made once more,  $T_{OPT}$  is the parameter representing *the* optimal trading strategy across a broad spectrum of possible risk-adjusted return measures. It is independent of the risk/reward preferences, but depends on the discount  $D$ . The aim next is to define and evaluate a particular risk-adjusted return measure.

## Definition of the Information Ratio

1. **Mathematical Definition of Information Ratio:** Almgren and Chriss (2003) define and compute the *information ratio* of a trade, incorporating the effect of the discount  $D$  received in the transaction. For a given characteristic time  $T$  the information ratio with respect to  $T$  represents the annualized risk-adjusted expected profit that may be achieved by trading along a trajectory with parameter  $T$

$$I(T) = \frac{\frac{\mathbb{E}_P[T]}{T}}{\sqrt{\frac{\mathbb{V}_P[T]}{T}}}$$

2. **Risk Adjusted Basket Return:** Note that  $I(T)$  is the risk-adjusted return for a basket implicitly assuming a discount  $D$  received for the trade and a trading time parameter  $T$ .



3. Estimating the Maximal Information Ratio: The question is, for which  $T$  is  $I(T)$  maximal? The answer to this is  $T_{OPT}$ , which can be substituted into the expression for  $I(T)$  to get

$$I_{MAX} = \frac{(3k + 1)^{\frac{k+2}{2k}} \left(D - \frac{1}{2}\gamma X\right)^{\frac{k+1}{k}}}{(k + 1)^{\frac{3k+4}{2k}} \eta^{\frac{1}{k}} X \sigma}$$

4. Alternative Interpretation of  $\mathbb{E}_P[T]$  and  $\mathbb{V}_P[T]$ : Since the numerator and the denominator in the definition of  $I$  are both proportional to the portfolio size, it would be equivalent to considering  $\mathbb{E}_P[T]$  and  $\sqrt{\mathbb{V}_P[T]}$  above as *percentage* return and risk.
5. Units of the Information Ratio: Thus this quantity allows comparison of baskets and other investment opportunities of arbitrary size. It has units of  $year^{-\frac{1}{2}}$  and thus should be compared only with other annualized measures.

## Applications of the Information Ratio

1. Discount Level Implied Information Ratio: The two main applications of information ratio can now be states as answers to two questions. First, for a given level of discount than can be demanded for the trade, what is the information ratio of the basket?
2. Information Ratio Implied Discount Hurdle: Second, for a given information ratio *hurdle*, what minimum discount must be demanded in order to clear it?
3. Discount Implied Maximum Information Ratio: The answer to the first question is simply  $I_{MAX}$ , the information ratio of the basket assuming a discount of  $D$ . Put a different way



$$I_{MAX} = \frac{(3k+1)^{\frac{k+2}{2k}} \left(D - \frac{1}{2}\gamma X\right)^{\frac{k+1}{k}}}{(k+1)^{\frac{3k+4}{2k}} \eta^{\frac{1}{k}} X \sigma}$$

shows that given a discount  $D$  that a desk can demand for a trade, it will yield a peak information ratio  $I_{MAX}$  which can then be used to determine if the trade clears a particular hurdle.

4. Information Ratio Implied Minimum Discount: The second question may be answered by simply inverting

$$I_{MAX} = \frac{(3k+1)^{\frac{k+2}{2k}} \left(D - \frac{1}{2}\gamma X\right)^{\frac{k+1}{k}}}{(k+1)^{\frac{3k+4}{2k}} \eta^{\frac{1}{k}} X \sigma}$$

to yield

$$D_{MIN} = \frac{1}{2}\gamma X \left[ \frac{(k+1)^{\frac{3k+4}{2k}}}{(3k+1)^{\frac{k+2}{2k}}} X \eta^{\frac{1}{k}} \sigma I_{HURDLE} \right]^{\frac{k}{k+1}}$$

The expression for  $D_{MIN}$  above gives the maximum that a desk can be bid for a given basket while still clearing the minimum information ratio threshold of  $I_{HURDLE}$

5. Power Law Process Impact Table:

$k$	$T$	$I_{MAX}$
$\frac{1}{2}$	$0.810 \frac{\eta^2 X}{\tilde{D}^2}$	$1.063 \frac{\tilde{D}^3}{\eta^2 X \sigma}$
1	$\frac{\eta X}{\tilde{D}}$	$0.707 \frac{\tilde{D}^2}{\eta X \sigma}$



2	$1.134 \frac{\eta^{\frac{1}{2}} X}{\tilde{D}^{\frac{1}{2}}}$	$0.449 \frac{\tilde{D}^{\frac{3}{2}}}{\eta^{\frac{1}{2}} X \sigma}$
---	--------------------------------------------------------------	---------------------------------------------------------------------

6. Power Law Process Impact – Legend: The table above shows the optimal trading time and maximum information ratio for three different values of the market exponent  $k$ .

$\tilde{D}$  is computed from

$$\tilde{D} = D - \frac{1}{2} \gamma X$$

the discount reduced by the anticipated permanent impact costs.

7. Execution Time/IR Exponent Dependence: The table above presents the specific forms of these expressions for a few particular and important values of  $k$ . Although the analytical expressions above are complex, for a specific choice of  $k$  they reduce to simple numerical coefficients.
8. Execution Time/IR Discount Dependence: What is particularly noteworthy is the relationship between the price of the principal basket – as embodied in the discount to fair – and both the information ratio and the optimal time for liquidation. It depends on the market impact functions assumed, and can be quite sensitive to small movements.
9. Example - BARRA Market Impact Exponent: For example, for the BARRA model

$$k = \frac{1}{2}$$

the maximum information ratio increases as the *cube* of the discount, after allowing for permanent impact, and the optimal time decreases as the square of the discount.

10. Risk-Adjusted Profit Discount Dependence: One interpretation of these results is that small changes in the price of the principal bid, expressed as cents per share discount to fair value, can have significant impact on both the risk-adjusted profitability of the



trade and the time it takes to liquidate the trade. For instance, a basket that commands 2.5c per share discount to fair is twice as profitable on a risk-adjusted basis versus one that commands a 2c per share discount.

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## Bayesian Trading with a Daily Trend

### Overview, Motivation, and Synopsis

1. Parametric Estimation using Updated Information: Standard models of algorithmic trading neglect the presence of a daily trend. Almgren and Lorenz (2006) construct a model in which the trader uses information from the observations of price evolution during the day to continuously update his estimate of other traders' target sizes and directions.
2. Constraint Based Optimal Trajectory Generation: The trader uses this information to determine an optimal trade schedule to minimize total expected costs of trading, subject to sign constraints, e.g., never buy as part of a sell program.
3. Dynamic Strategies using Projected Cost: It is argued that these strategies are determined using very simple dynamic reasoning – at each moment they assume that the current condition will last until the end of trading – they are in fact globally optimal strategies as would be determined by dynamic programming.

### Introduction and the Associated Literature

1. Market Information Based Learning Updates: The work of Almgren and Lorenz (2006) presents a model for price dynamics and optimal trading that explicitly includes the daily trend and the trader's attempt to learn the targets of other market participants.
2. Drawbacks of Current Approaches: This is in contrast to most current models of optimal trading strategies that view time as an undifferentiated continuum, and other





traders as a collection of random noise sources. This approach has two primary motivations.

3. Incorporating the Explicit Daily Trend: The first set of motivations is the academic articles by Brunnermeier and Pedersen (2005) and Carlin, Lobo, and Viswanathan (2007). In these articles, institutional trading has an explicit daily cycle, based on the assumption that at the beginning of each day, each informed market participant, or institutional investor, is given an exogenously specified trade target.
4. Targets of the Informed Traders: These participants know the targets of the other informed traders, and they must decide whether to cooperate with their peers so as to not lose value to the uninformed traders, or whether to compete and take value from their peers.
5. Dynamic Estimation of Peer Targets: The novel feature of this market is that the participants do not know each other's targets, but must guess them by observing the prices throughout the day. It is taken for granted that informed participants will use all available information to compete with each other.
6. Dynamic Determination of Execution Trajectory: The second set of motivations is the popularity of execution algorithms that adapt to the changes in the prices of the asset being traded, either by accelerating execution when the prices move in the traders' favor, or conversely.
7. Momentum and/or Mean Reversion: Although these optimal trade models may be handled by introducing various forms of risk aversion (Kissell and Malamut (2006), Almgren and Chriss (2007)), the most common justification for them is a belief in mean reversion or momentum of the asset price.
8. Underlying Institutional Investor Drift Factor: The model introduced in this chapter may be interpreted as one plausible way to model price momentum. There is an underlying drift factor, caused by the net positions being executed by the other institutional investors.
9. Daily Institutional Trader Price Momentum: This factor is approximately constant throughout the day because the other traders execute across the entire day. Thus price



increases in the early part of the day suggest that this factor is positive, which suggests that the prices will continue to increase throughout the day.

10. Short Term Price Change Correlation: This is different from the short term momentum model in which the price change across one short period of time is correlated with the price change across the preceding period; most empirical evidence shows that such correlation is weak if it exists at all.
11. Incorporating the Daily Price Momentum: The strategies presented in this chapter exploit this momentum to minimize the expected value of the trading costs, somewhat in the spirit of Bertsimas and Lo (1998), except that because the focus is on long term momentum, higher gains can be obtained.
12. Origin of the Daily Trend: The daily trend is an essential feature of this model. Large institutional participants make investment decisions overnight and implement them through the following day.
13. Trend Period vs. Implementation Horizon: Within each day morning is different from the afternoon, since an intelligent trader will spend the early hours collecting information about the targets of the other traders, and will use this information to trade in the rest of the day.
14. Random Nature of Trade Decisions: By contrast, in the market that is implicitly assumed by most models, trade decisions are made at random times, and trade programs have random durations, with no regard to the daily trends. Thus if one observes a buy pressure from the market as a whole, one has no reason to believe that this pressure will last more than a short term. From the point of view of optimal trading, price motions are purely random.
15. Constraint on the Trade Direction: In addition, the very important feature of constraints on the trade direction is incorporated; the trader must never sell as part of a buy program even if this yields lower expected costs – or even expected profit – because of the anticipated negative drift in the price.
16. Reasons for the Constraint Imposition: This is for two reasons. First the point of view of a broker/dealer executing an agency trade for a client is taken. Second, the bid/offer spread and the other fixed costs are neglected, which greatly reduce the



profitability of such reversing strategies. These adaptive strategies simply sift the buying or selling from one period to another.

17. Binding Nature of the Constraint: This constraint is often binding, and globally affects the structure of optimal strategies. In many cases it leads to the determination of an optimal end time for trading, and sometimes directs the strategy to stop completely for a finite period in the middle of the execution.
18. Bayesian Learning of Institutional Direction: In the section below a model is presented of Brownian motion with a drift whose distribution is updated continuously using Bayesian inference.
19. Best Estimate Based Optimal Trajectory: Subsequently, optimal strategies are presented which, surprisingly, can be computed by determining a “static” optimal Trajectory at each moment, assuming that the best parameter estimates as of that moment will persist through the end of the trading period.

## Price Model Using Bayesian Update

1. Arithmetic Brownian Motion Price Dynamics: Trading in a single asset is considered, whose price  $S(t)$  obeys an arithmetic random walk

$$S(t) = S_0 + \alpha t + \sigma B(t)$$

for

$$t \geq 0$$

where  $B(t)$  is a standard Brownian motion,  $\sigma$  is the absolute volatility, and  $\alpha$  is the drift. In the presence of intra-day seasonality,  $t$  is interpreted as a volume time relative to a historical profile.



2. Origin of Volatility - Uninformed Traders: The interpretation of volatility is that it comes from the activity of the “uninformed” traders, whose average behavior can be predicted reasonably well. Mathematically, the value of  $\sigma$  is assumed to be known precisely – for a Brownian process  $\sigma$  can be estimated arbitrarily precisely from an arbitrarily short observation of the process.
3. Origin of Drift - Institutional Traders: The drift is interpreted as coming from the activities of the other institutional traders, who have made trade decisions before the market opens, and who expect to execute these trades throughout the day. If these decisions are in the aggregate weighted to buys, then this will cause a positive price pressure and an upwards drift – conversely for overall selling.
4. Trade Direction Based Drift Estimate: No knowledge of the net direction of the trade estimates is presumed, but inferred by observing the prices. It is implicitly assumed that the traders are using VWAP-like strategies rather than the pure arrival price, so that their trading is not “front-loaded”. This assumption is questionable; if their strategies are front-loaded, then the drift coefficient would vary throughout the day.
5. Drift Belief - Mean and Confidence: Thus the drift  $\alpha$  is assumed constant throughout the day, but its value is unknown. At the beginning of the day the prior belief

$$\alpha \sim \mathcal{N}(\bar{\alpha}, v^2)$$

will be updated using price observations throughout the day.

6. “Frequentist” Volatility vs. “Bayesian” Drift: There are two sources of randomness in the problem – the continuous Brownian motion representing the uninformed traders, and the single drift coefficient representing the constant trading of the large traders.

## Bayesian Inference



1. Drift Estimate from Realized Price: Intuitively as the trader observes the prices from the beginning of the day onwards, he/she starts to get a feel for the day's overall flow. Mathematically the stock price trajectory  $S(\tau)$  is known for

$$0 \leq \tau \leq t$$

In fact all the information about the drift comes from the final value  $S(t)$

2. Bayesian Formulation of the Price Evolution: Conditional on the value of  $\alpha$  the distribution of  $S(t)$  is

$$S(t) - S_0 \sim \mathcal{N}(\alpha t, \nu^2 t)$$

The unconditional distribution can be found after some calculation as

$$S(t) - S_0 \sim \mathcal{N}(\bar{\alpha} t, [\sigma^2 + \nu^2 t]t)$$

3. The Posterior Conditional Drift Distribution: The Bayes' rule is then used:

$$\text{Prob}(\alpha | S(t)) = \frac{\text{Prob}(S(t) | \alpha) \cdot \text{Prob}(\alpha)}{\text{Prob}(S(t))}$$

to obtain the posterior conditional distribution

$$\alpha \sim \mathcal{N}\left(\frac{\bar{\alpha}\sigma^2 + \nu^2[S(t) - S_0]}{\sigma^2 + \nu^2 t}, \frac{\sigma^2}{\sigma^2 + \nu^2 t}\right)$$

conditional on  $S(t)$ .

4. Best Estimate of Mean/Variance: This represents the best estimate of the true drift  $\alpha$  as well as the uncertainty in this estimate based on the combination of the prior belief with the price information observed to time  $t$ .



5. Fully Certain Estimate of Drift: This formulation accommodates a wide variety of belief structures. If the belief in the initial information is perfect then one sets

$$\nu = 0$$

and the updated belief is always

$$\alpha = \bar{\alpha}$$

with no incremental updating.

6. Fully Uncertain Estimate of Drift: If one believes that there is no reliable prior information then

$$\nu^2 \rightarrow \infty$$

and the estimate is

$$\alpha \sim \mathcal{N}\left(\frac{S(t) - S_0}{t}, \frac{\sigma^2}{t}\right)$$

coming entirely from intra-day observations.

7. The  $t = 0$  and  $t \rightarrow \infty$  Asymptotes: For

$$t = 0$$

one has

$$S(0) = S_0$$

and the belief is just the prior. As



$$t \rightarrow \infty$$

the estimate becomes

$$\alpha \sim \mathcal{N}\left(\frac{S(t) - S_0}{t}, 0\right)$$

so much information has been accumulated that the prior belief becomes irrelevant.

## Trading and Price Impact

1. The Order Size and Horizon: The trader has an order of  $X$  shares which begins at time

$$t = 0$$

and must be completed by the time

$$t = T < \infty$$

For concreteness it is supposed that

$$X > 0$$

which is interpreted as a buy order.

2. Trade Rate and Trading Trajectory: A *trading trajectory* is a function  $x(t)$  with

$$x(0) = X$$



and

$$x(T) = 0$$

representing the number of shares to buy at time  $t$ . The corresponding *trading rate* is

$$v(t) = -\frac{dx(t)}{dt}$$

It shall be required that

$$v(t) \geq 0$$

for all  $t$  so that a program never sells as part of the buy order. Together with the endpoint constraints this requires

$$0 \leq x(t) \leq X$$

but it may also be binding in the interior of the region.

3. Linear Temporary Market Impact Function: A linear temporary market impact function is used for simplicity, although the empirical work of Almgren, Thum, Hauptmann, and Li (2005) suggests a concave function. The actual execution price is

$$\tilde{S}(t) = S(t) + \eta v(t)$$

where

$$\eta > 0$$

is the coefficient of temporary market impact.





4. Execution Trajectory Implementation Shortfall:  $\mathcal{C}$  is the total cost of executing the buy program relative to the initial value

$$\mathcal{C} = \int_0^T \tilde{S}(t)v(t)dt - XS_0 = \sigma \int_0^T x(t)dB(t) + \eta \int_0^T v^2(t)dt + \alpha \int_0^T x(t)dt$$

5. Deterministic and Random Cost Components: Here  $\alpha$  is the true drift, and this determines cost, whether or not its true value is known.  $\mathcal{C}$  is a random variable, both because  $S(t)$  is random, and because the optimal trading trajectory  $v(t)$  may be adapted to  $S$ .

## Optimal Trading Strategies

1. Classic Mean-Variance Risk Aversion: This section addresses the question of what trading strategies are optimal given the above model for price evolution and market impact. In the classic arrival price framework of Almgren and Chriss (2000) trajectories are determined by a trade-off between market impact and aversion to risk caused by volatility.
2. Balance between Slow/Fast Trading: The trader wants to complete the trade quickly to reduce exposure to price volatility; He or she wants to trade slowly to reduce the cost of market impact. The optimal trajectory is determined as a balance between these two effects, parametrized by a coefficient of risk aversion.
3. Optimal Cost Adaptive Trading Strategies: Risk-averse trading strategies can behave strangely in time even in the classic mean variance framework (Almgren and Lorenz (2007)) depending on the precise formulation of the mean-variance trade-off.
4. Complication Introduced by the Drift Variance: In this case the problem is complicated by the need to account for the variance in the estimate of  $\alpha$ . Almgren and Lorenz (2006) claim to have obtained partial solutions for the risk-averse problem, but the resulting complexity obscures the underlying structure.



5. Neglecting the Mean Variance Risk Aversion: To focus on the drift, which is the most important new aspect of this problem, risk aversion is neglected here; only the expectation of the trading cost is sought to be minimized.
6. Cost associated with the Drift: That is, it is assumed that the pressure to complete the trade rapidly comes primarily by a desire to capture the price motion expressed by the drift  $\alpha$ , and it is this effect that must be balanced against the desire to reduce the impact costs by trading slowly.
7. Positive Baseline Drift Assumption: To support this description it is generally supposed that the original buy decision was made because of the traders belief that

$$\bar{\alpha} > 0$$

Thus it is expected

$$\alpha > 0$$

in

$$\mathcal{C} = \int_0^T \tilde{S}(t)v(t)dt - XS_0 = \sigma \int_0^T x(t)dB(t) + \eta \int_0^T v^2(t)dt + \alpha \int_0^T x(t)dt$$

and the term  $\alpha \int_0^T x(t)dt$  is a positive cost. It may be that the true value has

$$\alpha < 0$$

or that the intermediate price movements result in the formation of a negative estimate.



8. Hard Trade Completion Time  $t = T$ : Because the point of view is that of a broker/dealer executing an agency trade, it shall always be required that the trade be completed by

$$t = T$$

unless the instructions are altered.

9. Conditional Expectation of Unrealized Cost: For any deterministic trajectory  $x(t)$  specified at

$$t = 0$$

$\mathcal{C}$  is a Gaussian variable. Conditional on the true value of  $\alpha$  it has the expected value

$$\mathbb{E}[\mathcal{C}] = \eta \int_0^T v^2(t) dt + \alpha \int_0^T x(t) dt$$

10. The Bayesian Estimate for  $\alpha$ : From

$$\alpha \sim \mathcal{N} \left( \frac{\bar{\alpha} \sigma^2 + v^2 [S(t) - S_0]}{\sigma^2 + v^2 t}, \frac{\sigma^2}{\sigma^2 + v^2 t} v^2 \right)$$

conditional on  $S(t)$  the best estimate at time  $t$  for the value of  $\alpha$  is

$$\alpha_*(t, S) = \frac{\bar{\alpha} \sigma^2 + v^2 [S(t) - S_0]}{\sigma^2 + v^2 t}$$

where

$$S \equiv S(t)$$



11. Bayesian Estimate of Unrealized Cost: Because the expectation

$$\mathbb{E}[\mathcal{C}] = \eta \int_0^T v^2(t) dt + \alpha \int_0^T x(t) dt$$

conditional on  $\alpha$  is linear  $\alpha$  one may substitute the expected value of  $\alpha_*$  to see that, conditional on the information available at time  $t$  the expected cost of the remaining program is

$$\mathbb{E}[t, x(t), S, \{x(t)\}] = \eta \int_t^T v^2(\tau) d\tau + \alpha_*(t, S) \int_t^T x(\tau) d\tau$$

12. Nomenclature - Description of the Terms: On the left  $t$  is the current time,  $x(t)$  is the number of shares currently remaining to buy,  $S$  is the current price, and  $\{x(t)\}$  denotes the liquidation strategy that will be used on the remaining time

$$t \leq \tau \leq T$$

13. Strategy Objective - Minimizing Transaction Cost: The trading goal is to choose the remaining strategy to minimize this expected cost, i.e., determine  $x(\tau)$  for

$$t \leq \tau \leq T$$

so that

$$\min_{\{x(\tau)\}} \mathbb{E}[t, x(t), S, \{x(\tau)\}]$$



14. Invariance of the Drift Estimate: In computing this solution, it is assumed that the drift estimate  $\alpha_*(t, S)$  does not change during the interval

$$t \leq \tau \leq T$$

In fact it will change as new price is obtained.

15. Dynamically Recomputed Unrealized Trajectory Cost: The actual strategy will only use the instantaneous trade rate of this trajectory, continuously responding to price information. This is equivalent to following the strategy only for a very small time interval  $\Delta t$  then re-computing. Thus the strategy is highly dynamic.
16. Equivalence with Full Dynamic Optimization: It shall be argued that the trajectory thus determined is the true optimum strategy that would be computed by a full dynamic optimization. Loosely speaking this will be because the expected value of future updates is zero, and thus they do not change the strategy of a risk-neutral trader.

## Trajectory by Calculus of Variations

1. Trajectory Perturbation at the End-points: A small perturbation of the path

$$x(\tau) \mapsto x(\tau) + \Delta x(\tau)$$

is considered for

$$t \leq \tau \leq T$$

Since  $x(\tau)$  is fixed at

$$\tau = t$$



and

$$\tau = T$$

this perturbation must have

$$\Delta x(t) = \Delta x(T) = 0$$

2. The Corresponding Bayesian Cost Impact: The associated trade rate perturbation is

$$\Delta v(\tau) = -\Delta x'(\tau)$$

and the perturbation in cost – assuming that  $x(\tau)$  and  $\Delta x(\tau)$  are twice differentiable – is

$$\begin{aligned} \Delta \mathbb{E}[t, x(t), S, \{x(t)\}] &= \eta \int_t^T 2v(\tau) [\Delta v(\tau)] d\tau + \alpha_*(t, S) \int_t^T [\Delta x(\tau)] d\tau \\ &= \int_t^T \{-2\eta x''(\tau) + \alpha_*(t, S)\} [\Delta x(\tau)] d\tau \end{aligned}$$

3. Cost Optimized Trajectory - Necessary Condition: Here

$$\alpha_* \equiv \alpha_*(t, S)$$

is the best available drift estimate using information available at time  $t$  which we assume is constant for

$$t \leq \tau \leq T$$



If  $x(\tau)$  is an optimal solution then there must not exist any admissible  $\Delta x(\tau)$  that gives

$$\Delta \mathbb{E}[t, x(t), S, \{x(\tau)\}] > 0$$

4. Unconstrained Trajectories - The Holdings ODE: For now the sign constraints on  $x'(\tau)$  is neglected. The  $\Delta x(\tau)$  may have either positive or negative values independently for each  $\tau$  and optimizing  $x(\tau)$  must satisfy the ordinary differential equation (ODE)

$$x''(\tau) = \frac{\alpha_*}{2\eta}$$

$$t \leq \tau \leq T$$

5. Unconstrained Trajectory - The Holding Solution: The solution to this equation that satisfies the boundary conditions is

$$x(\tau) = \frac{T - \tau}{T - t} x(t) - \frac{\alpha_*}{4\eta} (\tau - t)(T - \tau)$$

$$t \leq \tau \leq T$$

and the corresponding instantaneous trade rate is

$$v(t, x) = -x'(\tau)|_{\tau=T} = \frac{x(t)}{T - t} + \frac{\alpha_*}{4\eta} (T - t)$$

as a function of time and shares remaining.



6. Unconstrained Trajectory Holdings Constraint Violation: This solution may violate the constraints; if  $\alpha_*$  is large then the quadratic term in

$$x(\tau) = \frac{T - \tau}{T - t} x(t) - \frac{\alpha_*}{4\eta} (\tau - t)(T - \tau)$$

$$t \leq \tau \leq T$$

may cause  $x(\tau)$  to dip below zero, which would cause  $v(t)$  in

$$v(t, x) = -x'(\tau)|_{\tau=T} = \frac{x(t)}{T - t} + \frac{\alpha_*}{4\eta} (T - t)$$

to become negative.

7. Unconstrained Trajectory - The Holdings Component: The unconstrained solution is the sum of two parts. The first piece is proportional to  $x(t)$  and represents the linear (VWAP) liquidation of the current position; it is the optimal strategy to reduce the expected impact costs with no risk aversion.
8. Unconstrained Trajectory - Holdings Drift Component: The second piece is independent of  $x(t)$  and would exist even if the trader has no initial position. Just as in the solutions of Bertsimas and Lo (1998), this second piece is effectively a proprietary trading strategy superimposed on liquidation.
9. Unconstrained Trajectory - Relative Component Contribution: The magnitude of this strategy, and hence the possible gains, are determined by the ratio between the expected drift and the liquidity coefficient. Imposition of this constraint will couple these pieces together.
10. Constrained Trajectories - Consequences of Violation: If the constraint becomes binding then it is no longer clear that the integration by parts procedure used to derive





$$\begin{aligned}\Delta \mathbb{E}[t, x(t), S, \{x(t)\}] &= \eta \int_t^T 2v(\tau)[\Delta v(\tau)]d\tau + \alpha_*(t, S) \int_t^T [\Delta x(\tau)]d\tau \\ &= \int_t^T \{-2\eta x''(\tau) + \alpha_*(t, S)\}[\Delta x(\tau)]d\tau\end{aligned}$$

is valid.

11. Constrained Trajectories - Non Smooth Edges: For example if a trajectory that crosses the axis

$$x = 0$$

is simply clipped to satisfy

$$x \geq 0$$

then the derivative will be discontinuous. A more refined use of the calculus of variations gives the additional condition that  $v(\tau)$  must be continuous though not differentiable.

12. Constrained Trajectories - Smoothing the Edges: Thus when solutions meet the constraint, they must do so smoothly. Solutions are obtained by combining the ODE's

$$x''(\tau) = \frac{\alpha_*}{2\eta}$$

$$t \leq \tau \leq T$$

in the regions of smoothness, with “smooth pasting” conditions at the boundary points.

13. Constrained Trajectories - The “Critical” Drift: The results may be summarized as follows. There is a critical drift value  $\alpha_c$  such that if



$$|\alpha_*| \leq \alpha_c$$

then the constraint is binding. The solution is the one given in

$$x(\tau) = \frac{T - \tau}{T - t} x(t) - \frac{\alpha_*}{4\eta} (\tau - t)(T - \tau)$$

$$t \leq \tau \leq T$$

and

$$v(t, x) = -x'(\tau)|_{\tau=T} = \frac{x(t)}{T - t} + \frac{\alpha_*}{4\eta} (T - t)$$

14. Constrained Trajectories – Super-critical Drift Horizon: If

$$\alpha_* > \alpha_c$$

the solution is still

$$x(\tau) = \frac{T_* - \tau}{T_* - t} x(t) - \frac{\alpha_*}{4\eta} (\tau - t)(T_* - \tau)$$

$$t \leq \tau \leq T_*$$

and

$$v(t, x) = -x'(\tau)|_{\tau=t} = \frac{x(t)}{T_* - t} + \frac{\alpha_*}{4\eta} (T_* - t)$$



but with a shortened end-time

$$T_* < T$$

determined by

$$T_* - t = \sqrt{\frac{4\eta x(t)}{\alpha_*}}$$

15. Constrained Trajectories Super-critical Drift Value: The values for  $T_*$  above is determined so that

$$x'(T_*) = x(T_*) = 0$$

The threshold value  $\alpha_c$  is the value of  $\alpha_*$  for which

$$T_* = T$$

$$\alpha_c(x(t), T - t) = \frac{4\eta x(t)}{(T - t)^2}$$

16. Constrained Trajectories Sub Critical Drift: If

$$\alpha_* < -\alpha_c$$

then the solution is one of

$$x(\tau) = \frac{T - \tau}{T - t_*} x(t) - \frac{\alpha_*}{4\eta} (\tau - t_*)(T - \tau)$$



$$t_* \leq \tau \leq T$$

and

$$v(t, x) = -x'(\tau)|_{\tau=t_*} = \frac{x(t_*)}{T-t} + \frac{\alpha_*}{4\eta}(T-t)$$

except that trading does not begin until a starting time  $t_*$  determined by

$$T - t_* = \sqrt{\frac{4\eta x(t)}{-\alpha_*}}$$

This value is determined so that

$$x'(t_*) = 0$$

and

$$x(t_*) = x(t)$$

The threshold value  $\alpha_c$  is the value  $-\alpha_*$  for which

$$t_* = t$$

17. Constrained Trajectories - Illustration: Almgren and Lorenz (2006) illustrate the constrained solutions  $x(\tau)$  starting at time  $t$  with shares  $x(t)$  and drift estimate  $\alpha$ . For

$$\alpha > 0$$



the trajectories go below the linear profile to reduce the expected purchase cost. As shown in the shaded region in the illustration for

$$|\alpha| \leq \alpha_c$$

the constraint is not binding. At

$$\alpha = \alpha_c$$

the solutions become tangent to the line

$$x = 0$$

at

$$\tau = T$$

and for larger values they hit

$$x = 0$$

with zero slope at

$$\tau = T_* < T$$

For

$$\alpha < -\alpha_c$$

trading does not begin until



$$\tau = t_* > t$$

18. Bayesian Drift Trading Rates - Summary: Thus the overall trade rate may be summarized as

$$v(t, x, S) = \begin{cases} 0 & \alpha_* < \alpha_c \\ \frac{x(t_*)}{T-t} + \frac{\alpha_*}{4\eta}(T-t) & |\alpha_*| < \alpha_c \\ \frac{x(t)}{T_*-t} + \frac{\alpha_*}{4\eta}(T_*-t) = \sqrt{\frac{\alpha_* x(t)}{\eta}} & \alpha_* > \alpha_c \end{cases}$$

where

$$\alpha_* = \alpha_*(t, S(t))$$

and is given as

$$\alpha_*(t, S) = \frac{\bar{\alpha}\sigma^2 + v^2[S(t) - S_0]}{\sigma^2 + v^2t}$$

This is the Bayesian adaptive strategy; it is a specific formula for the instantaneous trade as a function of price, time, and shares remaining.

19. ODE Nature of Optimal Trajectories: Since

$$\Delta x = -v\Delta t$$

this gives an ordinary differential equation for the trajectory  $x(t)$  with a stochastic element due to the presence of  $S(t)$ . It is not a stochastic differential equation since  $\Delta B$  only appears in  $\Delta S$  and not in  $\Delta x$ . Thus  $x(t)$  will have a first time derivative but not a second derivative.



## Optimality of the Bayesian Adaptive Strategy

1. Joint Local and Global Optimality: The Bayes adaptive strategy for  $v(t, x, S)$  is locally optimal in the sense that at any intermediate time all the new available information is used to re-compute the trajectory for the remainder as though the same estimate for the drift will be used until the end of the trading. Since updates to the estimate are expected, it is not obvious of this is the true optimal strategy.
2. Stochastic Optimal Control using HJB: In the next section, using the methods of stochastic optimal control, a Hamilton-Jacobi-Bellman (HJB) partial differential equation (PDE) is formulated for the value function of the corresponding dynamic program.
3. Simplification under the Unconstrained Case: For the unconstrained case the PDE can be solved analytically. The corresponding optimal strategy is calculated by differentiating the value function and agrees precisely with

$$v(t, x) = -x'(\tau)|_{\tau=t_*} = \frac{x(t_*)}{T-t} + \frac{\alpha_*}{4\eta}(T-t)$$

This computation verifies that the local solution is the dynamic optimal solution for the unconstrained case.

4. Gains from the Dynamic Trajectory: Furthermore the gains due to adaptivity may be explicitly determined. At

$$t = 0$$

with initial shares  $X$  the value function for the dynamic strategy may be written as

$$E_{DYN} = E_{STAT} - \mathcal{G}$$



where

$$E_{STAT} = \frac{\eta X^2}{T} + \frac{\bar{\alpha} XT}{2} - \frac{\bar{\alpha}^2 T^3}{48\eta}$$

is the expected cost of the non-adaptive strategy determined at

$$t = 0$$

using the prior expected drift  $\bar{\alpha}$ .

5. Estimate of the Bayesian Adaptive Gains: The additional term

$$\mathcal{G} = \frac{\sigma^2 T^2}{48\eta} \int_0^1 \frac{(1 - \hat{t})^3}{(\hat{t} + \rho)^2} d\hat{t}$$

$$\rho = \frac{\sigma^2}{v^2 T}$$

$$\hat{t} = \frac{t}{T}$$

is the reduction in the expected cost obtained by using the adaptive Bayesian strategy.

Note that

$$\mathcal{G} > 0$$

6. Gains Independent of the Portfolio Size: The gain  $\mathcal{G}$  is independent of the portfolio size  $X$ , and thus as discussed above, represents the gains from a proprietary trading strategy super-imposed on a risk neutral liquidation profile.
7. Time Asymptote of the Gain: It can be seen that





$$\mathcal{G} \sim \mathcal{O}(T^4)$$

when  $T$  is small and

$$\mathcal{G} \sim \mathcal{O}(T^2)$$

when  $T$  is large, so the adaptivity adds very little value when applied to short term correlation. This accounts for the small gains obtained by Bertsimas and Lo (1998), as discussed by Almgren and Chriss (2000).

8. Analytic Tractability of the Constrained Case: For the constrained case the HJB equation has complicated boundary conditions, and Almgren and Lorenz (2006) are not able to determine explicit analytical solutions. However, they believe that the imposition of the constraint should not change the relationship between the static and the dynamic solutions. Thus they believe that the dynamic solution is the dynamic optimal solution in the constrained case as well.

## Stochastic Optimal Control Treatment

1. Full Dynamic Programming Framework: This section supports the claim that the trade velocity

$$v(t, x) = -x'(\tau)|_{\tau=t_*} = \frac{x(t_*)}{T-t} + \frac{\alpha_*}{4\eta}(T-t)$$

for the adaptive strategy is in fact the optimal strategy for

$$\min_{\{x(\tau)\}} \mathbb{E}[t, x(t), S, \{x(\tau)\}]$$



For that the problem will be formulated in a full dynamic programming framework.

2. Control Variables, State Variables, and the SDE: The control variables, state variable, and the stochastic differential equations of

$$\min_{\{x(\tau)\}} \mathbb{E}[t, x(t), S, \{x(\tau)\}]$$

are given as follows:

$$v \Rightarrow \text{Rate of Buying}$$

$$x \Rightarrow \text{Shares Remaining to Buy}$$

$$\Delta x = -v\Delta t$$

$$y \Rightarrow \text{Dollars Spent so far}$$

$$\Delta y = (s + \eta v)v\Delta t$$

$$S \Rightarrow \text{Stock Price}$$

$$\Delta s = \alpha\Delta t + \sigma\Delta B$$

where

$$\alpha \sim \mathcal{N}(\bar{\alpha}, v^2)$$

is chosen randomly at

$$t = 0$$



3. The Initial and Final Conditions: At

$$t = 0$$

the shares are

$$x(0) = X$$

the cash is

$$y(0) = 0$$

and the initial stock price is

$$S(0) = S$$

The strategy  $v(t)$  must be adapted to the full filtration of  $B$  and must satisfy

$$x(T) = 0$$

The focus is on the unconstrained case, and therefore

$$0 \leq x(0) \leq X$$

is not required.

4. The Value Function to be Optimized: The goal is to find the control function  $v(t)$  that minimizes the amount of final dollars spent:

$$\min_{\{v(\tau)\} \text{ such that } x(T) = 0} \mathbb{E}[y(T)]$$



This is a common problem in stochastic dynamic control, and is solved by dynamic programming.

5. The Stochastic Control HJB PDE: Standard techniques lead to the Hamilton-Jacobi-Bellman (HJB) partial differential equation

$$0 = \frac{\partial u}{\partial t} + \frac{1}{2} \sigma^2 \frac{\partial^2 u}{\partial s^2} + \alpha_* \frac{\partial u}{\partial s} + \min_v \left[ \left( s \frac{\partial u}{\partial y} - \frac{\partial u}{\partial x} \right) + \eta v^2 \frac{\partial u}{\partial y} \right]$$

so that the value function

$$u(t, x, y, s) = \min_{v(t), t \leq \tau \leq T \text{ such that } x(T) = 0} \mathbb{E}[y(T)]$$

$$\alpha_* \equiv \alpha_*(t, S)$$

denotes the estimate of  $\alpha$  at time  $t$  as computed in

$$\alpha \sim \mathcal{N} \left( \frac{\bar{\alpha} \sigma^2 + v^2 [S(t) - S_0]}{\sigma^2 + v^2 t}, \frac{\sigma^2}{\sigma^2 + v^2 t} v^2 \right)$$

conditional on  $S(t)$

6. Incorporating the Optimal Trade Velocity: The optimal trade velocity is found as

$$v_*(t, x, y, s) = \frac{\frac{\partial u}{\partial x} - s \frac{\partial u}{\partial y}}{2\eta \frac{\partial u}{\partial y}}$$

and the final HJB partial differential equation for  $u(t, x, y, s)$  is



$$0 = \frac{\partial u}{\partial t} + \frac{1}{2} \sigma^2 \frac{\partial^2 u}{\partial s^2} + \alpha_* \frac{\partial u}{\partial s} - \frac{\left( \frac{\partial u}{\partial x} - s \frac{\partial u}{\partial y} \right)^2}{4\eta \frac{\partial u}{\partial y}}$$

together with the boundary condition

$$u(T, 0, y, s) = y$$

for all  $y, s$ .

7. Solution to the HJB PDE: It is straightforward to check that

$$u(t, x, y, s) = y + xs + \eta \frac{x^2}{T-t} + \frac{1}{2} \alpha_*(y, s) x(T-t) - \frac{\alpha_*^2(t, S)}{48\eta} (T-t)^3 - \int_t^T \frac{\sigma^2 v^2 (T-\tau)^3}{48\eta (\sigma^2 + \tau v^2)^2} d\tau$$

satisfies the PDE

$$0 = \frac{\partial u}{\partial t} + \frac{1}{2} \sigma^2 \frac{\partial^2 u}{\partial s^2} + \alpha_* \frac{\partial u}{\partial s} - \frac{\left( \frac{\partial u}{\partial x} - s \frac{\partial u}{\partial y} \right)^2}{4\eta \frac{\partial u}{\partial y}}$$

and the boundary condition

$$u(T, 0, y, s) = y$$

for all  $y, s$ .

8. Expression for Optimal Trade Velocity: Moreover the corresponding optimal trade velocity



$$v_*(t, x, y, s) = \frac{\frac{\partial u}{\partial x} - s \frac{\partial u}{\partial y}}{2\eta \frac{\partial u}{\partial y}}$$

which is exactly the trade velocity

$$v(t, x) = -x'(\tau)|_{\tau=t_*} = \frac{x(t_*)}{T-t} + \frac{\alpha_*}{4\eta} (T-t)$$

9. Correspondence with the Earlier Formulation: That is the Bayesian adaptive strategy is in fact the optimal strategy for the optimization problem

$$\min_{\{x(\tau)\}} \mathbb{E}[t, x(t), S, \{x(\tau)\}]$$

10. Extension to the Constrained Case: For the constrained case the optimal velocity

$$v_*(t, x, y, s) = \frac{\frac{\partial u}{\partial x} - s \frac{\partial u}{\partial y}}{2\eta \frac{\partial u}{\partial y}}$$

becomes

$$v_*(t, x, y, s) = \max \left( \frac{\frac{\partial u}{\partial x} - s \frac{\partial u}{\partial y}}{2\eta \frac{\partial u}{\partial y}}, 0 \right)$$

This makes the corresponding PDE even more nonlinear, and derivation of explicit solutions is elusive.



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## Cost Adaptive Arrival Price Trading

### Synopsis and Key Results

1. Cost Uncertainty Balance in Trading: Electronic trading of Equities and other securities makes heavy use of *arrival price* algorithms that determine optimal trade execution strategies by balancing the market impact cost of rapid execution against the volatility risk of slow execution.
2. Optimal Static Mean Variance Strategies: In the standard formulation mean-variance optimal strategies are static; they do not modify the execution speed in response to price motions observed during trading.
3. Dynamically Adjusting Risk Tolerant Profiles: Almgren and Lorenz (2007) show that with a more realistic formulation of the mean-variance tradeoff, and even with no momentum or mean-reversion in the price process, substantial improvements are possible for adaptive strategies that spend trading gains to reduce risk by accelerating execution when the price moves in the traders' favor. The improvement is larger for large initial portfolios.

### Introduction, Background, and Motivation

1. Breaking-Down a Given Order: Algorithmic trading represents a large and growing fraction of the total order flow, especially in the equity markets. When the size of a requested buy or sell order is larger than what the market can immediately supply or absorb, then the order must be worked across some period of time, exposing the trader to price volatility.





2. Tailoring Execution to Risk Preferences: The algorithm attempts to achieve an average execution price whose profitability is suited to the client's preferences. Almgren and Lorenz (2007) propose a way to dramatically improve this distribution.
3. Benchmark Implementation Shortfall: Arrival price algorithms, which are currently the most widely used framework, take as their benchmark the *pre-trade* or *decision* price. The difference between the execution price and the benchmark is the *implementation shortfall* which is an uncertain quantity since the order execution takes a finite amount of time.
4. Expected Value of Shortfall: In the most straightforward implementation of this model, the expected value of the implementation shortfall is entirely due to the market impact incurred by trading at a non-zero rate (neglecting any anticipated price drift); this expected cost is minimized by trading as slowly as possible, for example, using a VWAP strategy across the maximum allowed time horizon.
5. Variance of Implementation Shortfall: Since market impact is assumed to be deterministic, the variance of the implementation shortfall is entirely due to price volatility; this variance is minimized by trading rapidly.
6. Efficient Frontier of Optimal Trading: This risk-reward trade-off is very common in finance, and a variety of criteria can be used to determine risk-averse optimal solutions. Arrival price algorithms compute the set of *efficient* strategies that compute the risk for a specified level maximum of expected cost or the converse; the set of such strategies is summarized in the *efficient frontier of optimal trading* introduced by Almgren and Chriss (1999, 2000).
7. Independence from the Portfolio Size: This simple mean-variance approach has the advantage that the risk-reward tradeoff is independent of the initial wealth – a useful property in an institutional setting.
8. Static vs. Dynamic Execution Schemes: A central question is whether the trade schedule should be *static* or *dynamic*; should the list of shares to be executed at each time interval be computed and fixed before the trading begins, or should the list be updated in “real time” using information revealed during the execution?



9. Static vs. Dynamic Schemes Equivalence: The observations of Almgren and Chriss (2000) is that, under very realistic assumptions about the price process (arithmetic random walk with no serial correlation), static strategies are *equivalent* to dynamic strategies. No value is added by considering “scaling” strategies in which the execution speed changes in response to price motions.
10. Static Strategy - Initial Time Determination: To be more specific, two different specifications of the trade scheduling problem are considered. For a static strategy the entire trade schedule is required to be fixed in advance – Huberman and Stanzl (2005) suggest that a reasonable example of this is insider trading – where trades must be announced in advance.
11. Pre-determination of the Trajectory Cost Distribution: For any candidate schedule the mean and the variance are calculated at the initial time, and the optimal schedule is determined for a specific risk aversion level.
12. Dynamic Determination of the Trading Schedule: For a dynamic strategy – as is usually understood in dynamic programming – arbitrary modification of the strategy is allowed at any time. To re-calculate the trade list all available information is used at that time, and the strategies are valued using a mean-variance trade-off of the remaining cost, using a constant parameter of risk aversion.
13. Reduction of Dynamic to Static: In the model of Almgren and Chriss (2000), the first and the second strategies have the same solution. Liquidity and volatility are assumed known in advance, so the only information revealed is the asset price motion.
14. Price Distribution Independence from the Realization: Price distribution revealed in the first part of the execution does not change the probability distribution of future price changes. Because the mean-variance trade-off is independent of the initial wealth, trading gains or losses incurred in the first part of the program are “sunk costs” and therefore do not influence the strategy for the remainder.
15. Trade Rate Determination Rule: Almgren and Lorenz (2007) present an alternate formulation. In this, they pre-compute the *rule* determining the trade rate as a function of price, using a mean-variance tradeoff measures at the initial time. Once trading begins the rule may not be modified, even if the trader’s preferences re-



evaluated at an intermediate time would lead him or her to choose a different strategy, as in the second strategy above.

16. Differences among the Computed Trajectories: The optimal solution to the third strategy is generally not the same as the solutions to the first and the second strategies.
17. Example: Comparison of the Strategies: As an illuminating contrast, in the well-known problem of option hedging, the optimal hedge position, once the trade list, depend on the price, and hence are not known until the price is observed, although the *rule* giving this hedge position is computed in advance using dynamic programming. Thus the first strategy is dramatically sub-optimal, and the second gives the same results as the third.
18. When is the Third Strategy Optimal? For algorithmic trading, the improvement of the third strategy over the first and the second come from introducing the negative correlation between the trading gains or losses in the first part of the execution and the market impact costs incurred in the second part.
19. Extraneously Imposed Serial Correlation Rule: Trading gains and losses due to price movements are serially uncorrelated, but can be correlated with the market impact costs via a simple rule; if the price moves in the traders' favor in the early part of the trading, then those gains are spent on the market impact costs by accelerating the remainder of the program.
20. Adaptive Strategy - Contra Price Move: If the price moves against, then the future costs are reduced by trading more slowly, despite the increased exposure to risk of future fluctuations. The result is an overall decrease in the variance measured at the initial time, which can be traded for a decrease in the expected cost.
21. Ex ante vs ex post Optimization: In practice there are no artificial constraints in the adaptivity of the trading strategies. The key observation contained in this chapter is that the *ex ante* mean-variance optimization expressed by the third formulation corresponds better to the way the trading results are measured in practice, via *ex post* sample mean and variance over a collection of similar programs.



## Adaptive Strategies – A Simple Illustration

1. Universe of Available Sample Bets: Suppose that two bets are available. Bet  $A$  pays 0 or 6 with equal probability; its expected value is 3 and its variance is 9. Bet  $B$  pays 1 with certainty; its expected value is 1 and its variance is 0.
2. Per-Strategy Objective Utility Value: Consider the case of a risk-averse investor whose coefficient of risk aversion is  $\frac{1}{9}$ ; he assigns an *ex ante* value of  $E - \frac{1}{9}V$  to a random payout with an expected value  $E$  and variance  $V$ . For this investor a single pay of  $A$  has a value 2 and a single pay of  $B$  has a value 1 so he prefers  $A$ .
3. Two Plays with Outcome Independence: Now suppose that the investor plays this game twice, with independence between the outcomes. Three ways in which he chooses his bets are considered.
4. First Strategy - Optimal Outcome: In a static strategy, the sequence  $AA$ ,  $AB$ ,  $BA$ , or  $BB$  must be fixed before the game begins. By independence choice  $AA$  has twice the value of  $A$  and is preferred. Its value is 4.
5. Second Strategy - Constant Wealth Effect: In a dynamic strategy, the second bet is chosen after the result of the first play is learnt. By that time the first result will be a constant wealth effect, so  $A$  will always be chosen on the second play.
6. Second Strategy - Optimal Outcome: Knowing that that will be the future choice  $A$  is chosen on the first bet as well to maximize the total value measured at the initial time. Thus the strategy and the payoff are the same as in the static case.
7. Third Strategy - Sequential Play Rule: In the new formulation the investor specifies *three* choices; his bet on the first play, his bet on the second play if he wins the first one, and his bet on the second play if he loses the first.
8. Third Strategy - Optimal Outcome: The optimal rule is to bet  $A$  on the first play, then if he wins to choose  $B$ , if he loses to play  $A$  again, giving payouts of 0, 6, 6, and 7 with equal probability. Its value is 4.06, better than the first two strategies.
9. Optimally using Slow/Fast Trading: In this model bet  $A$  corresponds to slow trading, with high expected value (low cost) and high variance, and  $B$  is fast trading. If the



random outcome (trading gain) in the first period is positive, then the trader spends some of this gain on reducing the variance in the second period.

10. Extension to Multi-Play: Now suppose the investor plays this game many times in sequence, and wishes to optimize the sample mean and variance, combined the coefficient of risk aversion.
11. Ex Post vs Ex Ante Single Play: If the results are reported over individual plays, then the *ex post* sample mean and variance will be close to the *ex ante* expectation and variance of a single play, and the optimal strategy would be to bet A each time, as in the first and the second strategies above.
12. Aggregation Over Play Pairs: However, suppose the results are aggregated over *pairs* of plays. That is, the gains of play 1 and play 2 are added together, play 3 and play 4 are added, *etc.*
13. Pairs Connected via Rule: Then the third strategy above, which is adaptive, will give the best results; within each pair choose the second bet based on the result of the first one. If the results are grouped into larger sets, then a more complicated strategy will be even more optimal.

## Trading in Practice

1. Reporting Driven Aggregation Granularity: As in the simple example, the question of which formulation is more realistic depends on how the trading results are reported. At Banc of America securities, and probably at other firms, clients of the agency trading desk are provided with a post-trade report daily, weekly, or monthly depending on their trading activity.
2. Aggregation along the Reporting Dimensions: Typically these reports show sample average and standard deviation of execution price relative to the implementation shortfall benchmark across all the trades executed for that client during the reporting period. The results are further broken down into subsets across a dozen dimensions



such as strategy type, buy or sell, primary exchange, trade sector, industry sector, market capitalization, *etc.*

3. Supra-Order Reporting Challenges: Because of these kinds of subsets, it is difficult to identify a larger unit than an individual order. Therefore it can be argued that the broker-dealer's goal is to design algorithms that optimize sample mean and variance at the per-order level so that the post-trade report will be as favorable as possible.
4. Order-Level Aggregation corresponds to Third Strategy: As in the simple example this criterion translates to the third strategy above which is not optimized by the typical arrival price algorithms.
5. Reporting Consistency with Client Goals: Of course, the broker also has a responsibility to design the post-trade report so that it will be maximally useful to the client; that is, it corresponds as closely as possible to the client's investment goals.
6. Execution Metrics under Finer Resolution: One interpretation of these results is that the reports should show details with a finer resolution. For instance, it can show the mean and the variance of shortfall for each one thousand dollars of client money spent. The best choice of the reporting intervals is an open question.

## **Other Adaptive Strategies**

1. "Aggressive-in-the-money" AIM: The new optimal strategies of Almgren and Lorenz (2007) are "aggressive-in-the-money" in the sense of Kissell and Malamut (2006); execution accelerates when the price moves in the traders' favor, and slows when the price moves adversely.
2. "Passive-in-the-money" PIM: A "passive-in-the-money" (PIM) strategy would react oppositely. Adaptive strategies of this form are called "scaling" strategies, and they can arise for a number of different reasons beyond those considered here.
3. Traders' Preference and Prospect Theory: A decrease in risk tolerance following a gain, and an increase following a loss, is consistent with traders' risk preferences



(Shefrin and Statman (1985)) and is well-known in “prospect theory” (Kahneman and Tversky (1979)).

4. Mathematical Foundations of Scaling Strategies: Perhaps for these reasons scaling strategies often seem intuitively reasonable, though such qualitative preferences properly have no place in quantitative institutional trading. The formulation here is straightforward mean-variance optimization.
5. PIM as Optimal Momentum Strategy: One important reason for using an AIM or a PIM strategy would be the expectation of serial correlation in the price process. If the price is believed to have momentum, i.e., positive serial correlation, then a PIM strategy is optimal; if the price moves favorably, one should slow down to capture even more favorable prices in the future.
6. AIM for Mean Reversion Optimality: Conversely if the price is believed to be mean-reverting, then favorable prices should be captured quickly before they mean-revert (Kissell and Malamut (2006)). The strategies presented in this chapter arise from pure random walk with no serial price correlation, using pure classic mean-variance optimization.
7. Caveats behind AIM/PIM Deployment: These models do provide an important caveat for their formulation. The AIM strategy suggests to “cut the gains and let the losses run”.
8. Adverse Impact of “Moneyness” Guesses: If the price process does have any significant momentum, even on a small fraction of the real orders, then this strategy can cause much more serious losses than the gains that it provides. Thus implementing them in practice should be done only after doing extensive empirical tests.
9. The “Market Power” Parameter: The next section presents the market and the trading model, and shows the general importance of the “market power” parameter.
10. Single Update vs. Continuous Time: Two simple “proofs of concept” are considered; first a single update time, then a continuous response function that depends linearly on the asset price. The final section describes some approaches towards a full continuous time model.



## The Market Model

1. Asset Price Arithmetic Random Walk: Trading in a single asset whose price is  $S(t)$  is considered.  $S(t)$  obeys the arithmetic random walk

$$S(t) = S_0 + \sigma B(t)$$

where  $B(t)$  is a standard Brownian motion and  $\sigma$  is an absolute volatility. This process has neither momentum nor mean reversion; future price changes are completely independent of past changes.

2. Intra-day Profile Adapted Randomness: The Brownian motion  $B(t)$  is the only source of randomness in the formulation. In the presence of intra-day seasonality  $t$  is interpreted as a time relative to a historical profile, and volume is assumed to constant under this transformation.
3. The Trade Order Execution Settings: The trader has an order of  $X$  shares, which begins at time

$$t = 0$$

and must be completed by time

$$t = T < \infty$$

$X$  is taken to be

$$X > 0$$





and this is interpreted as a buy order. The benchmark value of this position at the start of the strategy is  $XS_0$

4. The Estimation Output Trading Strategy: A *trading trajectory* is a function  $x(t)$  with

$$x(0) = X$$

and

$$x(T) = 0$$

representing the number of shares remaining to buy at time  $t$ . For a static trajectory  $x(t)$  is determined at

$$t = 0$$

but in general  $x(t)$  may be any non-anticipating random functional of  $B(t)$ .

5. Observability of the Equilibrium Price: Permanent market impact is also important but has no effect on the optimal trade trajectory as it is linear – Almgren and Chriss (2000) carry out a detailed discussion of this model. The model parameters are assumed to be known with certainty and thus the underlying price  $S(t)$  is observable based on the execution price  $\tilde{S}(t)$  and the trade rate  $v(t)$ .
6. The Arrival Price Shortfall: The *implementation shortfall*  $\mathcal{C}$  is the total cost of executing the buy program relative to its initial value.

$$\mathcal{C} = \int_0^T \tilde{S}(t)v(t)dt - XS_0 = \sigma \int_0^T x(t)dB(t) + \eta \int_0^T v^2(t)dt$$

7. Randomness of the Cost Components: The first term above represents the trading gains or losses. Since the trader is buying a positive price motion gives a positive



cost. The second term represents the market impact cost. For an adaptive strategy both terms are random since  $x(t)$  and  $v(t)$  are both random.

8. Adaptive Strategies not necessarily Gaussian: Mean-variance optimization solves the problem

$$\min_{x(t)} \{E[\mathcal{C}] + \lambda V[\mathcal{C}]\}$$

for each

$$\lambda \geq 0$$

where  $E[\mathcal{C}]$  and  $V[\mathcal{C}]$  are the expected values of the mean and the variance of  $\mathcal{C}$ . As  $\lambda$  varies the resulting set of points  $\{V_\lambda[\mathcal{C}], E_\lambda[\mathcal{C}]\}$  trace out an efficient frontier. For adaptive strategies  $\mathcal{C}$  is not Gaussian, but mean-variance optimization is still used.

## Static Trajectories

1. Non-random Optimal Execution Trajectory: If  $x(t)$  is fixed independently of  $B(t)$  then  $\mathcal{C}$  is a Gaussian random variable with mean and variance

$$E_\lambda[\mathcal{C}] = \eta \int_0^T v^2(t) dt$$

and

$$V_\lambda[\mathcal{C}] = \sigma^2 \int_0^T x^2(t) dt$$



2. Optimal Execution Trajectory Closed Form: The solution to

$$\min_{x(t)} \{\mathbb{E}[\mathcal{C}] + \lambda \mathbb{V}[\mathcal{C}]\}$$

is then obtained as

$$x(t) = Xh(t, T, \kappa)$$

where the static trajectory function is

$$h(t, T, \kappa) = \frac{\sinh[\kappa(T - t)]}{\sinh[\kappa T]}$$

for

$$0 \leq t \leq T$$

and the static *urgency* parameter is

$$\kappa = \sqrt{\frac{\lambda \sigma^2}{\eta}}$$

3. Portfolio Size Dependence of Urgency: The units of  $\kappa$  are inverse time, and  $\frac{1}{\kappa}$  is the desired time scale for liquidation – the “half-life” as described in Almgren and Chriss (2000). The static trajectory is effectively an exponential with adjustments made to reach

$$x = 0$$



at

$$t = T$$

For a fixed  $\lambda$  the optimal time scale is independent of the portfolio size  $X$  since both the expected costs and the variance scale as  $X^2$ .

4. Static vs Dynamic Trajectory Equivalence: Equivalence of the static and the dynamic trajectories is demonstrated by observing that

$$h(t, T, \kappa) = h(s, T, \kappa)h(t - s, T - s, \kappa)$$

for

$$0 \leq s \leq t \leq T$$

That is, the trajectory recomputed at time  $s$ , using the same urgency parameter, is the same as the tail of the original trajectory.

5. Low Urgency Limit VWAP Trading: By taking

$$\kappa \rightarrow 0$$

the linear profile

$$x(t) = X \frac{T - t}{T}$$

is recovered, which is equivalent to a VWAP profile under volume time transformation. The profile has expected cost

$$E_{LIN} = \frac{\eta X^2}{T}$$



and variance

$$V_{LIN} = \frac{\sigma^2 X^2 T}{3}$$

## Non-dimensionalization

1. Dimensional Constants Determining the Solution: The optimal trajectory and the cost depend on 5 dimensional constants; the initial shares  $X$ , the time horizon  $T$ , the volatility  $\sigma$ , the impact coefficient  $\eta$ , and the risk aversion  $\lambda$ . To simplify the structure of the solution, it is convenient to define scaled variables.
2. Non-dimensionalization of Horizon/Time: Time is measured relative to  $T$  and shares relative to  $X$ . That is, the non-dimensional time is defined as

$$\hat{t} = \frac{t}{T}$$

and the non-dimensional holdings as

$$\hat{x}(\hat{t}) = \frac{x(\hat{t}T)}{X}$$

so that

$$0 \leq \hat{t} \leq 1$$

and

$$\hat{x}(0) = 1$$



The non-dimensional velocity is

$$\hat{v}(\hat{t}) = \frac{v(\hat{t}T)}{X/T} = -\frac{d\hat{x}}{d\hat{t}}$$

3. Non-dimensionalization of the Cost: The cost is scaled by a dollar cost of a typical move due to volatility. That is, defining

$$\hat{c} = \frac{c}{\sigma X \sqrt{T}}$$

one then has

$$\hat{c} = \int_0^1 \hat{x}(\hat{t}) d\hat{B}(\hat{t}) + \mu \int_0^1 \hat{v}^2(\hat{t}) d\hat{t}$$

where

$$\hat{B}(\hat{t}) = \frac{B(\hat{t}T)}{\sqrt{T}}$$

and the “market power” parameter is

$$\mu = \frac{\eta X/T}{\sigma \sqrt{T}}$$

4. Definition of the “Market Power”: Here the numerator is the price concession for trading at a constant rate, and the denominator is the typical size of the price motion



due to volatility over the same period. The ratio  $\mu$  is the non-dimensional preference free measure of the portfolio size, in terms of its ability to move the market.

5. “Market Power” Estimation – ATHL Model: To estimate realistic sizes for this parameter one recalls that Almgren, Thum, Hauptmann, and Li (2005) introduced the non-linear model

$$\frac{K}{\sigma} = \eta \left( \frac{X}{VT} \right)^\alpha$$

where  $K$  is the temporary impact (the only kind relevant here),  $\sigma$  is the daily volatility,  $X$  is the trade size,  $V$  is the average daily volume (ADV), and  $T$  is the fraction of the day over which the trade is executed.

6. ATHL Model “Market Power” Estimates: The coefficient was estimated as

$$\eta = 0.142$$

as was the exponent

$$\alpha = \frac{3}{5}$$

Therefore a 100% *ADV* executed across one full day gives

\

$$\mu = 0.142$$

7. “Market Power” Estimate Typical  $\mu$ : Although the estimate above is only an approximate parallel to the linear model used here, it does suggest that for realistic trade sizes  $\mu$  will be substantially smaller than one.
8. Non-dimensionalization of the Urgency: The problem



$$\min_{x(t)} \{\mathbb{E}[\mathcal{C}] + \lambda \mathbb{V}[\mathcal{C}]\}$$

has the scaled form

$$\min_{\hat{x}(\hat{t})} \{\mathbb{E}[\hat{\mathcal{C}}] + \mu \bar{\kappa}^2 \mathbb{V}[\hat{\mathcal{C}}]\}$$

and the static urgency is

$$\bar{\kappa} = \kappa T$$

with  $\kappa$  from

$$\kappa = \sqrt{\frac{\lambda \sigma^2}{\eta}}$$

or

$$\bar{\kappa}^2 = \frac{\lambda \sigma^2 T^2}{\eta}$$

9. Non-dimensionalization of the Risk Aversion: The scaled risk aversion parameter  $\mu \bar{\kappa}^2$  depends on  $X$  via the factor  $\mu$  though the scaled time  $\bar{\kappa}$  is independent of  $X$ .
10. Non dimensionalization of the Trajectory:  $\bar{\kappa}$  will be used as the parameter to trace the frontier in place of  $\lambda$ . The result will be a trajectory  $\hat{x}(\hat{t}; \bar{\kappa}, \mu)$  with the scaled cost values  $\mathbb{E}[\hat{\mathcal{C}}(\bar{\kappa}, \mu)]$  and  $\mathbb{V}[\hat{\mathcal{C}}(\bar{\kappa}, \mu)]$ .
11. Non dimensionalization of Cost Distribution: For each of

$$\mu \geq 0$$





there will be an efficient frontier obtained by tracing  $\mathbb{E}[\hat{\mathcal{C}}(\bar{\kappa}, \mu)]$  and  $\mathbb{V}[\hat{\mathcal{C}}(\bar{\kappa}, \mu)]$  as functions of  $\bar{\kappa}$  over

$$0 \leq \bar{\kappa} < \infty$$

The profile has expected cost

$$\hat{E}_{LIN} = \mu$$

and variance

$$\hat{V}_{LIN} = \frac{1}{3}$$

## Small Portfolio Limit

1. Limit of Small “Market Power”: Next the limit

$$\mu \rightarrow 0$$

is considered, keeping  $\bar{\kappa}$  constant. Since  $X$  appears in  $\mu$  but not in  $\bar{\kappa}$  and all other dimensional variables do appear in  $\bar{\kappa}$  this is equivalent to taking

$$X \rightarrow 0$$

with  $T, \sigma, \eta$ , and  $\lambda$  fixed. Almgren and Lorenz (2006) show that for small portfolios status strategies are optimal.

2. Variance of the Non-dimensional Cost: When  $\mu$  is small, assuming that  $x(t)$  and  $v(t)$  have reasonable limits, the second term in



$$\hat{\mathcal{C}} = \int_0^1 \hat{x}(\hat{t}) d\hat{B}(\hat{t}) + \mu \int_0^1 \hat{v}^2(\hat{t}) d\hat{t}$$

is small compared to the first, and the variance of the non-dimensional cost is approximately

$$\mathbb{V}[\hat{\mathcal{C}}] \sim \mathbb{V} \left[ \int_0^1 \hat{x}(\hat{t}) d\hat{B}(\hat{t}) \right] = \int_0^1 \mathbb{E}[\hat{x}^2(\hat{t})] d\hat{t}$$

$$\mu \rightarrow 0$$

3. Market Impact Contribution to Volatility: That is, the uncertainty in realized price comes primarily from the price volatility. Even if the strategy is adapted to the price process so that  $\hat{x}(\hat{t})$  is random the market impact cost itself is a small number and the uncertainty in that number can be neglected next to the price volatility.
4. Expectation of Non-dimensional Cost: The first term in

$$\hat{\mathcal{C}} = \int_0^1 \hat{x}(\hat{t}) d\hat{B}(\hat{t}) + \mu \int_0^1 \hat{v}^2(\hat{t}) d\hat{t}$$

has strictly zero expected value for any non-anticipating strategy – it is an Ito integral – and hence the expectation comes entirely from the second term.

5. Corresponding Non-dimensional Objective Utility: Thus

$$\mathbb{E}[\hat{\mathcal{C}}] = \mu \mathbb{E} \left[ \int_0^1 \hat{v}^2(\hat{t}) d\hat{t} \right]$$



and the complete risk-aversion cost function is approximately

$$\mathbb{E}[\hat{\mathcal{C}}] + \mu \bar{\kappa}^2 \mathbb{V}[\hat{\mathcal{C}}] \sim \mu \int_0^1 \mathbb{E}[\hat{v}^2(\hat{t}) + \bar{\kappa}^2 \hat{x}^2(\hat{t})] d\hat{t}$$

$$\mu \rightarrow 0$$

6. Quadratic Nature of Objective Utility: Consider a candidate adaptive strategy  $\hat{x}(\hat{t})$ . Since the quadratic is convex the static strategy

$$\bar{x}(\hat{t}) = \mathbb{E}[\hat{x}(\hat{t})]$$

will give a lower value of the objective function (thus  $x(t)$  and  $v(t)$  have limits, thereby justifying the original assumption).

7. Consequence of the “Market Power”: When  $\mu$  is not small adaptive strategies can create negative correlation between the two terms in

$$\hat{\mathcal{C}} = \int_0^1 \hat{x}(\hat{t}) d\hat{B}(\hat{t}) + \mu \int_0^1 \hat{v}^2(\hat{t}) d\hat{t}$$

thereby reducing the overall variance below its value for purely static strategies.

## Portfolio Comparison

1. Optimal Strategy Portfolio Size Dependence: In the simplest form, the goal is to determine the optimal strategy  $\hat{x}(\hat{t})$  for any specific set of parameters. But to understand results it is useful to compare strategies and costs for portfolios of different sizes.



2. Quadratic Scaling of Static Trajectories: Consider two portfolios  $X_1$  and  $X_2$  with

$$X_2 = 2X_1$$

and all other parameters the same including risk aversion; thus

$$\mu_2 = 2\mu_1$$

and  $\bar{\kappa}$  is the same. Portfolio  $X_2$  will in general cost four times to trade as much as portfolio  $X_1$ . For example, static trajectories for the two portfolios will have identical shapes, and the cost will satisfy

$$\mathbb{E}[\hat{\mathcal{C}}_2] = 4\mathbb{E}[\hat{\mathcal{C}}_1]$$

and

$$\mathbb{V}[\hat{\mathcal{C}}_2] = 4\mathbb{V}[\hat{\mathcal{C}}_1]$$

3. Adaptive Strategies: Sub-Quadratic Scaling: For adaptive strategies, the large portfolio is still more expensive to trade than the small portfolio, but it can take advantage of the negative correlation. Thus one will have

$$\mathbb{E}[\hat{\mathcal{C}}_2] + \lambda \mathbb{V}[\hat{\mathcal{C}}_2] \leq 4(\mathbb{E}[\hat{\mathcal{C}}_1] + \lambda \mathbb{V}[\hat{\mathcal{C}}_1])$$

for each  $\lambda$  although it is generally not true that separately

$$\mathbb{E}[\hat{\mathcal{C}}_2] < 4\mathbb{E}[\hat{\mathcal{C}}_1]$$

AND



$$\mathbb{V}[\hat{\mathcal{C}}_2] < 4\mathbb{V}[\hat{\mathcal{C}}_1]$$

4. Cost Ratio - Adaptive to Static: The ratio of an adaptive cost to a static cost will be less for a large portfolio than for a small portfolio, though all costs are higher for the large portfolio. Therefore these solutions will be of most interest to the large investors.
5. Representative Illustration of the Relative Costs: To highlight the differences in relative costs, Almgren and Lorenz (2007) draw efficient frontiers which show the expectation of the cost and its variance *relative* to their values for the linear trajectory.
6. Static Strategies correspond to  $\mu = 0$ : Thus the static efficient frontiers for all the values of

$$\mu > 0$$

super-impose, since the cost of all static trajectories scale precisely as  $X^2$ . This common static frontier appears as the limit of adaptive frontiers as

$$\mu \rightarrow 0$$

As  $\mu$  increases the adaptive frontiers move down and to the left, away from the static frontier.

## Single Update

1. Non-dimensional Decision Time Instant: Here the assumption is that the urgency update occurs at a single update time  $\hat{T}_*$  where

$$0 < \hat{T}_* < 1$$



2. Starting with the Initial Urgency: On the first trading period

$$0 < \hat{t} < \hat{T}_*$$

an initial urgency  $\bar{\kappa}_0$  is used, that is, the trajectory is

$$\hat{x}(\hat{t}) = h(\hat{t}, 1, \bar{\kappa}_0)$$

with  $h$  from

$$h(\hat{t}, \hat{T}, \bar{\kappa}) = \frac{\sinh[\bar{\kappa}(\hat{T} - \hat{t})]}{\sinh[\bar{\kappa}\hat{T}]}$$

for

$$0 < \hat{t} < \hat{T}_*$$

3. The Set of Decision Urgencies: Let

$$\hat{x}_*(\bar{\kappa}_0, \hat{T}_*) = h(\hat{T}_*, 1, \bar{\kappa}_0)$$

be the shares remaining at the decision time. At time  $\hat{T}_*$  one switches to one of the  $n$  new urgencies  $\bar{\kappa}_1, \dots, \bar{\kappa}_n$ ; with urgency  $\bar{\kappa}_i$  one sets

$$\hat{x}(\hat{t}) = \hat{x}_*(\bar{\kappa}_0, \hat{T}_*)h(\hat{t} - \hat{T}_*, 1 - \hat{T}_*, \bar{\kappa}_i)$$

for

$$\hat{T}_* < \hat{t} < 1$$



4. Urgency Based on Realized Cost: The new urgency is chosen based on the non-dimensional realized cost up to time  $\hat{T}_*$ :

$$\hat{C}_0 = \int_0^{\hat{T}_*} \hat{x}(\hat{t}) d\hat{B}(\hat{t}) + \mu \int_0^{\hat{T}_*} \hat{v}^2(\hat{t}) d\hat{t} + \int_{\hat{T}_*}^1 [\hat{B}(\hat{t}) + \mu \hat{v}(\hat{t})] \hat{v}(\hat{t}) d\hat{t} + \hat{x}_* \hat{B}(\hat{T}_*)$$

5. Trajectory Cost Decomposition - Terms Explain: To measure  $\hat{C}_0$  at time  $\hat{T}_*$ , as can be seen in the second expression above, the first term is the total dollar cost paid to acquire the shares so far, minus the value of those shares at the pre-trade price.
6. Trading Cost Decomposition - Position Remaining: The second term is the estimation of the additional cost that will need to be paid on the remaining shares relative to the pre-trade price, due to price movements observed so far.
7. Observability of the Realized Price Brownian: As noted before  $\hat{B}(\hat{t})$  is observable if the execution price, the trade rate, and the coefficient of the market impact are all known.
8. Outcome Partitioning at the Decision Instant: The real-line is partitioned into  $n$  intervals  $I_1, \dots, I_n$  and  $\bar{\kappa}_j$  is used if

$$\hat{C}_0 \in I_j$$

For large  $n$  this approaches a continuous dependence

$$\bar{\kappa} = f(\hat{C}_0)$$

9. Price vs Cost Bound  $\bar{\kappa}$ : The intuition seen in the Introduction section indicates that using the accumulated cost should be more effective than using the instantaneous price at time  $\hat{T}_*$ .



10. Pre-fixing Decision Time Urgencies: Before trading begins, the decision time  $\hat{T}_*$ , the interval break-points, and the  $n + 1$  urgencies  $\bar{\kappa}_1, \dots, \bar{\kappa}_n$  are all fixed. However it is not known which trajectory shall actually be executed until  $\hat{\mathcal{C}}_0$  is observed at time  $\hat{T}_*$ .
11. Cost of the Decision Trajectory:  $\hat{\mathcal{C}}_j$  is the cost incurred in the second part of the trajectory if urgency  $\bar{\kappa}_j$  is used:

$$\hat{\mathcal{C}}_j = \int_{\hat{T}_*}^1 \hat{x}(\hat{t}) d\hat{B}(\hat{t}) + \mu \int_{\hat{T}_*}^1 \hat{v}^2(\hat{t}) d\hat{t} + \int_{\hat{T}_*}^1 [\hat{B}(\hat{t}) + \mu \hat{v}(\hat{t})] \hat{v}(\hat{t}) d\hat{t} - \hat{x}_* \hat{B}(\hat{T}_*)$$

12. Total Cost across the Trajectory: The total cost is then

$$\hat{\mathcal{C}} = \hat{\mathcal{C}}_j + \hat{\mathcal{C}}_{\mathcal{J}(\hat{\mathcal{C}}_0)}$$

where

$$\mathcal{J}(\hat{\mathcal{C}}_0) = i$$

if

$$\hat{\mathcal{C}}_0 \in I_i$$

Although the total cost is not Gaussian the optimal frontier is still computed using mean-variance optimization.

## Single Update Mean and Variance

1. Initial Time Decision Mean/Variance: As described before the mean and the variance are calculated at the initial time. Each variable  $\hat{\mathcal{C}}_i$  is Gaussian with mean





$$E_i = \mu F_i$$

and variance  $V_i$  where  $F_i$  and  $V_i$  are integrals of the form

$$F_i = \int_{\hat{T}_*}^1 \hat{v}^2(\hat{t}) d\hat{t}$$

and

$$V_i = \int_{\hat{T}_*}^1 \hat{x}^2(\hat{t}) d\hat{t}$$

which do not depend on  $\mu$ .

2. Initial and Decision Marginal Distributions: Next the mean and the variance of each possible decision trajectory cost needs to be evaluated.
3. Decision Cost Trajectory Mean and Variance: The following integrals are readily determined:

$$F_0 = \bar{\kappa}_0 \frac{\sinh(2\bar{\kappa}_0) - \sinh[2\bar{\kappa}_0(1 - \hat{T}_*)] + 2\bar{\kappa}_0 \hat{T}_*}{4 \sinh^2 \bar{\kappa}_0}$$

$$V_0 = \frac{\sinh(2\bar{\kappa}_0) - \sinh[2\bar{\kappa}_0(1 - \hat{T}_*)] - 2\bar{\kappa}_0 \hat{T}_*}{4 \sinh^2 \bar{\kappa}_0}$$

and

$$F_i = \frac{\sinh^2[\bar{\kappa}_0(1 - \hat{T}_*)]}{\sinh^2[\bar{\kappa}_i(1 - \hat{T}_*)]} \bar{\kappa}_i \frac{\sinh[2\bar{\kappa}_i(1 - \hat{T}_*)] + 2\bar{\kappa}_i(1 - \hat{T}_*)}{4 \sinh^2 \bar{\kappa}_0}$$



and

$$V_i = \frac{\sinh^2[\bar{\kappa}_0(1 - \hat{T}_*)] \sinh[2\bar{\kappa}_i(1 - \hat{T}_*)] - 2\bar{\kappa}_i(1 - \hat{T}_*)}{\sinh^2[\bar{\kappa}_i(1 - \hat{T}_*)] 4 \sinh^2 \bar{\kappa}_0}$$

for

$$i = 1, \dots, n$$

4. Trajectory Cost Distribution Density Expression: Each  $\hat{C}_i$  is a Gaussian with a mean  $F_i$  and a variance  $V_i$  so its density is

$$f_i(\hat{C}_i) = \frac{1}{\sqrt{2\pi V_i}} e^{-\frac{(F_i - \hat{C}_i)^2}{2V_i}}$$

$$i = 1, \dots, n$$

5. Partitioning the Cost Decision Space: The intervals are defined as

$$I_i = \{b_{j-1} < \hat{C}_0 < b_j\}$$

with

$$b_j = E_0 + a_j \sqrt{V_0}$$

where  $a_0, \dots, a_n$  are fixed constants with

$$a_0 = -\infty$$



and

$$a_n = +\infty$$

6. Cost Convolution over Decision Segments:

$$\begin{aligned} f(c)\Delta c &= Prob\{\hat{C} \in [c, c + \Delta c]\} \\ &= \sum_{i=1}^n Prob\{\hat{C}_0 \in I_i \text{ AND } \hat{C}_i \in [c - \hat{C}_0, c - \hat{C}_0 + \Delta c]\} \end{aligned}$$

so

$$\begin{aligned} f(\hat{C}) &= \sum_{i=1}^n \int_{b_{i-1}}^{b_i} f(\hat{C}_0) f(\hat{C} - \hat{C}_0) d\hat{C}_0 \\ &= \sum_{i=1}^n \frac{1}{\sqrt{2\pi V_0 V_i}} \int_{b_{i-1}}^{b_i} e^{-\left[\frac{(\hat{C}_0 - E_0)^2}{2V_0} + \frac{(\hat{C} - \hat{C}_0 - E_i)^2}{2V_i}\right]} d\hat{C}_0 \\ &= \sum_{i=1}^n \frac{1}{\sqrt{2\pi V_0 V_i}} e^{-\frac{1}{2}\left[\frac{E_0^2}{V_0} + \frac{(\hat{C} - E_i)^2}{V_i} - \frac{\{E_0 V_i + (\hat{C} - E_i) V_0\}^2}{V_0 V_i (V_0 + V_i)}\right]} \int_{b_{i-1}}^{b_i} e^{-\frac{1}{2} \frac{V_0 + V_i}{V_0 V_i} \left[\hat{C}_0 - \frac{\{E_0 V_i + (\hat{C} - E_i) V_0\}}{V_0 + V_i}\right]^2} d\hat{C}_0 \\ &= \sum_{i=1}^n \frac{1}{\sqrt{2\pi (V_0 + V_i)}} e^{-\frac{(\hat{C} - \hat{C}_0 - E_i)^2}{2V_i}} \\ &\quad \times \left[ \Phi\left(\frac{\{\hat{C} - E_i - b_{i-1}\} V_0 + \{E_0 - b_{i-1}\} V_i}{\sqrt{V_0 V_i (V_0 + V_i)}}\right) \right. \\ &\quad \left. - \Phi\left(\frac{\{\hat{C} - E_i - b_i\} V_0 + \{E_0 - b_i\} V_i}{\sqrt{V_0 V_i (V_0 + V_i)}}\right) \right] \end{aligned}$$

7. Incremental Cost Distribution and Density: To calculate the mean and the variance of the composite cost  $\hat{C}$  the following non-dimensional fixed costs are defined.



$$p_j = \Phi(a_j) - \Phi(a_{j-1})$$

and

$$q_j = \phi(a_{j-1}) - \phi(a_j)$$

for

$$j = 1, \dots, n$$

$\phi$  is the standard normal density, and  $\Phi$  is its cumulative. Thus

$$Prob\{\hat{\mathcal{C}}_0 \in I_i\} = p_j$$

and

$$\mathbb{E}[\hat{\mathcal{C}}_0 | \hat{\mathcal{C}}_0 \in I_i] = E_0 + \frac{q_j}{p_j} \sqrt{V_0}$$

8. Total Cost Mean and Variance: By linearity of expectation one readily gets

$$E = \mu(F_0 + \bar{F})$$

with

$$\bar{F} = \sum p_i F_i$$



The variance is more complicated because of the dependence between the two terms in

$$\hat{\mathcal{C}} = \hat{\mathcal{C}}_0 + \hat{\mathcal{C}}_{\mathcal{I}(\hat{\mathcal{C}}_0)}$$

9. The Full Trajectory Cost Variance: One uses the conditional variance expression

$$\mathbb{V}[X] = \mathbb{E}[\mathbb{V}[X|Y]] + \mathbb{V}[\mathbb{E}[X|Y]]$$

to write, using

$$\bar{V} = \sum p_i V_i$$

$$\begin{aligned} \mathbb{V}[\hat{\mathcal{C}}] &= \mathbb{E} \left[ \mathbb{V} \left[ \hat{\mathcal{C}}_0 + \hat{\mathcal{C}}_{\mathcal{I}(\hat{\mathcal{C}}_0)} | \hat{\mathcal{C}}_0 \right] \right] + \mathbb{V} \left[ \mathbb{E} \left[ \hat{\mathcal{C}}_0 + \hat{\mathcal{C}}_{\mathcal{I}(\hat{\mathcal{C}}_0)} | \hat{\mathcal{C}}_0 \right] \right] \\ &= \mathbb{E} \left[ \mathbb{V} \left[ \hat{\mathcal{C}}_{\mathcal{I}(\hat{\mathcal{C}}_0)} \right] \right] + \mathbb{V} \left[ \hat{\mathcal{C}}_0 + \mathbb{E} \left[ \hat{\mathcal{C}}_{\mathcal{I}(\hat{\mathcal{C}}_0)} \right] \right] \\ &= \bar{V} + \mathbb{V}[\hat{\mathcal{C}}_0] + 2 \text{Covar} \left[ \hat{\mathcal{C}}_0, \hat{\mathcal{C}}_{\mathcal{I}(\hat{\mathcal{C}}_0)} \right] + \mathbb{V} \left[ \mathbb{E} \left[ \hat{\mathcal{C}}_{\mathcal{I}(\hat{\mathcal{C}}_0)} \right] \right] \end{aligned}$$

10. Full Trajectory Cost Variance Components: By definition

$$\mathbb{V}[\hat{\mathcal{C}}_0] = V_0$$

and

$$\mathbb{V} \left[ \mathbb{E} \left[ \hat{\mathcal{C}}_{\mathcal{I}(\hat{\mathcal{C}}_0)} \right] \right] = \mu^2 \sum p_i (F_i - \bar{F})^2$$

Further



$$\begin{aligned}
 \text{Covar} [\hat{C}_0, \hat{C}_{j(\hat{C}_0)}] &= \mathbb{E} [\hat{C}_0 \mathbb{E} [\hat{C}_{j(\hat{C}_0)}]] - \mathbb{E} [\hat{C}_0] \mathbb{E} [\hat{C}_{j(\hat{C}_0)}] \\
 &= \sum \text{Prob}\{\hat{C}_0 \in I_i\} \mathbb{E} [\hat{C}_0 \mathbb{E} [\hat{C}_{j(\hat{C}_0)}] | \hat{C}_0 \in I_i] - \mathbb{E} [\hat{C}_0] \mathbb{E} [\hat{C}_{j(\hat{C}_0)}] \\
 &= \mu \sqrt{V_0} \sum q_i F_i
 \end{aligned}$$

11. Bringing all the Parts Together: Putting all this together one gets

$$V = \mathbb{V}[\hat{C}] = V_0 + \bar{V} + \mu \sqrt{V_0} \sum q_i F_i + \mu^2 \sum p_i (F_i - \bar{F})^2$$

12. The Non-dimensional Objective Function: The overall objective function is

$$U = \frac{E + \mu \bar{\kappa}^2 V}{\mu}$$

or

$$\begin{aligned}
 U(\bar{\kappa}_1, \dots, \bar{\kappa}_n, \hat{T}_*, \bar{\kappa}, \mu) \\
 = F_0 + \bar{F} + \bar{\kappa}^2 (V_0 + \bar{V}) + \mu \bar{\kappa}^2 \sqrt{V_0} \sum q_i F_i + \mu^2 \bar{\kappa}^2 \sum p_i (F_i - \bar{F})^2
 \end{aligned}$$

13. Negative Two Period Cross Correlation: The  $\mathcal{O}(\mu)$  term is approximately

$2 \sum (\hat{C}_0 - E_0) p_i E_i$  and can be made negative by making  $E_i$  negatively related to  $\hat{C}_0$  corresponding to anti-correlation between second period impact costs and the first period trading losses.

14. The Optimizer Input/Search Space: For a given market power  $\mu$  and static urgency  $\bar{\kappa}$ ,

$U$  is minimized numerically over  $\bar{\kappa}_0, \dots, \bar{\kappa}_n$  and the decision time  $\hat{T}_*$

15. Efficient Frontier Curve over  $\bar{\kappa}$ : As  $\bar{\kappa}$  varies the resulting set of points  $(V, E)$  traces the efficient frontier. This results in a one-parameter family of efficient frontiers, depending on  $\mu$ . The static trajectories appear at the limit of



$$\mu = 0$$

## Almgren and Lorenz (2007) Results

1. Decision Urgency Based Efficient Frontier: Almgren and Lorenz (2000) illustrate the complete set of efficient frontiers for the single update problem. Each curve is computed by varying a static urgency parameter  $\bar{\kappa}$  from 0 to  $\infty$  for a fixed value of  $\mu$ .
2. Discretization of the Decision Urgency: The solution for each pair of  $(\bar{\kappa}, \mu)$  is computed using a fixed set of 32 equal-probability breakpoints. As described earlier  $\hat{E}$  and  $\hat{V}$  are plotted relative to their values for the linear trajectories to clearly see the improvement due to the adaptivity.
3. Improved Execution Strategy Cost Distribution: The frontiers are used to obtain adaptive strategies that are better than the cost distribution for any static strategies.
4. Static Urgency Trajectory and Cost: First Almgren and Lorenz (2007) compute a static trajectory using

$$\bar{\kappa} = 8$$

and generate the resulting cost distribution that is Gaussian. For a portfolio with

$$\mu = 0.1$$

this distribution has an expectation

$$\hat{E} \approx 4 \times \hat{E}_{LIN} \approx 4 \times \mu = 0.4$$

and variance



$$\hat{V} \approx 0.2 \times \hat{V}_{LIN} = \frac{0.2}{3} = 0.067$$

5. Market Power Based Efficient Frontier: Likewise they generate adaptive efficient frontiers for different values of the market power  $\mu$ . They identify the set of values accessible to a static strategy as well as the static frontier – which is also the limit

$$\mu \rightarrow 0$$

with a static strategy  $\bar{\kappa}$ . The improved values accessible to the adaptive strategies are also identified; the improvement is greater for larger portfolios. The actual cost distributions corresponding to different  $\bar{\kappa}$  are also estimated.

6. Improvement available over the Static Trajectory: The region in the  $(\hat{V}, \hat{E})$  space accessible to an adaptive strategy with

$$\mu = 0.1$$

that are strictly preferable to a static strategy since they have lower expected cost and/or variance can be readily observed.

7. Cost Profile Adaptive Urgency Range: On the efficient frontier for

$$\mu = 0.1$$

these solutions are obtained by computing adaptive solutions with parameters approximately in the range

$$4.9 \leq \bar{\kappa} \leq 7.1$$

There is no need to use the same value for  $\bar{\kappa}$  for the adaptive strategy as for the static strategy to which it is compared.





8. Adaptive Trajectory Urgency - Cost/Variance: Detailed cost distributions associated with these adaptive strategies can also be generated. For

$$\bar{\kappa} = 4.9$$

the adaptive distribution has a lower expected cost than the static distribution with the same variance. For

$$\bar{\kappa} = 7.1$$

the adaptive distribution has a lower variance than the static distribution with the same mean.

9. Strictly Optimal Adaptive Strategy Urgency: These distributions are the extreme points of a one-parameter family of distributions, each of which is strictly preferable to the given static strategy, regardless of the traders' risk preferences. For example the adaptive solution for

$$\bar{\kappa} = 6$$

has both lower expected cost and lower variance than the static distribution.

10. Strongly Positive Optimal Distribution Skew: These cost distributions are strongly skewed toward positive distribution costs suggesting that the mean-variance optimization may not give the best possible solutions.
11. Realized Static vs. Adaptive Trajectories: Almgren and Lorenz (2007) compare the adaptive trading trajectories for

$$\mu = 0.1$$

and



$$\bar{\kappa} = 6$$

against the static optimal trajectory with urgency

$$\bar{\kappa} = 8$$

The adaptive strategy clearly delivers both lower expectation of cost and lower variance.

12. Urgency Dependence on Trading Cost: They also demonstrate the dependence of the decision urgency on the initial trading cost  $\hat{C}_0$  - in their plots they normalize  $\hat{C}_0$  by its initial *ex ante* expectation and trading cost.
13. Adaptation under Favorable Price Move: The adaptive strategy initially trades more slowly than the optimal static trajectory. At  $\hat{T}_*$ , if the prices have moved in the traders' favor, the adaptive strategy accelerates, spending the investment gains on the impact costs.
14. Adaptation under Unfavorable Price Move: If the prices have moved against the trader, corresponding to positive values of  $\hat{C}_0$ , then the strategy decelerates to save impact costs in the remaining period. The values of  $\bar{\kappa}$  become very large when  $\hat{C}_0$  is large negative, corresponding to the instruction: "if you have gains in the first part of the trading, then finish the program immediately".

## Continuous Response

1.  $\mathbb{R}^1 \rightarrow \mathbb{R}^1$  Dependence on Brownian: Next Almgren and Lorenz (2007) illustrate a simple form of *continuous response* to trading gains or losses. In general one can specify any rule  $\hat{v}(\hat{t})$  as a function of the price history  $\hat{B}(s)$  for

$$0 \leq s \leq \hat{t}$$



Rather than adjusting the rate  $\hat{v}(\hat{t})$  directly it is more convenient to adjust  $\bar{\kappa}$ .

2. Trade Rate Explicit Functional Form: From

$$h(t, T, \kappa) = \frac{\sinh[\kappa(T - t)]}{\sinh[\kappa T]}$$

for

$$0 \leq t \leq T$$

on differentiating

$$x(s) = x(t)h(s - t, 1 - t, \kappa)$$

with respect to  $s$  and evaluating at

$$s = t$$

the following relationship between  $v$  and  $\kappa$  is obtained.

$$v(t) = x(t)\kappa(t) \coth[\kappa(t)(1 - t)]$$

For all choices of  $\kappa(t)$  the trajectories hit

$$x = 0$$

at

$$t = 1$$



3. Exponential Price Brownian Functional Form: Determining the full optimal dependence of  $\kappa(t)$  on  $B(s)$  for

$$0 \leq s \leq t$$

is difficult. Thus the following relationship is considered:

$$\kappa(t) = ae^{bB(t)}$$

Thus the instantaneous urgency depends on the instantaneous price level. Other functional relationships for  $\kappa(t)$  in terms of  $B(t)$  are possible as well. Here  $\kappa(t)$  is always positive, and is monotone in  $B(t)$ .

4. Corresponding Trade Rate Shortfall: From

$$v(t) = x(t)\kappa(t) \coth[\kappa(t)(1 - t)]$$

one readily obtains  $x(t)$  and finally the shortfall  $\mathcal{C}$  by integration as in

$$\mathcal{C} = \sigma \int_0^T x(t)dB(t) + \eta \int_0^T v^2(t)dt$$

5. Need for Numerical Framework: However, because of the highly nonlinear dependence of  $\kappa(t)$ , and thus  $v(t)$  and  $x(t)$ , on the Brownian motion  $B(t)$ , analytic solution of this stochastic integral is beyond reach.

## Continuous Response Numerical Results



1. Price Move Brownian Bridge Construction: For numerical solutions one generates a fixed collection of sample paths using a Browning bridge construction with quasi-random variables.
2. Objective Value Function Numerical Evaluation: For any candidate values of  $a$  and  $b$  the stochastic integrals are evaluated numerically, and the sample mean  $E$  and the variance  $V$  are calculated. The objective function  $E + \bar{\kappa}^2 \mu^2 V$  is then numerically minimized over  $a$  and  $b$ .
3. Generation of the Efficient Frontier: By solving for a series of values of

$$0 < \bar{\kappa} < \infty$$

the efficient frontier can again be traced for different values of  $\mu$ , yielding similar results as in the single update framework.

4. Execution Cost Gain/Loss Adaptation: Again the optimal strategies are “aggressive in the money”, having

$$b < 0$$

When the stock price goes down, an unexpected smaller shortfall is incurred, and a reaction occurs with increasing urgency  $\bar{\kappa}(t)$  whereas for rising stock prices the trading is slowed down.

5. Exponential Urgency Response Trajectory Sample: As an illustration, Almgren and Lorenz (2007) generate optimal trading trajectories using the adaptation rule

$$\bar{\kappa}(t) = ae^{bB(t)}$$

with

$$a = 5.9$$



and

$$b = -1.7$$

for a static urgency

$$\bar{\kappa} = 6$$

As the stock price goes down the trading is accelerated compared to the optimal static trajectory, whereas for rising stock price it is slowed down.

## Discussion and Conclusions

1. Rule Based Adaptive Scaling Strategies: The simple update rules presented in the previous sections demonstrate that price adaptive scaling strategies can lead to significant improvements over static trade schedules, and illustrate the importance of the market power parameter  $\mu$ .
2. Dynamic Programming Based Optimal Trajectory: However neither of these rules is the fully adaptive optimal trading strategy. A fully optimal adaptive trading strategy would use stochastic dynamic programming to determine the trading rate as a general function of the continuous state variables such as the number of shares remaining, time remaining, current stock price, and trading gains or losses experienced to date.
3. Infeasibility of Mean Variance Optimization: One subtlety is that the mean-variance optimization cannot be used directly in this context; it involves the square of an expectation, which is not amenable to dynamics programming techniques.
4. Quadratic Utility Family of Optimization: However Li and Ng (2000) have shown how to embed mean-variance optimization into a family of optimizations that use the quadratic utility function.



5. MVO as a Family Member: The mean-variance solution is recovered as one element of this family. The need to solve this family of problems is an additional degree of complication.
6. HJB PDE Based Stochastic Control: The calculation uses tools of optimal stochastic control and requires the numerical solution of a highly nonlinear Hamilton-Jacobi-Bellman partial differential equation.
7. Adaptive Strategies as a Simplifier: Partial formulation of this problem, and the solution of the resulting equations, is an involved undertaking and the focus of a later chapter. The examples shown here show that even with very simple adaptive strategies substantial improvement is possible over static strategies.

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## Mean Variance Optimal Adaptive Execution

### Background, Synopsys, and Key Results

1. Trade Cost Expectation vs. Volatility: Electronic trading of equities and other securities makes heavy use of “arrival price” algorithms that balance market impact costs of rapid execution against the volatility risk of slow execution.
2. Static Optimal MVO Execution Strategies: In the standard formulation, mean variance optimal trading strategies are static, they do not modify the execution speeds in response to the price motions observed during trading.
3. Dynamic Optimal MVO Execution Strategies: Lorenz and Almgren (2011) show that substantial improvement is possible by using dynamic trading strategies, and that the improvement is larger for large initial positions.
4. Tree Discretization of Asset Price: They develop a technique for computing optimal dynamic strategies to any desired degree of precision. The asset price process is observed on a discrete tree with an arbitrary number of levels.
5. Control Variables for Dynamic Optimization: A novel dynamic programming techniques is introduced in which the control variables are not only the shares traded at each step, but also the maximum expected cost for the remainder of the program; the value function is the variance for the remainder of the program.
6. Aggressive-in-the-Money Strategies: The resulting adaptive strategies are “aggressive-in-the-money”; they accelerate the execution when the price moves in the traders’ favor, spending parts of the trading gains to reduce risk.

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# Optimal Trading in a Dynamic Market

## Introduction, Overview, and Motivation

1. Stock Market Liquidity and Volatility: This chapter considers the problem of mean-variance agency execution strategies when the market volatility and the liquidity vary randomly in time.
2. Cost/Strategy Dynamic Optimal Trajectory: Under specific assumptions for the stochastic processes satisfied by these parameters, a Hamilton-Jacobi-Bellman equation is presented for the optimal cost and the strategy.
3. Trajectory Adoption to Market Conditions: This equation is solved numerically, and optimal strategies are illustrated for varying risk aversion. These strategies adapt optimally to the instantaneous variations of market quality.

## Limitations of Arrival Price Frameworks

1. Optimal Order Execution Trade Scheduling: A fundamental part of agency algorithmic trading in equities and other asset classes is trade scheduling. Given a trade target, that is a number of shares of a trade that must be bought or sold before a fixed time horizon, trade scheduling refers to how many shares that will be bought or sold by each time instant between the beginning of trading and the horizon.
2. Optimal Measure of Execution Quality: The optimal execution is done so as to optimize some measure of execution quality, usually measured as the final average execution price relative to some benchmark price.
3. Definition of the Arrival Price: One of the most popular benchmarks is the “arrival price”, i.e., the price prevailing in the market the time the order was received into the



trading system. The difference between the execution price and this pre-trade price is the *implementation shortfall* (Perold (1988)) or *slippage*.

4. Balancing Transaction Costs and Variance: Grinold and Kahn (1995) and Almgren and Chriss (2000) suggested that the optimal trajectory could be determined by balancing the market impact cost, which leads toward slow trading, versus volatility risk, which leads toward rapid completion of the order.
5. Risk Aversion Based Efficient Frontier: This framework leads to an efficient frontier in which the trade schedule is selected from a one-parameter family based on a risk-aversion parameter that must be specified by the trading client.
6. Risk Aversion Based Front Loading: Optimal trading strategies are typically *front-loaded*. They execute as much as possible early in the program to reduce risk relative to the benchmark price. The degree of front-loading depends on the risk aversion parameter that must be specified by the trading client. The exact shape of the schedule depends on the form of the market impact model.
7. Market Price Based Benchmarks: The largest alternative category of benchmarks is composed of some form of average market price during the trading interval; usually either time-weighted average price (TWAP) or volume weighted average price (VWAP).
8. Close Tailing of the Benchmarks: For these benchmarks optimal strategy follows the benchmarks quite closely, since deviation from the profile both increases the risk relative to the benchmark and the impact costs. Determining optimal response to the short-term price is an interesting topic for optimization, but is not the focus here.
9. Use of Arrival Price Frameworks: While other factors such as anticipated price drift, serial correlation or other short-term signals, and daily patterns are certainly important, this fundamental “arrival price” framework has proven remarkably robust and useful in designing practical trading systems.
10. Time Profiles of Liquidity/Volatility: A fundamental assumption of most of this work has been that the market parameters are constant, or at least have known predictable profiles. This assumption is reasonably accurate for large-cap US stocks.



11. Static Nature of the Framework: Under that assumptions optimal strategies are *static*; that is the trade schedule can be determined before the trading starts and is not modified by the new information revealed by price moves during trading. Almgren and Chriss (2000) did consider a model in which the market parameters updated at a single time to one of a known set of possible new values.
12. Algorithmic Trading of Less Liquid Assets: over the last few years, a major push of providers of algorithmic trading services has been to extend their functionality to smaller stocks and less liquid assets.
13. Random Intra-day Volatility/Liquidity: A distinguishing feature of these assets is that their liquidity and volatility vary randomly in time. That is, there will be times during the trading day when trading becomes very expensive, and times when trading is cheap; similarly there will be times when delaying trading introduces large amounts of volatility risk and other times when the delay is relatively costless.
14. Optimal Mean-Variance Tradeoff: The modeling challenge is to determine optimal strategies that adapt to the instantaneous market state, while retaining the mean-variance trade-off inherent in the arrival price framework.
15. Continuous Time and State Treatment: Walia (2006) solved this problem in a discrete time discrete state model. Almgren (2009) provides a systematic mathematical solution to the problem in continuous time and continuous state.
16. Coordinated Liquidity/Volatility Joint Moves: The first section of this chapter presents the basic price and the impact models used, and presents the optimal trading problem. Also presented is the “coordinated variation” approximation in which the liquidity and the volatility vary together, which is very realistic and greatly simplifies the mathematical problem.
17. Dynamic HJB Optimal Cost Function: The second section uses a Hamilton-Jacobi-Bellman PDE describing the optimal cost function and the trade rate. The third section examines some aspects of the numerical solution to this PDE, and presents example solutions.



## The Liquidation Problem

1. The Continuous Holdings Rate Trajectory: The trader begins trading at a time

$$t = 0$$

with a purchase order of  $X$  shares which must be completed by

$$t = T$$

The number of shares remaining to purchase at the time  $t$  is the remaining trajectory  $x(t)$  with

$$x(0) = X$$

and

$$x(T) = 0$$

The rate of buying is

$$v(t) = -\frac{dx(t)}{dt}$$

2. The Trajectory as a Random Variable: Thus for a buy program

$$X > 0$$



$$x(t) \geq 0$$

and decreasing, and

$$v(t) \geq 0$$

– sell program may be modeled similarly. In general, the trajectory conditions  $x(t)$  may be determined depending on price motions and market conditions discovered during trading, so it is a random variable.

3. The Arithmetic Brownian Price Dynamics: The price  $S(t)$  follows the arithmetic Brownian motion

$$\Delta S(t) = \sigma(t)\Delta B(t)$$

$$S(0) = S_0$$

where  $B(t)$  is a standard Brownian motion, and the instantaneous volatility  $\sigma(t)$  depends on time either deterministically or stochastically.

4. Volatility and Permanent Impact Parameters: Note that  $\sigma(t)$  is an absolute volatility rather than fractional; it contains an implicit factor of the reference price  $S_0$ . It is possible to include the permanent impact into the price equation, but it is not central to the problem.
5. Execution Price - Incorporating the Temporary Impact: The price actually received on each trade is

$$\tilde{S}(t) = S(t) + \eta(t)v(t)$$

where  $\eta(t)$  is the coefficient of the temporary market impact, also time varying. Again  $\eta(t)$  is an absolute coefficient rather than fractional.



6. More Elaborate Market Impact Models: Much richer market impact models have been considered in the literature (Gatheral (2010)), but this simple one is adequate to highlight the response to stochastic liquidity.
7. Estimation of  $\sigma(t)$  and  $\eta(t)$ : Both  $\sigma(t)$  and  $\eta(t)$  are assumed to be observable in real-time with some degree of confidence. There is a variety of techniques available for doing this estimation.
8. Techniques for Estimation of  $\sigma(t)$ : For volatility  $\sigma(t)$  there is an extensive literature on estimation using high-frequency market data (for example, Gatheral and Oomen (2010)). The primary focus there is to find effective means to filter out noise associated with market details such as bid and offer prices so as to obtain reliable estimates on time intervals that are as short as possible. Thus, for example, one could estimate  $\sigma(t)$  by using market data from the preceding five minutes, which would typically contain hundreds of trades and potentially thousands of quote updates.
9. Techniques for Estimation of  $\eta(t)$ : Instantaneous liquidity, the inverse of  $\eta(t)$  is more difficult to estimate, since it is an estimation of what *would* happen if one were to submit trades to the market rather than being an observable in itself. One proxy for the instantaneous trade history would be the realized trade volume over the last few minutes; if more people are trading actively in the market then one would be able to move a given number of shares with less slippage.
10. Trade Volume as Liquidity Proxy: A refined version of the above would be to measure the trade volume at or near the bid price if one is a buyer (or at the ask if one is a seller); large volume there would indicate the presence of a motivated seller and a good opportunity to go in as a buyer with low impact. Although these measures are not quantitatively very precise, they are often adequate to distinguish *good* opportunity from *bad*.
11. Persistence of the Market Properties: Both of these estimators rely on the presence of market properties (volatility and liquidity), so that information about the past provides reasonable forecasts for the future. Such persistence, at least across short horizons, is well documented (Bouchard, Farmer, and Lillo (2009) contain a review).





12. Time Dependent Liquidity/Volatility Patterns: Two broad classes of problems may be addressed. First is the case in which  $\sigma(t)$  and  $\eta(t)$  are both known non-random functions in time. This would accommodate the well-known intra-day profiles of volatility and liquidity; generally markets are more active in the mornings and in the close than in the middle of the day. This case is not the primary focus.
13. Stochastic Liquidity and Volatility Processes: The second case is when the volatility and the liquidity vary randomly through the day, so that  $\sigma(t)$  and  $\eta(t)$  follow some stochastic processes. This effect is very important in small and medium capitalization stocks' algorithmic trading, and other assets that are less heavily traded than the large-cap US stocks.

## Cost of Trading

1. Expression for the Transaction Cost: The *cost of trading* is the total cost paid to purchase  $X$  shares relative to the initial market value of  $XS_0$

$$\mathbb{C} = \int_0^T \tilde{S}(t)v(t)dt - XS_0 = \int_0^T \sigma(t)x(t)dB(t) - \int_0^T \eta(t)v^2(t)dt$$

where

$$x(t) = \int_t^T v(t)dt$$



2. Dynamic Optimal Trading Cost Control: The cost  $\mathbb{C}$  is a random variable, both because of the price uncertainty in  $B(t)$  in the first and because of the liquidity uncertainty. The strategy  $x(t)$  is to tailor the properties of this random variable to meet some optimal criterion.
3. Forward Time Cost of Trading: More generally, starting at time

$$t \geq 0$$

with  $x(t)$  shares remaining to purchase, the cost of a strategy  $x(s)$  on

$$t \leq s \leq T$$

is

$$\mathbb{C} = \int_t^T \sigma(s)x(s)dB(s) + \int_t^T \eta(s)v^2(s)ds$$

4. Trading Cost Expectation and Variance: The optimal trajectory is defined by the mean-variance criterion

$$\min_{x(s): t \leq s \leq T} \{E[\mathbb{C}] + \lambda V[\mathbb{C}]\}$$

where

$$\lambda \geq 0$$

is a risk-aversion coefficient. Note that



$$\mathbb{E}[\mathbb{C}] = \int_t^T \eta(s)v^2(s)ds$$

since the first term is an Ito's integral, and

$$\mathbb{V}[\mathbb{C}] = \int_t^T \sigma^2(s)x^2(s)ds + \{Terms from the Uncertainty of \eta(s) and \sigma(s)\}$$

5. Components of the Transaction Cost Variance: The first term in the variance contains the largest source of uncertainty, which corresponds to the price changes during execution. The other terms arise from the uncertainty in the market impact  $\eta(s)$  that will be paid on the transaction in the future, in the volatility  $\sigma(s)$  that will be experienced at a later time, and in the trade strategy  $v(s)$  itself if it is determined in response to uncertain market conditions.
6. Domination of the Market Volatility Term: Almgren (2009) argues that the first term in  $\mathbb{V}[\mathbb{C}]$  above dominates the other terms.
7. Practical Use of Risk Aversion: The risk aversion coefficient  $\lambda$  is rarely defined in terms of fundamental investment preferences (Engle and Ferstenberg (2007)). Rather it is a parameter used to adjust the trajectories to a form that seems reasonable by other criteria such as representing a desired fraction of the market volume.

## Constant Coefficients

1. Constant Volatility and Market Impact: The classic problem of Almgren and Chriss (2000) takes  $\sigma$  and  $\eta$  constant. Then for a strategy  $x(t)$  that is fixed in advance and does not adapt to price motions



$$\mathbb{E}[\mathbb{C}] + \lambda \mathbb{V}[\mathbb{C}] = \int_t^T [\eta(s)v^2(s) + \sigma^2(s)x^2(s)]ds$$

2. Application of the Calculus of the Variations: Using the calculus of variations to minimize this over trajectories  $x(s)$  gives the second order ODE

$$\frac{d^2x}{ds^2} = \kappa^2 x(s)$$

with

$$\kappa^2 = \frac{\lambda \sigma^2}{\eta}$$

3. Optimal Trading Rate and Trajectory: The solution is a combination of the exponentials  $e^{\pm \kappa s}$

$$x(s) = x(t) \frac{\sinh[\kappa(T-s)]}{\sinh[\kappa(T-t)]}$$

$$v(s) = \kappa x(t) \frac{\cosh[\kappa(T-s)]}{\sinh[\kappa(T-t)]}$$

Thus  $\frac{1}{\kappa}$  is the characteristic time scale of liquidation.

4. The Corresponding Cost of Trading: The strategy may also be expressed as a rule for

$$v(t) = \kappa x(t) \coth[\kappa(T-t)]$$

The corresponding cost function is



$$\mathbb{C}(x, t, \eta, \sigma) = \eta \kappa x^2 \coth[\kappa(T - t)] = \eta v x$$

5. Components of the Trading Cost: The total cost is equal to the impact cost component – neglecting the volatility term – incurred by trading  $x$  shares at a price concession given by the instantaneous velocity  $v$ . The actual trajectory slows down as the position size decreases, thus reducing market impact costs, but the total cost includes volatility risk as well as impact costs, giving the above value.
6. Non-dimensionalization of the Time Scales: The shape of the solution is governed by the non-dimensional quantity  $\kappa(T - t)$  – the ratio of time remaining to the intrinsic time scale determined by the market's parameters and the trader's risk aversion.
7. Limit of Long Execution Time: In the infinite horizon limit

$$\kappa(T - t) \gg 1$$

the strategy has the limit

$$x(s) = x(t)e^{-\kappa(s-t)}$$

with

$$v(t) = \kappa x(t)$$

and the cost function

$$\mathbb{C} \rightarrow \eta \kappa x^2$$

Trading is substantially completed well before the expiration, and the precise value of  $T$  is not controlling.



8. Risk Neutral Optimal Execution Trajectory: Note that discounting has not been included, so the only motivation for rapid execution is risk aversion. In the limit of complete risk neutrality

$$\lambda \rightarrow 0$$

minimization of market impact costs would lead the trader to use all available time, and no infinite-horizon limit would exist; since

$$\kappa \rightarrow 0$$

the regime

$$\kappa T \gg 1$$

would never be achieved.

9. Limit of Short Execution Time: In the short horizon limit

$$\kappa(T - t) \ll 1$$

the strategy has the linear form

$$x(s) = x(t) \frac{T - s}{T - t}$$

$$v(s) = \frac{x(t)}{T - t}$$

and the cost function is essentially non-random with the value



$$\mathbb{C} \sim \frac{\eta x^2}{T - t}$$

$$\kappa(T - t) \rightarrow 0$$

If a time change is applied to match the market average profile then this is equivalent to the volume weighted average price (VWAP) execution.

10. Short-Term Limit – Higher Orders: In the same limit, the cost function has the higher order local behavior

$$\mathbb{C} \sim \frac{\eta x^2}{T - t} + \frac{\lambda \sigma^2 x^2}{3} (T - t) + \mathcal{O}((T - t)^3)$$

where  $\sim$  denotes asymptotic equivalence, that is, equal up to the terms that are asymptotically smaller than the displayed expressions in the given limit.

11. Short Term Limit Cost Components: The first term in this expression is the transaction cost associated with selling  $x$  shares at a price concession of

$$\eta v = \frac{\eta x}{T - t}$$

The second term is the risk penalty for holding an average of  $\frac{x^2}{3}$  shares across time  $T - t$ .

12. Rolling Forward Dynamically Optimal Strategies: Whether adaptive strategies are better than a fixed one is a subtle question. Almgren and Chriss (2000) showed that if the strategy is re-evaluated at an intermediate time using the mean and variance measured at that time, then the optimal strategy is the remaining part of the initial strategy, and hence the optimal strategy is fixed. This is the context of Almgren (2009, 2012), since it is appropriate for dynamic programming.

13. Adaptive Strategies for Large Portfolios: In contrast, Almgren and Lorenz (2007), Lorenz (2008), and Lorenz and Almgren (2011) showed that adaptive strategies are



optimal if the mean and the variance are measured at an initial time for portfolios that are large enough so that their impact is a substantial fraction of volatility. This framework is appropriate for *ex post* measurement of historical mean and variance across a large collection of trades. Tse, Forsyth, Kennedy, and Windcliff (2013) have given a fuller description of optimal solutions in the latter framework.

14. Cost Reductions from Adaptive Strategies: Schied and Schoneborn (2009) and Schied, Schoneborn, and Tehranchi (2010) showed that improvement from adaptivity depends on the risk profile; for example, it vanishes for a CARA utility function.

## Coordinated Variation

1. Inverse Relation between Liquidity/Variance: Suppose  $\sigma(t)$  and  $\eta(t)$  vary inversely so that

$$\sigma^2(t)\eta(t) = \text{constant} = \bar{\sigma}^2\bar{\eta}$$

where  $\bar{\sigma}$  and  $\bar{\eta}$  are constant reference values.

2. Joint Arrival trading Time Model: For example, this relationship would be a natural consequence of a *trading time* model (Jones, Kaul, and Lipson (1994), Geman, Madan, and Yor (2001)) in which the single source of uncertainty is the arrival rate of trade events. If each trade event brings both a fixed amount of price variance, and the opportunity to trade a fixed number of shares for a particular cost, then one obtains the above relation.
3. Change of Drift/Wander Variables: Time may then be changed to an artificial variable defined by  $\hat{t}(t)$  defined by

$$\Delta\hat{t} = \sigma^2(t)\Delta t$$

In this time frame a modified Brownian motion  $\hat{B}(\hat{t})$  results, with





$$\Delta \hat{B}(\hat{t}) = \sigma(t) \Delta B(t)$$

4. Change of Variables - The Trading Rate: The holdings are the same trajectory at different times, so

$$\hat{x}(\hat{t}) = x(t)$$

The trade rate is modified to

$$\hat{v}(\hat{t}) = -\frac{d\hat{x}}{d\hat{t}} = \frac{v(t)}{\sigma^2(t)}$$

5. Change of Variables: Transaction Cost: In terms of these new variables the trading cost is

$$\mathbb{C} = \int_0^{\hat{T}} \hat{x}(\hat{t}) d\hat{B}(\hat{t}) + \bar{\sigma}^2 \bar{\eta} \int_0^{\hat{T}} \hat{v}^2(\hat{t}) d\hat{t}$$

where

$$\hat{T} = \hat{t}(T)$$

is the time horizon in the changed variable.

6. Deterministic Liquidity and Volatility Profiles: The above is easy to solve in two cases. First if the time varying volatility and liquidity have known non-random profiles, then the upper bound  $\hat{T}$  may be computed exactly. The problem reduces exactly to the constant coefficient problem



$$\mathbb{E}[\mathbb{C}] + \lambda \mathbb{V}[\mathbb{C}] = \int_t^T [\eta(s)v^2(s) + \sigma^2(s)x^2(s)]ds$$

and the solution is the exponential functions computed there.

7. The Corresponding Trade Rate/Time Scale: The rule

$$v(t) = \kappa x(t) \coth[\kappa(T - t)]$$

becomes

$$v(t) = \kappa(t)x(t) \coth \left[ \frac{\kappa(t)}{\sigma^2(t)} \int_t^T \sigma^2(s)ds \right]$$

where

$$\kappa(t) = \sqrt{\frac{\lambda \sigma^2(t)}{\eta(t)}}$$

is the time scale formed with the instantaneous values of the parameters.

8. Special Random Case - Infinite Horizon: If the coefficients vary randomly, then the problem is not the same as the constant-coefficient problem, because of the uncertainty in the end. But in the infinite horizon case

$$T = \infty$$

one also has

$$\hat{T} = \infty$$



under very mild assumptions on  $\sigma(t)$ . The trade rate is

$$v(t) = \kappa(t)x(t)$$

and the cost is

$$\mathbb{C} = \eta(t)\kappa(t)x^2 = x^2\sqrt{\lambda\bar{\sigma}^2\bar{\eta}}$$

9. Infinite Horizon Trade Rate/Cost: Somewhat surprisingly the optimal cost in the coordinated variation random market infinite horizon case does not depend on the instantaneous market state  $\eta(t)$  and  $\sigma(t)$  though the instantaneous trade rate does depend on the market state.
10. Trading Only Under Favorable Conditions: In effect, since volatility is low whenever the market impact is high, the strategy is always able to wait for favorable market conditions without incurring very much risk from the delay.
11. Absence of Variance/Liquidity Constraint: Thus the interesting problems come from two sources. First is the case of variation of the profiles of  $\sigma(t)$  and  $\eta(t)$  away from the “base case”

$$\sigma^2(t)\eta(t) = \text{constant}$$

with non-random coefficients. Kim and Boyd (2008) contain a fuller discussion of optimal trading with general market profiles.

12. Departure from “Trading Time” Approximation: For example, even within the *trading time* framework intra-day profiles may vary from the base case because different market participants are active at different times of the day. This leads to problems in the ODE’s that are not the focus of this chapter.
13. Finite Horizon Adaptation to Randomness: With random coefficients, the proper handling of the uncertainty is needed as the end time is approached. For example, if



liquidity is temporarily poor, is it worthwhile to wait for a better opportunity to trade, or is there a large risk that the opportunity will not come before expiration?

## Rolling Time Horizon Approximate Strategy

1. Piecewise Constant Time Realizations: One way to determine a plausible strategy is to use

$$v(t) = \kappa x(t) \coth[\kappa(T - t)]$$

to compute  $v(t)$  using instantaneous values of  $\eta(t)$ ,  $\sigma(t)$ , and hence  $\kappa(t)$ .

2. Explicitly Adapted On-Change Re-evaluation: That is, the assumption is that the values observed at each instant will remain constant throughout the liquidation period, and determine the optimal strategy using those values. When the values change, a stationary solution is re-computed.
3. Piecewise Adaptation Approach - Caveats: This strategy is strictly optimal only in the infinite horizon case, and only when the market parameters co-vary in the appropriate way. In general it is not optimal, but provides a reasonable solution that is easy to implement.

## Small Impact Approximation

1. Approximating the Trading Cost Variance: In order to do dynamic programming when  $\eta(t)$  and  $\sigma(t)$  vary randomly, the variance term needs to be approximated. Almgren (2009) approximates it as



$$\mathbb{V}[\mathbb{C}] = \mathbb{E} \left[ \int_t^T \sigma^2(s) x^2(s) ds \right]$$

That is, the variance comes primarily by the price volatility represented by  $\sigma$  with lesser contributions from the uncertainty in  $\eta(t)$  and  $\sigma(t)$ .

2. The Small Impact Approximation Assumption: When the market impact is small in absolute terms, it is nonetheless significant because it is always positive, but the uncertainty in the market impact is negligible compared to price volatility. This is called the *small-impact approximation*.
3. “Market Power” Non-dimensional Quantity: In the language of Almgren and Lorenz (2007) and Lorenz (2008) this is a small value of the “market power”. This is also equivalent to the “small portfolio” approximation used in Lorenz and Almgren (2011) to neglect uncertainty in impact cost when the portfolio is small enough. Mathematically, the approximation relies on small values of “market power” parameter

$$\mu = \frac{\eta^X / T}{\sigma \sqrt{T}}$$

the amount by which trading moves the market compared to its intrinsic motion due to volatility across time  $T$ .

4. The Corresponding Optimal Value Function: The value function is then taken as

$$\mathbb{C}(t, x, \eta, \sigma) = \min_{x(s): t \leq s \leq T} \mathbb{E} \left[ \int_t^T \lambda \sigma^2(s) x^2(s) ds + \int_t^T \eta(s) v^2(s) ds \right]$$

From this point on this approximation shall be made.



## Dynamic Programming – Fully Co-ordinated Version

1. PDE Derivation and Numerical Solution: It is simplest to derive the PDE for the coordinated variation case directly, since that the only one that is solved here numerically. The extensions that are necessary to handle the general case are treated soon after.
2. Dynamics of Liquidity and Volatility: Since  $\eta(t)$  and  $\sigma(t)$  are positive it is convenient to write

$$\eta(t) = \bar{\eta} e^{\xi(t)}$$

and

$$\sigma(t) = \bar{\sigma} e^{-\frac{1}{2}\xi(t)}$$

where  $\bar{\eta}$  and  $\bar{\sigma}$  are typically values for  $\eta$  and  $\sigma$ , and  $\xi(t)$  is a single non-dimensional variable indicating the *market state*. When  $\xi(t)$  is large positive, the market is non-volatile and illiquid, and trading should be done more slowly; when  $\xi(t)$  is large negative, the market is volatile and liquid, and trading should be done fast.

3. Dynamics of the Intrinsic Time Scale: The intrinsic time scale in the mean market is written as

$$\bar{\kappa} = \sqrt{\frac{\lambda \bar{\sigma}^2}{\bar{\eta}}}$$

and

$$\kappa(t) = \sqrt{\frac{\lambda \sigma^2(t)}{\eta(t)}} = \bar{\kappa} e^{-\xi(t)}$$



for the instantaneous value. The value function  $c(t, x, \xi)$  then depends only on three variables.

4. Coordinated Market State Evolution:  $\xi(t)$  is assumed to solve an SDE of the form

$$\Delta \xi(t) = a(\xi(t))\Delta t + b(\xi(t))\Delta B_L(t)$$

where  $B_L(t)$  is a Brownian motion independent of the one driving the price motion.

5. The Corresponding HJB Variational Increment: Then by standard dynamic programming applied to

$$c(t, x, \eta, \sigma) = \min_{v(s), t \leq s \leq T} \mathbb{E} \left[ \int_t^T \{ \lambda \sigma^2(s) x^2(s) + \eta(s) v^2(s) \} ds \right]$$

with instantaneous trade rate

$$v = -\frac{dx}{dt}$$

as the control parameter, one writes

$$c(t, x, \xi) = \min_v \{ \lambda \sigma^2 x^2 \Delta t + \eta v^2 \Delta t + \mathbb{E}[c(t + \Delta t, x + \Delta x, \xi + \Delta \xi)] \}$$

giving the HJB PDE

$$0 = \frac{\partial c(t, x, \xi)}{\partial t} + \lambda \sigma^2 x^2 + \min_v \left[ \eta v^2 - v \frac{\partial c}{\partial x} \right] + a \frac{\partial c}{\partial \xi} + \frac{1}{2} b^2 \frac{\partial^2 c}{\partial \xi^2}$$

6. Value Function Optimal HJB PDE: The minimum is clearly



$$v = \frac{1}{2\eta} \frac{\partial c}{\partial x}$$

and the PDE for  $c(t, x, \xi)$  becomes

$$-\frac{\partial c(t, x, \xi)}{\partial t} = \lambda \sigma^2 x^2 - \frac{1}{4\eta} \left( \frac{\partial c}{\partial x} \right)^2 + a \frac{\partial c}{\partial \xi} + \frac{1}{2} b^2 \frac{\partial^2 c}{\partial \xi^2}$$

7. Near Expiration Asymptotic Cost Behavior: The initial data for the HJB PDE above is in fact a local asymptotic condition and must be treated with some care. Near expiration, liquidation must happen on a linear trajectory

$$v = \frac{x}{T - t}$$

As with constant coefficients

$$\mathbb{C} \sim \frac{\eta x^2}{T - t} + \frac{\lambda \sigma^2 x^2}{3} (T - t) + \mathcal{O}((T - t)^3)$$

the cost comes primarily from market impact.

8. Approximating the Terminal Cost Estimate: To accurately approximate the cost one must account for the expected changes in the impact coefficient during the time

$$t \leq s \leq T$$

A simple application of the Ito's lemma shows that

$$\mathbb{E}[\eta(s)] = \eta(t) \left[ 1 + \left( a + \frac{1}{2} b^2 \right) (s - t) \right]$$

$$s - t \rightarrow 0$$





and hence the average value of  $\eta(s)$  for  $s$  between  $t$  and  $T$  is

$$\eta \sim \eta(t) \left[ 1 + \frac{1}{2} \left( a + \frac{1}{2} b^2 \right) (T - t) \right]$$

$$T - t \rightarrow 0$$

9. The Terminal Cost Estimate Approximation: Using this value in

$$\mathbb{C} \sim \frac{\eta x^2}{T - t} + \frac{\lambda \sigma^2 x^2}{3} (T - t) + \mathcal{O}((T - t)^3)$$

$$\kappa(T - t) \rightarrow 0$$

with

$$\eta(t) = \bar{\eta} e^{\xi(t)}$$

one gets the cost expansion

$$\mathbb{C} \sim \frac{\bar{\eta} e^{\xi(t)} x^2}{T - t} + \frac{1}{2} \left( a + \frac{1}{2} b^2 \right) \bar{\eta} e^{\xi(t)} x^2 + \mathcal{O}(T - t)$$

$$\kappa(T - t) \rightarrow 0$$

In the  $\mathcal{O}(T - t)$  term there would appear both the risk contribution and a further expansion of the impact cost.

## Log-Normal Model and Non-dimensionalization



1. Market State Explicit Drift/Wander: The next step is to assume that  $\xi(t)$  evolves according to an Ornstein-Uhlenbeck mean-reverting process of zero mean. Thus

$$a(\xi(t)) = -\frac{\xi(t)}{\delta}$$

and

$$b(\xi(t)) = \frac{\beta}{\sqrt{\delta}}$$

2. Coordinated Market State Behavior: Here  $\delta$  is a market relaxation time, and  $\beta$  is a *burstiness* parameter describing the dispersion of liquidity and volatility around their average levels. In the steady state  $\xi(t)$  is normal with unconditional moments

$$\mathbb{E}[\xi(t)] = 0$$

and

$$\mathbb{V}[\xi(t)] = \frac{1}{2}\beta^2$$

3. Cost Function Dependence on  $x$ : Clearly the value function is strictly proportional to  $x^2$  – the square of the number of shares remaining to execute. This is a consequence of the linear market impact model, since both the variance and the expected cost are quadratic in quantity.
4. Non-dimensionalization of the Cost Function: The non-dimensionalization may now be done using  $\delta$  as the time scale and incorporating the factor  $x^2$ . One this defines



$$\tau = \frac{T - t}{\delta}$$

the time remaining to expiration as a multiple of the market relaxation time, and sets

$$c(t, x, \xi) = \frac{\bar{\eta} x^2}{\delta} u\left(\frac{T - t}{\delta}, \xi\right)$$

where  $u(\tau, \xi)$  is a non-dimensional function of non-dimensional variables.

5. Non-dimensionalization of the HJB PDE: Then

$$-\frac{\partial c(t, x, \xi)}{\partial t} = \lambda \sigma^2 x^2 - \frac{1}{4\eta} \left(\frac{\partial c}{\partial x}\right)^2 + a \frac{\partial c}{\partial \xi} + \frac{1}{2} b^2 \frac{\partial^2 c}{\partial \xi^2}$$

becomes

$$\frac{\partial u(\tau, \xi)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi)}{\partial \xi} = e^{-\xi} [K^2 - u^2(\tau, \xi)] + \frac{1}{2} \beta^2 \frac{\partial^2 u(\tau, \xi)}{\partial \xi^2}$$

in which the non-dimensional risk aversion parameter  $K$  is given as

$$K = \bar{\kappa} \delta = \frac{\text{Market Relaxation Time}}{\text{Trade Time Scale in Mean Market State}}$$

6. The Corresponding Dimensional Trade Velocity: From

$$v = \frac{1}{2\eta} \frac{\partial c}{\partial x}$$

the dimensional trade velocity becomes



$$v = \frac{x}{\delta} e^{-\xi} u(\tau, \xi)$$

7. Terminal Asymptote Behavior of  $u(\tau, \xi)$ : Substituting the above expression into

$$\mathbb{C} \sim \frac{\bar{\eta} e^{\xi(t)} x^2}{T-t} + \frac{1}{2} \left( a + \frac{1}{2} b^2 \right) \bar{\eta} e^{\xi(t)} x^2 + \mathcal{O}(T-t)$$

$$\kappa(T-t) \rightarrow 0$$

the initial condition is determined as

$$u(\tau, \xi) = \frac{e^\xi}{\tau} - \frac{1}{2} \left( \xi - \frac{1}{2} \beta^2 \right) e^\xi + \mathcal{O}(\tau)$$

as

$$\tau \rightarrow 0$$

for each fixed  $\xi$ .

8. Terminal  $u(\tau, \xi)$  Asymptote at  $\xi < 0$ : For

$$\xi < 0$$

when trading is fast, the region of approximate validity of this trading is limited by the rate of trading itself, and this expression should be replaced by

$$u(\tau, \xi) \sim K \coth(K\tau e^{-\xi})$$

$$\xi \rightarrow -\infty$$



for

$$\tau > \mathcal{O}(e^{-\xi})$$

9. Terminal  $u(\tau, \xi)$  Asymptote at  $\xi > 0$ : For

$$\xi > 0$$

when trading is slow, the region of validity is

$$\tau \ll \mathcal{O}(1)$$

since the market itself changes on times of scale  $\mathcal{O}(1)$ . Almgren (2012) illustrates using pictorial summary the various asymptotic behavior of solutions to

$$\frac{\partial u(\tau, \xi)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi)}{\partial \xi} = e^{-\xi} [K^2 - u^2(\tau, \xi)] + \frac{1}{2} \beta^2 \frac{\partial^2 u(\tau, \xi)}{\partial \xi^2}$$

## Constant Market

1. Non-volatile Steady-State Market: The steady-state market takes

$$\beta = 0$$

Along the line

$$\xi = 0$$

the PDE



$$\frac{\partial u(\tau, \xi)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi)}{\partial \xi} = e^{-\xi} [K^2 - u^2(\tau, \xi)] + \frac{1}{2} \beta^2 \frac{\partial^2 u(\tau, \xi)}{\partial \xi^2}$$

reduces to the ODE

$$\frac{\partial u(\tau, \xi)}{\partial \tau} = K^2 - u^2(\tau, \xi)$$

with

$$u(\tau) \sim \frac{1}{\tau} + \mathcal{O}(\tau)$$

as

$$\tau \rightarrow 0$$

whose solution is

$$u(\tau) \sim K \coth(K\tau)$$

On undoing the change of variables, this reduces exactly to

$$c(t, x, \eta, \sigma) = \eta \kappa x^2 \coth[\kappa(T - t)] = \eta v(t) x$$

2. The  $\xi \rightarrow -\infty$  Case: Fast Trading: To generalize the above relation one considers the limit

$$\xi \rightarrow -\infty$$



That is, the market impact is very small, and the volatility is very large, thus the optimal strategy is trade very quickly.

3. Fast Relative to Market Relaxation: Since the market relaxation time scales are fixed, fast trading means that the program is completed before the market parameters have had time to change. Thus, the cost is the static cost

$$c(t, x, \eta, \sigma) = \eta \kappa x^2 \coth[\kappa(T - t)] = \eta v(t)x$$

using the instantaneous market parameters, which, in the transformed functions becomes

$$u(\tau, \xi) \sim K \coth(K\tau e^{-\xi})$$

$$\xi \rightarrow -\infty$$

4. Relaxation to Rolling Horizon Strategy: The corresponding trade rate is the *rolling horizon* strategy, which is always an admissible, though sub-optimal, strategy. The expression for  $u(\tau, \xi)$  accurately describes the optimal cost only in the indicated limit when indeed the market coefficients do not change substantially before trading is completed.

## Long Time

1. Asymptotic  $u(\tau, \xi)$  far from Expiration: As noted before, with coordinated variation, when time is far from expiry, the value of the function is

$$C = x^2 \sqrt{\lambda \bar{\sigma}^2 \bar{\eta}}$$

or



$$u(\tau, \xi) \rightarrow \infty$$

as

$$\tau \rightarrow \infty$$

in non-dimensional terms. Certainly

$$u = K$$

is a steady state solution of the PDE.

2. Validity of the Terminal Asymptote: And since the value function must be decreasing in  $\tau$  it is clear that

$$u(\tau, \xi) \geq K$$

for all

$$\tau \geq 0$$

As a consequence, the initial expression

$$u(\tau, \xi) = \frac{e^\xi}{\tau} - \frac{1}{2} \left( \xi - \frac{1}{2} \beta^2 \right) e^\xi + \mathcal{O}(\tau)$$

as

$$\tau \rightarrow 0$$





for each fixed  $\xi$  can only be valid when

$$\frac{e^\xi}{\tau} \geq K$$

or

$$\tau \leq \mathcal{O}(e^\xi)$$

- a very thin region when  $\xi$  is negative.

3. Uniqueness of the Solution to the PDE: Provided that a unique solution  $u(\tau, \xi)$  to

$$\frac{\partial u(\tau, \xi)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi)}{\partial \xi} = e^{-\xi} [K^2 - u^2(\tau, \xi)] + \frac{1}{2} \beta^2 \frac{\partial^2 u(\tau, \xi)}{\partial \xi^2}$$

exists, a standard verification argument establishes that this function does indeed give the optimal control to the original control problem.

4. Uniqueness of the Solution to the PDE: Since

$$\frac{\partial u(\tau, \xi)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi)}{\partial \xi} = e^{-\xi} [K^2 - u^2(\tau, \xi)] + \frac{1}{2} \beta^2 \frac{\partial^2 u(\tau, \xi)}{\partial \xi^2}$$

is a non-degenerate diffusion equation with lower-order terms, it certainly has smooth unique solutions locally in time if the solution at some positive time satisfies

$$u(\tau, \xi) < C e^{\alpha \xi^2}$$

5. Decomposition of the Initial Term: To understand the initial behavior near the initial term, writing



$$u(\tau, \xi) = \frac{e^\xi}{\tau} [1 + w(\tau, \xi)]$$

$w(\tau, \xi)$  for

$$\tau > 0$$

satisfies the PDE

$$\begin{aligned} \frac{\partial w(\tau, \xi)}{\partial \tau} + \frac{w(\tau, \xi)}{\tau} [1 + w(\tau, \xi)] \\ = K^2 \tau e^{-2\xi} - \left( \xi - \frac{1}{2} \beta^2 \right) - \left( \xi - \frac{1}{2} \beta^2 \right) w(\tau, \xi) - (\xi - \beta^2) \frac{\partial w(\tau, \xi)}{\partial \tau} \\ + \frac{1}{2} \beta^2 \frac{\partial^2 w(\tau, \xi)}{\partial \xi^2} \end{aligned}$$

as

$$\lim_{\tau \rightarrow 0} w(\tau, \xi) = 0$$

for each  $\xi$ .

6. Uniqueness of the Decomposed Solution: It is in this sense that  $u(\tau, \xi)$  satisfies its PDE

$$\frac{\partial u(\tau, \xi)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi)}{\partial \xi} = e^{-\xi} [K^2 - u^2(\tau, \xi)] + \frac{1}{2} \beta^2 \frac{\partial^2 u(\tau, \xi)}{\partial \xi^2}$$

and the singular boundary condition. Although Almgren (2012) does not formally present a proof for the existence and the uniqueness of the function  $w(\tau, \xi)$  and hence of  $u(\tau, \xi)$  there do not appear to be any obstacles.



7. Perturbation of the Decomposed Solution: A search for the perturbation expansion of the form

$$w(\tau, \xi) \sim \tau w_1(\xi) + \tau^2 w_2(\xi) + \dots$$

$$\tau \rightarrow 0$$

readily determines

$$w_1(\xi) = -\frac{1}{2} \left( \xi - \frac{1}{2} \beta^2 \right)$$

$$w_2(\xi) = \frac{1}{3} K^2 e^{-2\xi} + \frac{1}{12} \left[ \xi^2 + (2 - \beta^2) \xi + \frac{1}{4} \beta^4 - 2\beta^2 \right]$$

8. Local Behavior Description for  $u(\tau, \xi)$ : The construction of this asymptotic behavior is strong evidence that the solution exists and has the associated local behavior. Thus a description of the local behavior of  $u(\tau, \xi)$  slightly fuller than

$$u(\tau, \xi) = \frac{e^\xi}{\tau} - \frac{1}{2} \left( \xi - \frac{1}{2} \beta^2 \right) e^\xi + \mathcal{O}(\tau)$$

as

$$\tau \rightarrow 0$$

for each fixed  $\xi$  is

$$\begin{aligned} u(\tau, \xi) \sim & \frac{e^\xi}{\tau} - \frac{1}{2} \left( \xi - \frac{1}{2} \beta^2 \right) e^\xi \\ & + \tau \left\{ \frac{1}{3} K^2 e^{-2\xi} + \frac{1}{12} \left[ \xi^2 + (2 - \beta^2) \xi + \frac{1}{4} \beta^4 - 2\beta^2 \right] \right\} + \mathcal{O}(\tau^2) \end{aligned}$$



## Dynamic Programming – Custom $\eta(t)$ and $\sigma(t)$

1. Non-dimensional Liquidity and Volatility: Since  $\eta(t)$  and  $\sigma(t)$  are positive it is convenient to use

$$\xi(t) = \log \frac{\eta(t)}{\bar{\eta}}$$

and

$$\zeta(t) = \log \frac{\sigma(t)}{\bar{\sigma}}$$

as state variables.

2. Mean Market State Time Scale: Here  $\bar{\eta}$  and  $\bar{\sigma}$  are typical values of  $\eta(t)$  and  $\sigma(t)$ , and  $\xi(t)$  and  $\zeta(t)$  are non-dimensional values that fluctuate around zero.  $\bar{\kappa}$  is written as

$$\bar{\kappa} = \sqrt{\frac{\lambda \bar{\sigma}^2}{\bar{\eta}}}$$

for the intrinsic time scale in the mean market state.

3. Evolution of  $\xi(t)$  and  $\zeta(t)$ :  $\xi(t)$  and  $\zeta(t)$  are taken to evolve according to the stochastic differential equations (SDE) of the forms

$$\Delta \xi = a_{\xi} \Delta t + b_{\xi} \Delta \beta_L$$

and



$$\Delta\zeta = a_\zeta\Delta t + b_\zeta\Delta\beta_V$$

where  $a_\xi$ ,  $b_\xi$ ,  $a_\zeta$ , and  $b_\zeta$  are coefficients whose values may depend on  $\xi(t)$  and  $\zeta(t)$ .

4. Correlated Liquidity/Volatility Brownian Processes:  $\beta_L(t)$  and  $\beta_V(t)$  are Brownian motions that are independent of the process  $B(t)$  driving the price process, but possibly correlated with each other, with

$$\mathbb{E}[\Delta\beta_L\Delta\beta_V] = \rho\Delta t$$

5. Applying the Dynamic Programming Criterion: Then, by dynamic programming, it follows that

$$\mathbb{C}(t, x, \xi, \zeta) = \min_v \{ \lambda\sigma^2 x^2 \Delta t + \eta v^2 \Delta t + \mathbb{C}(t + \Delta t, x + \Delta x, \xi + \Delta\xi, \zeta + \Delta\zeta) \}$$

giving the PDE

$$\begin{aligned} 0 = & \frac{\partial \mathbb{C}(t, x, \xi, \zeta)}{\partial t} + \lambda\sigma^2 x^2 + \min_v \left[ \eta v^2 - v \frac{\partial \mathbb{C}(t, x, \xi, \zeta)}{\partial x} \right] + a_\xi \frac{\partial \mathbb{C}(t, x, \xi, \zeta)}{\partial \xi} \\ & + a_\zeta \frac{\partial \mathbb{C}(t, x, \xi, \zeta)}{\partial \zeta} + \frac{1}{2} b_\xi^2 \frac{\partial^2 \mathbb{C}(t, x, \xi, \zeta)}{\partial \xi^2} + \frac{1}{2} b_\zeta^2 \frac{\partial^2 \mathbb{C}(t, x, \xi, \zeta)}{\partial \zeta^2} \\ & + \frac{1}{2} b_\xi b_\zeta \frac{\partial^2 \mathbb{C}(t, x, \xi, \zeta)}{\partial \xi \partial \zeta} \end{aligned}$$

6. Optimality in the Trade Rate Space: The minimum is clearly

$$v = \frac{1}{2\eta} \frac{\partial \mathbb{C}(t, x, \xi, \zeta)}{\partial x}$$

and the PDE for  $\mathbb{C}(t, x, \xi, \zeta)$  is



$$\begin{aligned}
& - \frac{\partial \mathbb{C}(t, x, \xi, \zeta)}{\partial t} \\
& = \lambda \sigma^2 x^2 - \frac{1}{4\eta} \left[ \frac{\partial \mathbb{C}(t, x, \xi, \zeta)}{\partial x} \right]^2 + a_\xi \frac{\partial \mathbb{C}(t, x, \xi, \zeta)}{\partial \xi} + a_\zeta \frac{\partial \mathbb{C}(t, x, \xi, \zeta)}{\partial \zeta} \\
& + \frac{1}{2} b_\xi^2 \frac{\partial^2 \mathbb{C}(t, x, \xi, \zeta)}{\partial \xi^2} + \frac{1}{2} b_\zeta^2 \frac{\partial^2 \mathbb{C}(t, x, \xi, \zeta)}{\partial \zeta^2} + \rho b_\xi b_\zeta \frac{\partial^2 \mathbb{C}(t, x, \xi, \zeta)}{\partial \xi \partial \zeta}
\end{aligned}$$

7. Exogenous Expiration Trade Rate Asymptote: Near expiration the liquidation must happen on a linear trajectory

$$v = \frac{x}{T - t}$$

The cost comes entirely from market impact in the market conditions at that time, since volatility risk is negligible across a short time. Thus

$$\mathbb{C}(t, x, \xi, \zeta) \sim \frac{\eta x^2}{T - t}$$

$$\kappa(T - t) \rightarrow 0$$

applies, and

$$\mathbb{C}(t, x, \xi, \zeta) \sim \frac{\eta x^2}{T - t} = \frac{\bar{\eta} e^\xi x^2}{T - t}$$

$$(T - t) \rightarrow 0$$

8. De-dimensionalization of the PDE State Variables: To non-dimensionalize the cost function and the differential equation, a time scale needs to be defined, which also helps define a cost scale; the market parameters are already non-dimensionalized by their mean values.



9. Time Scale Choice - Liquidity Reversion: So far, the only two-time scales are the intrinsic liquidation time in the mean market state  $\frac{1}{\kappa}$  and the imposed horizon  $T$ . Since both of these depend on a trader's preferences for a particular trade order, it will be more natural to use a time scale based on market dynamics.

## Log-Normal Model

1. Ornstein-Uhlenbeck Mean-Reverting Dynamics: Here the assumption is that  $\xi(t)$  and  $\zeta(t)$  evolve according to the mean-reverting process of zero mean.
2.  $\xi(t)$  and  $\zeta(t)$  Drift/Wander: Accordingly

$$a_{\xi} = -\frac{\xi}{\delta_L}$$

$$a_{\zeta} = -\frac{\zeta}{\delta_V}$$

$$b_{\xi} = \frac{\beta_L}{\sqrt{\delta_L}}$$

$$b_{\zeta} = \frac{\beta_V}{\sqrt{\delta_V}}$$

3. Liquidity/Volatility Relaxation Time Scales: Here  $\delta_L$  and  $\delta_V$  are relaxation time scales for liquidity and volatility, and  $\beta_L$  and  $\beta_V$  are non-dimensional “burstiness” parameters.
4.  $\xi(t)$  and  $\zeta(t)$  Steady State: In the steady state,  $\xi(t)$  and  $\zeta(t)$  are normal with

$$\mathbb{E}[\xi(t)] \rightarrow 0$$



$$\mathbb{V}[\xi(t)] \rightarrow \frac{1}{2}\beta_L^2$$

$$\mathbb{E}[\zeta(t)] \rightarrow 0$$

$$\mathbb{V}[\zeta(t)] \rightarrow \frac{1}{2}\beta_V^2$$

as

$$t \rightarrow \infty$$

Thus  $\beta_L$  and  $\beta_V$  describe the liquidity and the volatility around their mean levels.

5.  $\delta_L$  as the Reference Time Scale: One may non-dimensionalize using  $\delta_L$  as the time scale. That is, defining

$$\tau = \frac{T-t}{\delta_L}$$

and setting

$$\mathbb{C}(t, x, \xi, \zeta) = \frac{\bar{\eta}x^2}{T-t} = u\left(\frac{T-t}{\delta_L}, \xi, \zeta\right)$$

where  $u\left(\frac{T-t}{\delta_L}, \xi, \zeta\right)$  is a non-dimensional function of non-dimensional variables, one gets





$$\begin{aligned}
& \frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi, \zeta)}{\partial \xi} + \mu \zeta \frac{\partial u(\tau, \xi, \zeta)}{\partial \zeta} \\
& = K^2 e^{2\zeta} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2} \beta_L^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi^2} + \frac{1}{2} \beta_V^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \zeta^2} \\
& + \rho \sqrt{\mu} \beta_L \beta_V \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi \partial \zeta}
\end{aligned}$$

6. Volatility Market State Time Scales: On writing

$$\mu = \frac{\delta_L}{\delta_V}$$

the multi-dimensional risk aversion parameter becomes

$$K = \bar{\kappa} \delta_L = \frac{\text{Relaxation Time for Market Liquidity}}{\text{Trade Time Scale in Mean Market State}}$$

Of course  $\tau$  is the time remaining to expiration measured in units of the market relaxation time.

7. Initial Condition Re-cast: The initial condition becomes

$$u(\tau, \xi, \zeta) = \frac{e^\xi}{\tau}$$

$$\tau \rightarrow 0$$

8. The Corresponding Dimensional Trade Rate: From

$$v = \frac{1}{2\eta} \frac{\partial C(t, x, \xi, \zeta)}{\partial x}$$

the dimensional trade velocity is



$$v = \frac{xe^{-\xi}}{\delta_L} u(\tau, \xi, \zeta)$$

9. Deterministic Liquidity and Volatility Processes: The constant volatility market takes

$$\beta_L = \beta_V = 0$$

Along the line

$$\xi = \zeta = 0$$

the PDE

$$\begin{aligned} \frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi, \zeta)}{\partial \xi} + \mu \zeta \frac{\partial u(\tau, \xi, \zeta)}{\partial \zeta} \\ = K^2 e^{2\zeta} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2} \beta_L^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi^2} + \frac{1}{2} \beta_V^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \zeta^2} \\ + \rho \sqrt{\mu} \beta_L \beta_V \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi \partial \zeta} \end{aligned}$$

reduces to the ODE

$$\frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} = K^2 - u^2(\tau, \xi, \zeta)$$

with

$$u(\tau) \rightarrow \frac{1}{\tau}$$

as



$$\tau \rightarrow 0$$

whose solution is

$$u(\tau) = K \coth K\tau$$

10. Constant Coefficient Cost Function Reduction: On undoing the change of variables, this reduces exactly to

$$\mathbb{C}(t, x, \eta, \sigma) = \eta \kappa x^2 \coth \kappa(T - t) = \eta v x$$

11. Low Market Impact/High Volatility Scenario: To generalize the above solution the limits

$$\xi \rightarrow -\infty$$

and

$$\zeta \rightarrow +\infty$$

are considered. That is, the market impact is temporarily very small and the volatility is very large; the optimal strategy would be to trade very quickly.

12. Consequence of the Fast Trading: Since the market relaxation times are fixed, fast trading means that the program is completed before the market parameters have had time to change.

13. The Corresponding Non-dimensional Cost: Thus the cost is the static cost

$$\mathbb{C}(t, x, \eta, \sigma) = \eta \kappa x^2 \coth \kappa(T - t) = \eta v x$$



using instantaneous market parameters, which in the transformed functions becomes

$$u(\tau, \xi, \zeta) \sim K e^{\zeta + \frac{1}{2}\xi} \coth K \tau e^{\zeta - \frac{1}{2}\xi}$$

$$\xi \rightarrow -\infty$$

$$\zeta \rightarrow +\infty$$

14. Comparison with the “Rolling Horizon” Approximation: The corresponding trade rate is the “rolling horizon” strategy seen earlier, which is always an admissible, although sub-optimal, strategy. The expression

$$u(\tau, \xi, \zeta) \sim K e^{\zeta + \frac{1}{2}\xi} \coth K \tau e^{\zeta - \frac{1}{2}\xi}$$

$$\xi \rightarrow -\infty$$

$$\zeta \rightarrow +\infty$$

accurately describes the optimal cost only in the indicated limit, when indeed the market coefficients do not change substantially before the trading is completed.

## Coordinated Variation

1. Coordinated Variation Case Reduction: Rather than solve the full PDE



$$\begin{aligned}
& \frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi, \zeta)}{\partial \xi} + \mu \zeta \frac{\partial u(\tau, \xi, \zeta)}{\partial \zeta} \\
& = K^2 e^{2\zeta} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2} \beta_L^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi^2} + \frac{1}{2} \beta_V^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \zeta^2} \\
& + \rho \sqrt{\mu} \beta_L \beta_V \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi \partial \zeta}
\end{aligned}$$

in two space dimensions and one time dimension, more insight can be attained by considering the coordinated variation model described above.

2. Equal Liquidity/Volatility Time Scales: Thus, the following assumptions are made on the stochastic processes. First the time scales of liquidity and volatility are assumed to be equal.

$$\delta_L = \delta_V = \delta$$

so

$$\mu = 1$$

3. Fully Correlated Liquidity/Volatility Brownian: The Brownian motions driving the liquidity and the volatility have perfect positive correlation

$$\rho = 1$$

4. Liquidity/Volatility Wander Intensity Ratio: For now the fluctuation magnitudes  $\beta_L$  and  $\beta_V$  are arbitrary. The setting is

$$\psi = -\frac{\beta_L}{\beta_V} = \frac{\text{Signed Fractional Variation of } \sigma^2}{\text{Signed Fractional Variation of } \eta}$$

so that the coordinated variation case takes



$$y = 1$$

The assumption here is that

$$y > 0$$

5. Wander Intensity Scaled Volatility/Liquidity: Then, from

$$\Delta\xi = a_\xi\Delta t + b_\xi\Delta\beta_L$$

and

$$\Delta\zeta = a_\zeta\Delta t + b_\zeta\Delta\beta_V$$

$$a_\xi = -\frac{\xi}{\delta_L}$$

$$a_\zeta = -\frac{\zeta}{\delta_V}$$

$$b_\xi = \frac{\beta_L}{\sqrt{\delta_L}}$$

$$b_\zeta = \frac{\beta_V}{\sqrt{\delta_V}}$$

one gets

$$\Delta(\beta_V\xi - \beta_L\zeta) = -(\beta_V\xi - \beta_L\zeta)\frac{\Delta t}{\delta}$$



and hence, after at most an initial transient, the solutions satisfy

$$(\beta_V \xi - \beta_L \zeta) = 0$$

or

$$\zeta = -\frac{\psi}{2}\xi$$

#### 6. The Coordinated Variation Cost PDE: The PDE

$$\begin{aligned} \frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi, \zeta)}{\partial \xi} + \mu \zeta \frac{\partial u(\tau, \xi, \zeta)}{\partial \zeta} \\ = K^2 e^{2\zeta} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2} \beta_L^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi^2} + \frac{1}{2} \beta_V^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \zeta^2} \\ + \rho \sqrt{\mu} \beta_L \beta_V \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi \partial \zeta} \end{aligned}$$

maybe re-cast as

$$\begin{aligned} \frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \left( \xi \frac{\partial}{\partial \xi} + \zeta \frac{\partial}{\partial \zeta} \right) u(\tau, \xi, \zeta) \\ = K^2 e^{2\zeta} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2} \left( \beta_L \frac{\partial}{\partial \xi} + \beta_V \frac{\partial}{\partial \zeta} \right)^2 u(\tau, \xi, \zeta) \end{aligned}$$

Ignoring cross-variation (see the reasons below) the PDE for  $u(\tau, \xi, \zeta)$  is, with

$$\beta = \beta_L$$

$$\frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi, \zeta)}{\partial \xi} = K^2 e^{-\psi \xi} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2} \beta^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi^2}$$



7. Change of Variable - Initial Condition: The initial condition is still

$$u(\tau, \xi) = \frac{e^\xi}{\tau}$$

as

$$\tau \rightarrow 0$$

8. Change of Variable - Wander Differential: To trace the change of variables in detail, introduce  $w(\tau, \xi, \zeta)$  with

$$u(\tau, \xi, \zeta) = w(\tau, \xi, \beta_V \xi - \beta_L \zeta)$$

so that

$$\left( \xi \frac{\partial}{\partial \xi} + \zeta \frac{\partial}{\partial \zeta} \right) u(\tau, \xi, \zeta) = \left( \xi \frac{\partial}{\partial \xi} + \chi \frac{\partial}{\partial \chi} \right) w(\tau, \xi, \chi)$$

and

$$\left( \beta_L \frac{\partial}{\partial \xi} + \beta_V \frac{\partial}{\partial \zeta} \right)^2 u(\tau, \xi, \zeta) = \beta_L^2 \frac{\partial^2 w(\tau, \xi, \chi)}{\partial \xi^2}$$

9. Change of Variables Zero Wander: Thus

$$\frac{\partial w(\tau, \xi, \chi)}{\partial \tau} + \left( \xi \frac{\partial}{\partial \xi} + \chi \frac{\partial}{\partial \chi} \right) w(\tau, \xi, \chi) = K^2 e^{2\zeta} - e^{-\xi} w^2(\tau, \xi, \chi) + \frac{1}{2} \beta_L^2 w(\tau, \xi, \chi)$$

and on the plane





$$\chi = 0$$

this reduces to

$$\frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi, \zeta)}{\partial \xi} = K^2 e^{-\eta \xi} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2} \beta^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi^2}$$

-

## Asymptotic Behavior

1. Short Time Frame Asymptotic Behavior: To study the behavior as

$$\tau \rightarrow 0$$

for a fixed  $\xi$  one writes

$$u(\tau, \xi) = \frac{e^\xi}{\tau} + u_0(\xi) + \tau u_1(\xi) + \dots$$

$$\tau \rightarrow 0$$

2. Short Time Higher Order Dependence: One finds that at  $\mathcal{O}\left(\frac{1}{\tau}\right)$

$$u_0(\xi) = -\frac{1}{2} \left( \xi - \frac{1}{2} \beta^2 \right) e^\xi$$

and at  $\mathcal{O}(1)$

$$3u_1(\xi) = K^2 e^{-\eta \xi} - e^{-\xi} u_0^2(\xi) - \xi u_0'(\xi) + \frac{1}{2} \beta^2 u_0''(\xi)$$



or

$$u_1(\xi) = \frac{1}{3}K^2 e^{-\psi\xi} + \frac{1}{12}e^\xi \left[ \left( \xi + 1 - \frac{1}{2}\beta^2 \right)^2 - (1 + \beta^2) \right]$$

3. Implications for the Solution Robustness: Thus  $u(\tau, \xi)$  has a regular expansion on the powers of  $\tau$ . This reassures that the singular initial data is indeed enough to define the solution.
4. Long Time Asymptotic PDE Dependence: As

$$\tau \rightarrow \infty$$

presumably there is a steady state cost and a strategy in which the horizon is not controlling. The steady state solution  $u(\xi)$  will be determined by the second order nonlinear ODE

$$\xi u' = K^2 e^{-\psi\xi} u^2 + \frac{1}{2}\beta^2 u''$$

5. Explicit Long Time Asymptote PDE: In the coordinated variation case

$$\psi = 1$$

this has a constant solution

$$u(\xi) = K$$

For

$$\psi \neq 1$$



an explicit solution cannot be given, but for

$$\psi > -1$$

the asymptotic behavior

$$u(\xi) \sim K e^{-\frac{1}{2}(\psi-1)\xi}$$

as

$$\xi \rightarrow -\infty$$

can be identified, based on the balance

$$0 = K^2 e^{-\psi\xi} - e^{-\xi} u^2$$

#### 6. Low Impact High Volatility Simplification: As

$$\xi \rightarrow -\infty$$

with

$$\psi > 0$$

one also has

$$\zeta \rightarrow +\infty$$

and thus the asymptotic solution



$$u(\tau, \xi, \zeta) \sim K e^{\zeta + \frac{1}{2}\xi} \coth\left(K \tau e^{\zeta - \frac{1}{2}\xi}\right)$$

$$\xi \rightarrow -\infty$$

$$\zeta \rightarrow +\infty$$

is valid, and simplifies to

$$u(\tau, \xi) \sim K e^{-\frac{1}{2}(\psi-1)\xi} \coth\left(K \tau e^{-\frac{1}{2}(\psi+1)\xi}\right)$$

$$\xi \rightarrow -\infty$$

7. Consistency with Long/Short Time Asymptote: At leading order this is consistent with both the short-term and the long-term behavior above.

## Numerical Solution

1. Numerical Solution to the HJB: Since explicit analytical solutions cannot be given, Almgren (2009) resorts to numerical solutions to generate solution solutions to

$$\frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi, \zeta)}{\partial \xi} = K^2 e^{-\psi \xi} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2} \beta^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi^2}$$

for a range of the given parameters.

2. Choice for the Fluctuation Ratio: The coordination parameter  $\psi$  should be chosen as part of the market structure. Since there is no particular reason to choose other values



$$\psi = 1$$

shall be considered.

3. Solution to the Generalized HJB: Similarly, Almgren (2009) does not illustrate numerical solutions to the two-variable problem

$$\begin{aligned} \frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi, \zeta)}{\partial \xi} + \mu \zeta \frac{\partial u(\tau, \xi, \zeta)}{\partial \zeta} \\ = K^2 e^{2\zeta} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2} \beta_L^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi^2} + \frac{1}{2} \beta_V^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \zeta^2} \\ + \rho \sqrt{\mu} \beta_L \beta_V \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi \partial \zeta} \end{aligned}$$

since a truly complete study would also consider a broader range of market dynamics models.

4. Choice of the Burstiness Parameters: The burstiness parameter  $\beta$  is stock-specific. A large cap stock will have a  $\beta$  near zero, for a near-uniform profile. A small cap stock will have

$$\beta = 1$$

or larger. For the sample calculations below  $\beta$  is fixed at 2 – a relatively large value to better illustrate the effects of market variation.

5. Choice of the Risk Aversion: The risk aversion parameter  $K$  must range across non-negative values, since the actual choice of the trajectory will be determined by the trader's risk preference. Values of  $K$  smaller than 1 are the most realistic, so that the algorithm has time to adapt to at least one market reversion time.
6. Technical Issues behind the Solution: Almgren (2009) briefly discusses a few issues with space and time discretization, and presents example solutions, which is covered below.



## Time Discretization

1. Rationale for the Modified Euler Scheme: The first obstacle is that the initial condition is given as singular behavior. A simple modification to the Euler's forward scheme handles this problem. This is illustrated below using an ordinary differential equation (ODE).
2. The ODE and its Solution: Consider

$$\frac{du(t)}{dt} = -(u - a)(u - b)$$

$$u(t) \sim \frac{1}{t}$$

as

$$t \rightarrow 0$$

whose exact solution is

$$u(t) = \frac{ae^{-bt} - be^{-at}}{e^{-bt} - e^{-at}}$$

3. Local Expansion at the Origin: Either by expanding the solution, or directly from the ODE, the local expansion is determined as

$$u(t) \sim \frac{1}{t} + \frac{1}{2}(a + b) + \frac{t}{12}(a - b)^2 + \dots$$

as



$$t \rightarrow 0$$

4. Euler Scheme on Modified ODE: For the numerics a forward Euler scheme is applied to

$$w(t) = tu(t)$$

which is regular near

$$t = 0$$

With

$$w'(t) = tu'(t) + u(t)$$

and denoting

$$u_n \approx u(t_n)$$

this gives

$$u_{n+1} = u_n + \frac{t_n}{t_{n+1}}(t_{n+1} - t_n)u_n'$$

5. Correction to the Euler Update: Thus, a correction is applied to the Euler update formula, which becomes small as one moves away from the initial singular time and

$$\frac{t_n}{t_{n+1}} \rightarrow 1$$



6. Evolution on a Time Grid: The test is done on a regular grid with

$$t_n = n\Delta t$$

starting at

$$n = k \geq 1$$

$k$  is chosen to satisfy the stability criterion for the forward Euler scheme.

7. The First Time Node: For an ODE

$$\frac{du}{dt} = f(u)$$

the stability criterion requires that

$$\Delta t < \frac{1}{\left| \frac{df(u)}{du} \right|}$$

In this case

$$\frac{df(u)}{du} \sim 2u \sim \frac{2}{t}$$

so the stability criterion translates to

$$\Delta t < \frac{t}{2}$$

or





$$t > 2\Delta t$$

Thus one can expect the scheme to be stable for

$$k \geq 2$$

8. Discretization Modification to the Scheme: Four cases, resulting from all combinations of the two parameters, are explored. First:
  - a. The forward Euler discretization scheme can be applied directly to  $u$
  - b. The forward Euler discretization scheme can be applied directly to  $tu$  as seen above.
9. First Time Step Data Update: Second, for the data at the first-time step:

a.

$$u_k = \frac{1}{t_k}$$

using the given initial conditions

b.

$$u_k = \frac{1}{t_k} + \frac{1}{2}(a + b)$$

using the local expansion

$$u(t) \sim \frac{1}{t} + \frac{1}{2}(a + b) + \frac{t}{12}(a - b)^2 + \dots$$

as

$$t \rightarrow 0$$



10. Improvements from Discretization/Data Modifications: Almgren (2009) carries a demonstration of the example solutions. The combination of improved initial data, with a time discretization that takes into account the initial singularity, yields far more accurate results than naïve discretization.

## Space Discretization

1. Diffusion and Convection Terms Discretization: Almgren (2009) uses a 3-point standard discretization scheme for the diffusion term, and upwind differencing for the convection term (see, for example, Le Veque (1992)). A forward Euler time discretization scheme with the correction seen earlier is used; thus, a small-time step is used for stability.
2. Initial Time Node Discretization Scheme: For initial data, the asymptotic expressions

$$u(\tau, \xi) = \frac{e^\xi}{\tau} + u_0(\xi) + \tau u_1(\xi) + \dots$$

$$\tau \rightarrow 0$$

$$u_0(\xi) = -\frac{1}{2} \left( \xi - \frac{1}{2} \beta^2 \right) e^\xi$$

and

$$3u_1(\xi) = K^2 e^{-\psi\xi} - e^{-\xi} u_0'^2(\xi) - \xi u_0'(\xi) + \frac{1}{2} \beta^2 u_0''(\xi)$$

or



$$u_1(\xi) = \frac{1}{3}K^2 e^{-\psi\xi} + \frac{1}{12}e^\xi \left[ \left( \xi + 1 - \frac{1}{2}\beta^2 \right)^2 - (1 + \beta^2) \right]$$

are used at an initial time

$$t = k\Delta t$$

3. Discretizing the Initial Trade Date: It is more convenient to discretize

$$v(\tau, \xi) = e^{-\xi} u(\tau, \xi)$$

rather than  $u$  directly; from

$$v = \frac{x}{\delta_L} e^{-\xi} u(\tau, \xi, \zeta)$$

this is the instantaneous trade rate, except for the dimensional factor. The PDE for  $v$  is easily derived from

$$\frac{\partial u(\tau, \xi, \zeta)}{\partial \tau} + \xi \frac{\partial u(\tau, \xi, \zeta)}{\partial \xi} = K^2 e^{-\psi\xi} - e^{-\xi} u^2(\tau, \xi, \zeta) + \frac{1}{2}\beta^2 \frac{\partial^2 u(\tau, \xi, \zeta)}{\partial \xi^2}$$

4. Left Far Field Boundary Condition: A finite spatial domain

$$-\Xi \leq \xi \leq \Xi$$

is used. At the left boundary

$$\xi = -\Xi$$

the far field solution



$$u(\tau, \xi) \sim K e^{-\frac{1}{2}(\psi-1)\xi} \coth\left(K \tau e^{-\frac{1}{2}(\psi+1)\xi}\right)$$

$$\xi \rightarrow -\infty$$

is used.

5. Right Far Field Boundary Condition: At the right boundary

$$\xi = +\Xi$$

the “natural” boundary conditions

$$\frac{\partial^2 v(\tau, \xi, \zeta)}{\partial \xi^2} = 0$$

are used. Since the convective term is flowing outwards, the effect of the boundary conditions is confined to a narrow boundary layer.

## Almgren (2009, 2012) Sample Solutions

1. Runs for  $\psi = 1$ ,  $\beta = 1$ , and  $K = 0.1$ : Almgren (2009, 2012) illustrate the computed solution of the PDE for

$$\psi = 1$$

$$\beta = 1$$

and



$$K = 0.1$$

As noted above, the natural log of  $e^{-\xi}u$  - the dimensionless trade rate as a fraction of the shares remaining – is examined.

2. High Impact/Low Volatility Behavior: As expected, when  $\tau$  is small, the trade rate becomes large like  $\frac{1}{\tau}$ . When  $\xi$  is large positive the market impact is high and the volatility is low, so the optimal strategy trades very slowly except near expiration.
3. Low Impact High Volatility Behavior: When  $\xi$  is large negative, the market impact is low and the volatility is high, so the optimal strategy trades rapidly. As

$$\tau \rightarrow \infty$$

the solution approaches the steady state

$$\log(e^{-\xi}u) = \log K - \xi$$

4. Realization of the Market State: Almgren (2009, 2012) also show a realization of the market state process  $\xi(t)$  used for the trajectory simulations. With the “coordinated variation” approximation, the market moves back and forth between a high-activity regime with low impact and high volatility (small  $\xi$ ) and a low-activity regime with high impact and low volatility (large  $\xi$ ).
5. Multi-Market Cycle Simulation Span:

$$\beta = 1$$

has been assumed so that the root mean square fluctuation of  $\xi(t)$  is  $\frac{1}{2}$ . The mean reversion time is

$$\delta = 1$$



so that with a time

$$T = 10$$

several market cycles are experienced.

6. Response Dynamics across Risk Aversion: The optimal trading trajectories are examined for several values of the risk aversion parameter  $K$  and are compared with the non-adaptive trajectories computed in the mean market state. From these examinations the dynamic nature of the response is very clear.
7. Trading Slow Down/Speed Up: For instance, in the simulation, Almgren (2009, 2012) shows that around

$$t = 1$$

the market state is poor, so all trajectories trade slowly and fall behind the static ones. Around

$$t = 1.5$$

there is a brief burst of liquidity, and all the trajectories accelerate in response.

8. Impact of Urgency of the Trajectory: The trajectories with lower urgency have more shares remaining to trade, so they are able to react more than the high-urgency trajectories, which have completed a substantial fraction of the goal by that time. Thus the lowest urgency trajectory is able to adapt and is able to benefit from an eventual large and prolonged burst of liquidity.
9. “Rolling Horizon” vs. Fast Trading: For large risk aversion (fast trading), this approximate strategy is almost identical to the optimum.



10. “Rolling Horizon” vs. Slow Trading: For smaller risk-aversion (slow trading), the rolling horizon strategy almost rigidly follows a straight-line trajectory, while the true optimum is able to adapt to the varying market state even when its profile is linear.
11. Validity of the “Rolling Horizon” Approximation: In general, the rolling horizon strategy seems to be an adequate approximation when the risk aversion is relatively high.

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# Order Placement in Limit Order Markets

## Overview

1. Limit/Market Orders across Exchanges: To execute a trade, participants in electronic equity markets may choose to submit limit order or market orders across various exchanges where a stock is traded.
2. Parameters Influencing the Submission Decision: The decision is influenced by the characteristics of the order flow and queue sizes in each limit order book, as well as the structure of transaction fees and rebates across exchanges.
3. Framework for Order Placement Problem: Cont and Kukanov (2017) propose a quantitative framework for studying this *order placement* problem by formulating it as a convex optimization problem.
4. Interplay between the Placement Parameters: This formulation allows studying how the interplay between the state of the order books, the fee structure, the order flow properties, and the preferences of a trader determine the optimal placement decision.
5. Case of a Single Exchange: In the case of a single exchange, an explicit solution for the optimal order split between limit and market orders is derived.
6. Case of Multiple Exchanges: For the general problem of order placement across multiple exchanges, they propose a stochastic algorithm for computing the optimal policy and study the sensitivity of the solution to various parameters using a numerical implementation of the algorithms.

## Introduction

1. Decomposition of the Trading Process: In automated electronic financial markets, the trading process is divided into several stages, each taking place on a different time



horizon; portfolio allocation decisions are usually made on a monthly or a daily basis and translate into trades that are executed over minutes to several days.

2. Modeling the Optimal Trade Execution: Studies on optimal trade execution (Bertsimas and Lo (1998), Almgren and Chriss (2000)) have investigated how the execution cost of a large trade may be reduced by splitting it into multiple *orders* spread in time.
3. Order Scheduling Followed by Placement: Once this *order scheduling* decision is taken, one still needs to specify how each individual order should be *placed*, this order placement decision involves the choice of an *order type* – limit order, market order – order size and destination, when multiple trading venues are available.
4. Timeframe for Order Filling: Orders are filled over short time intervals of few seconds to several minutes and the mechanics of how the orders are filled in the limit order book are relevant for such order placement decisions.
5. Impact of the Order Decisions: Market participants need to make such decisions thousands of time each day, and their outcomes have a large impact on each participant's transaction cost as well as on aggregate market dynamics.
6. Process for Filling the Order: Early work on optimal trade execution (Bertsimas and Lo (1998), Almgren and Chriss (2000)) did not explicitly model the process by which each order is filled, but more recent formulations have tried to incorporate some elements in this direction.
7. First Approach - Use of Market Orders: In one stream of literature – see Obizhaeva and Wang (2006), Alfonsi, Fruth, and Schied (2010), Predoiu, Shaikhet, and Shreve (2011) – a trader is restricted to using market orders whose execution costs are given by an idealized order book shape function.
8. Second Approach - Random Order Filling: Another approach is to model the process through which a order is filled as a dynamic random process (Cont (2011), Cont and de Larrard (2013)) and thus formulate the optimal execution problem as a stochastic control problem; this formulation has been studied in various settings in limit orders (Bayraktar and Ludkovski (2012), Gueant and Lehalle (2013)) or limit and market



orders (Guilbaud and Pham (2012), Huitema (2014)) but its complexity makes it intractable unless restrictive assumptions are made on price and order book dynamics.

9. Focus of this Chapter: This chapter adopts a simpler, more tractable approach; assuming that the trade execution schedule has been specified, the focus is on the task of filling each order.
10. Decoupling Order Scheduling from Placement: Decoupling the scheduling problem from the order placement problem leads to a more tractable approach which is closer to the market practice and allows us to incorporate some realistic features which matter for the order placement decisions while preserving analytical tractability.
11. Order Placement and Routing Decisions: Individual order placement and routing decisions play an important role in modern financial markets.
12. Legally Mandated Best Execution Quality: Brokers are commonly obliged by law to deliver the best execution quality to their clients and empirical evidence confirms that a large percentage of market orders in the US and Europe is sent to trading venues providing lower execution costs or smaller delays (Boehmer and Jennings (2007), Foucault and Menkveld (2008)).
13. Use of Market vs. Limit Orders: Market orders gravitate towards exchanges with larger posted quote sizes and low fees, while limit orders are submitted to exchanges with high rebates and lower execution waiting times – see Maglaras, Moallemi, and Zheng (2011).
14. Investors Aggregate Order Routing Decisions: The studies demonstrate how investors' aggregate order routing decisions have a significant influence on the market dynamics, but a systematic study of the order routing problem from the investor's perspective is lacking.
15. Limit Order Reduced Form Model: A reduced-form model for routing an infinitesimal order to a single destination is used by Maglaras, Moallemi, and Zheng (2011), while Laruelle, Lehalle, and Pages (2010) and Ganchev, Nevmyvaka, Kearns, and Vaughan (2010) propose numerical algorithms to optimize order executions across multiple dark pools, where supply/demand is unobserved.



16. Order Type Placement across Exchanges: Cont and Kukanov (2017) are the first to provide a detailed treatment of investor's order placement decision in a multi-exchange market, unified with market/limit order choice.
17. Quantitative Formulation of Order Placement: The key contribution of this chapter is the quantitative formulation of the order placement problem which takes into account multiple important factors – the size of an order to be executed, lengths of order queues across exchanges, statistical properties of order flows in these exchanges, trader's execution preferences, and the structure of liquidity rebates across trading venues.
18. Tractable Optimal Allocation Solution: The problem formulation is tractable and intuitive, and blends the aforementioned factors into an optimal allocation of limit and market orders across available trading venues.
19. Routing Heuristics from Past Behavior: Order routing heuristics employed in practice depend on past order fill rates at each exchange and are inherently backward-looking.
20. Order Routing Forward-looking Treatment: In contrast, the approach here is forward-looking – the optimal order allocation depends on the current queue sizes and distributions of future trading volumes across exchanges.
21. Case of a Single Exchange: When only a single exchange is available for execution, the order placement problem is reduced to the problem of choosing an optimal split between market and limit orders.
22. Explicit Solution for Single Exchange: An explicit solution to this problem is derived and its sensitivity to the order size, the trader's urgency for filling the order, and other factors is analyzed.
23. Case of Two Trading Venues: Similar results are also established in the case of two trading venues under some approximations on order flow distributions.
24. Case of Multiple Exchanges: Finally, a stochastic approximation method is proposed for solving the order placement problem in the general case and its efficiency is demonstrated through examples.
25. Numerical Solution using Stochastic Approximation: The numerical examples demonstrate that the use of optimal order placement method allows for substantial



trading cost decreases in comparison with the various ‘naïve’ order placement strategies.

26. Modeling the Execution Risk: An important aspect of the framework is to account for *execution risk*, through the incorporation of a penalty for under- or over-filling an order.
27. Penalizing Time-sensitive Executions: This penalty is high for time-sensitive executions or when it is costly up on the unfilled portion of the order.
28. When Market Orders are Preferred: Although market orders are executed at a less favorable price, it becomes optimal to use them when execution risk is a primary concern.
29. Determining Optimal Limit-Order Sizes: Optimal limit order sizes are strongly influenced by total quantities of orders queuing for execution at each exchange and by the distribution of order outflows from these queues.
30. When Limit Orders are Preferred: For example, if at one of the exchanges the queue size is much smaller than the expected future order outflow, it is optimal to place a large limit order there.
31. Impact of Total Order Size: Finally, the total order size plays an important role – limit orders are used predominantly to execute small order sizes and market orders are used for medium and large sizes.
32. Limitations in Filling Limit Orders: The amount that can be realistically filled with a limit order at each exchange is naturally constrained by the corresponding queue size and order outflow distribution, so the share of market orders in the optimal allocation increases as the total order size increases.
33. Limit Order Split across Exchanges: It is found that the optimal order allocation always splits the total quantity among all available exchanges, suggesting that there is a benefit in having multiple markets.
34. Formulation of Order Placement Problem: The next section describes the formulation of the order placement and shows that it has a global optimum.
35. Optimal Market/Limit Order Split: The section following that derives an optimal split between market and limit orders for a single exchange.



36. Order Placement on Multiple Venues: The penultimate section analyzes the general case of order placement on multiple trading venues.
37. Numerical Algorithm for Order Placement: The final section presents a numerical algorithm for solving the order placement problem in a general case and the simulation results, and follows with the conclusion.
38. Proofs: All proofs are presented right where the proposition is stated.

## The Order Placement Problem

1. Mandate to Buy  $S$  Shares: Consider a trader who has a mandate to buy  $S$  shares of a stock within a short time interval  $[0, T]$ . The deadline  $T$  may be a fixed horizon, e.g., 1 minute, or a stopping time triggered by a market activity.
2. Submission of  $K$  Limit Orders: To gain queue priority the trader may immediately submit  $K$  limit orders of sizes  $L_k$  to various exchanges

$$k = 1, \dots, K$$

or submit one market order of size  $M$ .

3. Optimal Order Placement State Vector: The trader's *order placement* decision is thus summarized by a vector

$$X \triangleq (M, L_1, \dots, L_K) \in \mathbb{R}_+^{K+1}$$

whose components are non-negative, i.e., only buy orders are allowed.

4. Goal - Formulation of Comprehensive Framework: The objective is to define a meaningful framework in which the trader may choose the various settings for this decision.



5. Filling Market Order with Certainty: The focus is on limit order placement and execution and the assumption is that a market order of size  $M$  can be filled immediately and with certainty.
6.  $S$  Small relative to Depth: This assumption is reasonable if  $S$  is small relative to the prevailing market depth. Under the assumption of immediate and certain market order execution, it is easy to show that sending market orders to exchanges with high fees is always sub-optimal.
7. Single Exchange for Market Order: One therefore considers a single exchange – with the smallest liquidity fee – for the purpose of sending a single market order.
8. Limit Orders on Pre-existing Queues: Limit orders with quantities  $(L_1, \dots, L_k)$  join queues of pre-existing limit orders of sizes  $(Q_1, \dots, Q_k)$  at the best bids of  $K$  exchanges, where

$$Q_k \geq 0$$

9. Bid Queues at Best Prices: To simplify the notation, one makes an assumption that all available  $K$  bid queues are lined up at the best price, but this is easily relaxed.
10. Modeling the Queue Outflow Process: Denote by

$$x_+ \triangleq \max(x, 0)$$

If  $L_k$  is constant within  $[0, T]$ , the amount purchased by a limit order on exchange  $k$  by time  $T$  is equal to  $(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+$  where

$$\xi_k \triangleq C_k + D_k$$

is an order outflow from the front of the  $k^{th}$  bid queue consisting of

$$C_k \in [0, Q_k]$$



cancelations of pre-existing orders from that queue and  $D_k$  trades with contra-side marketable orders reaching the queue.

11. Random Limit Order Fill Process: It is specifically noted that the limit order fill amounts are random, and partial fills are allowed.
12. Total Amount Purchased by the Placement: The *total amount*  $A(X, \xi)$  bought by the trader by time  $T$  with all of his orders is a function of his order allocation  $X$  and an overall bid queue outflow

$$\xi = (\xi_1, \dots, \xi_K)$$

$$A(X, \xi) = M + \sum_{k=1}^K [(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+]$$

13. Expression for the Transaction Execution Cost: The total price of this purchase is divided into a benchmark cost paid regardless of the trader's decisions, computed using a mid-quote price level, and an execution cost given by

$$(s + f)M - \sum_{k=1}^K (s + r_k)[(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+]$$

where  $s$  is half of the bid-ask spread at time 0,  $f$  is the lowest available liquidity fee, and  $r_k$

$$k = 1, \dots, K$$

are liquidity rebates for all exchanges.

14. Limit Orders Lower the Cost: The trader can reduce the execution cost by sending more limit orders, but this leads to a risk of falling behind the target quantity  $S$  because the fills are random.





15. Penalization of the Execution Cost: To capture this *execution risk* one includes, in the objective function, a penalty for violations of target quantity in both directions

$$\lambda_U [S - A(X, \xi)]_+ + \lambda_O [A(X, \xi) - S]_+$$

where  $\lambda_U, \lambda_O$  are marginal penalties for falling behind or exceeding the execution target  $S$ , respectively.

16. Incorporating Adverse Selection Price Movements: These penalties are motivated by a correlation that exists between limit order executions and price movements, the so-called adverse selection.

17. Consequence of Under-filling the Order: If

$$A(X, \xi) < S$$

the trader has to purchase the remaining  $S - A(X, \xi)$  shares at time  $T$  with market orders.

18. Transaction Cost Impact of Under-filling: Adverse selection implies that conditionally on the event

$$\{A(X, \xi) < S\}$$

prices likely have moved up and the transaction cost of market orders at time  $T$  is higher than at time 0, i.e.,

$$\lambda_U > s + f$$

19. Incorporation of the Buyer's Remorse: Alternatively, if

$$A(X, \xi) < S$$



the trader experiences buyer's remorse, i.e., conditional on this event, prices have moved down and the trader could have achieved better execution by being more patient.

20. Tuning Parameters to Capture "Alpha": Besides adverse selection, the parameters  $\lambda_U$ ,  $\lambda_O$  may reflect the trader's execution preferences. For example, a trader with a positive forecast of short-term returns may prefer to trade early with a market order and set a larger value for  $\lambda_U$ .

21. Optimal Order Placement Problem - Statement: An optimal order placement is a vector

$$X^* \in \mathbb{R}_+^{K+1}$$

solution to

$$\min_{X \in \mathbb{R}_+^{K+1}}$$

where

$$\begin{aligned} v(X, \xi) = & (s + f)M - \sum_{k=1}^K (s + r_k)[(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+] \\ & + \lambda_U[S - A(X, \xi)]_+ + \lambda_O[A(X, \xi) - S]_+ \end{aligned}$$

is the sum of the execution cost and penalty for the execution risk.

22. Range Restriction on the Parameters: Denoting

$$V(X) = \mathbb{E}[v(X, \xi)]$$

this section begins by placing certain economically reasonable restrictions on the parameter values.



## The Optimal Order Problem – Assumptions

1. Penalty for Under/Over Filling:

$$\lambda_U > 0$$

$$\lambda_O > 0$$

The trader is penalized for falling behind or exceeding the target quantity.

2. Suboptimal to exceed the Target:

$$\lambda_O > s + \max_k \{r_k\}$$

and

$$\lambda_O > -(s + f)$$

It is suboptimal to exceed the target quantity  $S$  regardless of fees and rebates.

3. Enforcing Limit Order Cost Reduction:

$$s + \min_k \{r_k\} > 0$$

Even if some  $r_k$  are negative, limit orders still reduce the execution cost.

4. Convex Nature of the Problem: Proposition 1 below shows that it is not optimal to submit market or limit orders that are *a priori* too large or too small, i.e., larger than the target size  $S$  or whose sum is less than  $S$ . Proposition 2 guarantees the existence of an optimal solution.



## The Optimal Order Problem – Proposition 1

1. Compact Convex Subset of State Vector: Consider  $\mathcal{C}$  – a compact convex subset of  $\mathbb{R}_+^{K+1}$  defined by

$$\mathcal{C} \triangleq \left\{ X \in \mathbb{R}_+^{K+1} \mid 0 \leq M \leq S, 0 \leq L_k \leq S - M, k = 1, \dots, K, M + \sum_{k=1}^K L_k \geq S \right\}$$

2. Infimum achieved under Compact Set: Under the assumptions

$$\lambda_U > 0$$

$$\lambda_O > 0$$

$$\lambda_O > s + \max_k \{r_k\}$$

$$\lambda_O > -(s + f)$$

for any

$$\tilde{X} \notin \mathcal{C}$$

$$\exists \tilde{X}' \in \mathcal{C}$$

has

$$V(\tilde{X}') \leq V(\tilde{X})$$



3. Strictness of the Inequality: Moreover, if

$$\min_k \mathbb{P}[\xi_k > Q_k + S] > 0$$

the inequality is strict:

$$V(\tilde{X}') < V(\tilde{X})$$

4. Proof Start - Case where  $\tilde{M} > S$ : First, for any allocation  $\tilde{X}$  that has

$$\tilde{M} > S$$

one automatically has

$$A(\tilde{X}) > S$$

and it can be shown that the random cost and penalty  $\tilde{X}$  is larger than those of

$$X_{naive} \triangleq (S, 0, \dots, 0) \in \mathcal{C}$$



$$\begin{aligned}
v(\tilde{X}, \xi) - v(X_{naive}, \xi) &= (s + f)(\tilde{M} - S) - \sum_{k=1}^K (s + r_k)[(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+] \\
&\quad + \lambda_o \left\{ \tilde{M} - S + \sum_{k=1}^K (s + r_k)[(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+] \right\} \\
&= (\lambda_o + s + f)(\tilde{M} - S) \\
&\quad + \sum_{k=1}^K (\lambda_o - s - r_k)[(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+] > 0
\end{aligned}$$

which holds for all random  $\xi$ . Therefore

$$V(\tilde{X}) > V(X_{naive})$$

5. Case where  $L_k > S - \tilde{M}$ : Similarly, for any allocation  $\tilde{X}$  with

$$\tilde{L}_k > S - \tilde{M}$$

define a different allocation  $\tilde{X}'$  by

$$\tilde{M}' = \tilde{M}$$

$$\tilde{L}'_j = \tilde{L}_j \forall j \neq k$$

and

$$\tilde{L}'_k = S - \tilde{M}$$

6.  $V(X, \xi)$  Difference when  $\xi_k > Q_k + S - M$ : Then



$$v(\tilde{X}, \xi) - v(\tilde{X}', \xi) = 0$$

on the event

$$B = \{\omega \mid \xi_k(\omega) < Q_k + S - M\}$$

7.  $V(X, \xi)$  Difference in the Complementary Case: On its complementary event  $B_c$

$$\begin{aligned} v(\tilde{X}, \xi) - v(\tilde{X}', \xi) \\ = -(s + r_k)[(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+] \\ + \lambda_o[(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+] \end{aligned}$$

8. Directionality of the above Difference: Therefore

$$\begin{aligned} V(\tilde{X}) - V(\tilde{X}') &= \mathbb{E}[v(\tilde{X}, \xi) - v(\tilde{X}', \xi) \mid B] \mathbb{P}[B] + \mathbb{E}[v(\tilde{X}, \xi) - v(\tilde{X}', \xi) \mid B_c] \mathbb{P}[B_c] \\ &= 0 + \mathbb{E}[\{\lambda_o - (s + r_k)\} \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+\}] \mathbb{P}[B_c] \geq 0 \end{aligned}$$

with a strict inequality when

$$\mathbb{P}[B_c] > 0$$

9. Truncation across Exchanges with  $L'_j > S - \tilde{M}$ : If

$$\tilde{X}' \in \mathcal{C}$$

one can continue truncating limit order sizes

$$L'_j > S - \tilde{M}$$



using the same argument. Each time the truncation does not increase the objective function and finally one obtains

$$\tilde{X}'' \in \mathcal{C}$$

such that

$$V(\tilde{X}) \geq V(\tilde{X}'')$$

10. Assigning the Under-filled Order Amounts: Next, if  $\tilde{X}$  is such that

$$\tilde{M} + \sum_{k=1}^K \tilde{L}_k < S$$

define

$$s = S - \tilde{M} - \sum_{k=1}^K \tilde{L}_k$$

take

$$\tilde{M}' = \tilde{M}$$

$$\tilde{L}'_k = \tilde{L}_k$$

$$k = 1, \dots, K - 1$$

and





$$\tilde{L}'_K = \tilde{L}_K + s$$

11.  $v(\tilde{X}, \xi)$  when  $\xi_K < Q_K + \tilde{L}_K$ : Then, on the event

$$B = \{\omega \mid \xi_K(\omega) < Q_K + \tilde{L}_K\}$$

where one has

$$v(\tilde{X}', \xi) = v(\tilde{X}, \xi)$$

12. Proof End -  $v(\tilde{X}, \xi)$  when  $\xi_K \geq Q_K + \tilde{L}_K$ : However, on the complementary event  $B_c$

$$\begin{aligned} v(\tilde{X}, \xi) - v(\tilde{X}', \xi) \\ &= (s + r_K) \left[ (\xi_K - Q_K - \tilde{L}_K)_+ - (\xi_K - Q_K - \tilde{L}_K - s)_+ \right] \\ &\quad + \lambda_U \left[ (\xi_K - Q_K - \tilde{L}_K)_+ - (\xi_K - Q_K - \tilde{L}_K - s)_+ \right] \end{aligned}$$

therefore

$$\begin{aligned} V(\tilde{X}) - V(\tilde{X}') &= \mathbb{E}[v(\tilde{X}, \xi) - v(\tilde{X}', \xi) \mid B] \mathbb{P}[B] + \mathbb{E}[v(\tilde{X}, \xi) - v(\tilde{X}', \xi) \mid B_c] \mathbb{P}[B_c] \\ &= 0 \\ &\quad + \mathbb{E} \left[ \{ \lambda_U + (s + r_K) \} \left\{ (\xi_K - Q_K - \tilde{L}_K)_+ \right. \right. \\ &\quad \left. \left. - (\xi_K - Q_K - \tilde{L}_K - s)_+ \right\} \mid B_c \right] \mathbb{P}[B_c] \geq 0 \end{aligned}$$

with a strict inequality of

$$\mathbb{P}[B_c] > 0$$



13. Penalizer Terms as Soft Penalties: The penalty function  $\lambda_U[S - A(X, \xi)]_+ + \lambda_O[A(X, \xi) - S]_+$  implements a soft constraint for order sizes and effectively focuses the search for an optimal order allocation to the set  $\mathcal{C}$ .
14. Incorporation of Additional Meaningful Constraints: Specific economic or operational considerations could also motivate hard constraints, e.g.

$$M = 0$$

or

$$\sum_{k=1}^K L_k = S$$

Such constraints can be easily included in this framework, but absent the aforementioned considerations, they are not imposed here.

## The Optimal Order Problem – Proposition 2

1. Existence of a Global Minimum: Under assumptions

$$\lambda_U > 0$$

$$\lambda_O > 0$$

$$\lambda_O > s + \max_k \{r_k\}$$

$$\lambda_O > -(s + f)$$



$$s + \max_k \{r_k\} > 0$$

$V(X)$  is a convex function on  $\mathbb{R}_+^{K+1}$  bounded below, and has a global minimizer

$$X^* \in \mathcal{C}$$

2. Proof Start - Concave Limit Order Purchase Functions: First, note that  $(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k)_+$  are concave functions of  $L_k$ . Therefore,  $A(X, \xi)$  is concave as a sum of concave functions.
3. Criteria Determining Cost Term Convexity: Similarly, the cost term in  $v(X, \xi)$  is a sum of convex functions, as long as

$$r_k \geq -s$$

$$k = 1, \dots, K$$

and is itself a convex function.

4. Convex Cost Function Terms: Further, since  $S - A(X, \xi)$  is a convex function of  $X$ , and the function

$$h(x) \triangleq [\lambda_U(x)]_+ - [\lambda_O(-x)]_+$$

is convex in  $x$  for positive  $\lambda_U$  and  $\lambda_O$ , the penalty term  $h(S - A(X, \xi))$  is also convex.

5. Case where  $V(X)$  has Lower Bound: If

$$\lambda_O > s + \max_k \{r_k\}$$

the function  $V(X)$  is also bounded from below since



$$v(X, \xi) \geq -\left(s + \max_k \{r_k\}\right) S$$

6. Local/Global Minimum on  $\mathcal{C}$ : Finally, since  $V(X)$  is convex, it is also continuous and reaches on local minimum  $V_{min}$  on the compact set  $\mathcal{C}$  at some point

$$X^* \in \mathcal{C}$$

By convexity,  $V_{min}$  is a global minimum of  $V(X)$  on  $\mathcal{C}$ .

7. Proof End - Global Minimum across  $\mathbb{R}_+^{K+1}$ : Moreover, since

$$\lambda_o > s + \max_k \{r_k\}$$

Proposition 1 guarantees that

$$V_{min} < V(\tilde{X})$$

for any

$$\tilde{X} \in \mathcal{C}$$

so  $V_{min}$  is also a global minimum of  $V(X)$  on  $\mathbb{R}_+^{K+1}$ .

## Choice of Order Type: Limit Orders vs Market Orders

1. Trade-off – Limit against Market: To highlight the tradeoff between limit and market order executions in the optimization setup, one first considers the case where the asset is traded on a single exchange, and the trader has to choose an optimal split between limit and market orders.



2. Elimination of the Exchange Subscript: Since

$$K = 1$$

the subscript 1 is suppressed throughout this section.

### **Proposition 3 – Single Exchange: Optimal Split between Limit and Market Orders**

1. Lower and Upper  $\lambda_U$  Bounds: Assume that  $\xi$  has a continuous distribution and that

$$\lambda_U > 0$$

$$\lambda_O > 0$$

$$\lambda_O > s + \max_k \{r_k\}$$

$$\lambda_O > -(s + f)$$

$$s + \max_k \{r_k\} > 0$$

Denote

$$\underline{\lambda_U} \triangleq \frac{2s + f + r}{F(Q + S)} - (s + r)$$

and



$$\overline{\lambda_U} \triangleq \frac{2s + f + r}{F(Q)} - (s + r)$$

2. Case where  $\lambda_U \leq \underline{\lambda_U}$ : If

$$\lambda_U \leq \underline{\lambda_U}$$

the optimal allocation is

$$(M^*, L^*) = (0, S)$$

3. Case where  $\lambda_U \geq \overline{\lambda_U}$ : If

$$\lambda_U \geq \overline{\lambda_U}$$

the optimal allocation is

$$(M^*, L^*) = (S, 0)$$

4.  $\lambda_U$  Values between the Bounds: If

$$\lambda_U \in (\underline{\lambda_U}, \overline{\lambda_U})$$

the optimal allocation is:

$$M^* = S - F^{-1} \left( \frac{2s + f + r}{\lambda_U + s + r} \right) + Q$$

$$L^* = F^{-1} \left( \frac{2s + f + r}{\lambda_U + s + r} \right) - Q$$



where  $F(\cdot)$  is a cumulative distribution function of the bid queue outflow  $\xi$ .

5. Proof Start – Existence of an Optimal Split: By Proposition 1, there exists an optimal split

$$(M^*, L^*) \in \mathcal{C}$$

between limit and market orders.

6. The Market/Limit Order Split: Moreover, for

$$K = 1$$

the set  $\mathcal{C}$  reduces to the line

$$M^* + L^* = S$$

so it is sufficient to find  $M^*$ .

7. Objective Function along the Optimum: Restricting

$$L = S - M$$

implies that

$$\{A(X, \xi) < S\} = \emptyset$$

$$\{A(X, \xi) < S, \xi > Q + L\} = \emptyset$$

and the objective function can be re-written as



$$V(M) = \mathbb{E} \left[ (s + f)M - (s + r) \{ (\xi - Q)_+ - (\xi - Q - S + M)_+ \} \right. \\ \left. + \lambda_U \{ S - M - (\overline{\xi - Q}_+ - \overline{\xi - Q - S + M}_+) \}_+ \right]$$

8. Differentiability of the Objective Function: For

$$M \in (0, S)$$

the expectation is bounded for all  $\xi$  and differentiable with respect to  $M$  for almost all  $\xi$ , so one can compute

$$V'(M) = \frac{dV(M)}{dM}$$

by interchanging the order of differentiation and integration – see e.g. Aliprantis and Burkinshaw (1998):

$$V'(M) = \mathbb{E} \left[ (s + f) + (s + r) \mathbb{I}_{\xi > Q + S - M} - \lambda_U \mathbb{I}_{\xi < Q + S - M} \right] \\ = 2s + f + r - (s + r + \lambda_U) F(Q + S - M)$$

9. Case where  $\lambda_U$  undershoots Lower Bound: Note that if

$$\lambda_U \leq \frac{2s + f + r}{F(Q + S)} - (s + r)$$

then

$$V'(M) \geq 0$$

for





$$M \in (0, S)$$

and therefore  $V$  is non-decreasing at these points.

10.  $M^*$  Resulting from Lower Breach: Checking that

$$V(S) - V(0) \geq (s + f - \lambda_U)S + (\lambda_U + s + r) = S[1 - F(Q + S)] \geq 0$$

one concludes that

$$M^* = 0$$

11. Case where  $\lambda_U$  Overshoots Upper Bound: Similarly, if

$$\lambda_U \geq \frac{2s + f + r}{F(Q)} - (s + r)$$

then

$$v(M) \leq 0$$

for all

$$M \in (0, S)$$

and  $V(M)$  is non-increasing at these points.

12.  $M^*$  Resulting from Upper Breach: Checking that

$$V(S) - V(0) \leq (s + f - \lambda_U)S + (\lambda_U + s + r) = S[1 - F(Q)] \leq 0$$

one concludes that



$$M^* = S$$

13. Case of  $\lambda_U$  between Bounds: Finally, if  $\lambda_U$  is between these two values

$$\exists c > 0$$

such that

$$V'(\epsilon) < 0$$

$$V'(S - \epsilon) > 0$$

and by continuity of  $V'$  there is a point where

$$V'(M^*) = 0$$

14. Proof End -  $M^*$  Resulting from No Breach: Thus  $M^*$  is optimal by convexity of  $V(M)$  and

$$M^* = S - F^{-1}\left(\frac{2s + f + r}{\lambda_U + s + r}\right) + Q$$

$$L^* = F^{-1}\left(\frac{2s + f + r}{\lambda_U + s + r}\right) - Q$$

solves equations where

$$v(M^*, \xi) = 0$$

$$L^* = S - M^*$$



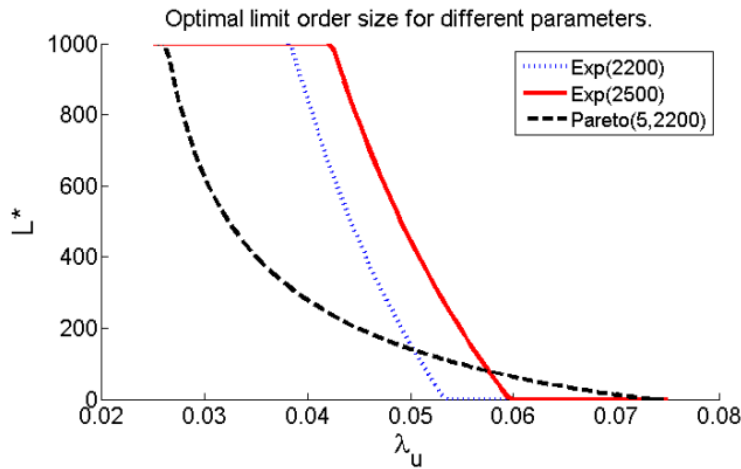
15. No Overfill with Single Exchange: In the case of a single exchange, Proposition 1 implies that

$$M^* + L^* = S$$

therefore, there is no risk of exceeding the target size and  $\lambda_O$  does not affect the optimal solution.

16. Single Exchange Risk of Underfill: The trader is only concerned with the risk of falling behind the target quantity, and balances this risk with fee, rebate, and other market information.

17.  $\lambda_U$  as Fill Urgency Tuner: The parameter  $\lambda_U$  can be interpreted as the trader's urgency to fill the orders, and higher values of  $\lambda_U$  lead to smaller order sizes, as illustrated in the figure below.



**Figure 2** Optimal limit order size  $L^*$  for one exchange. The parameters for this figure are:  $Q = 2000$ ,  $S = 1000$ ,  $h = 0.02$ ,  $r = 0.002$ ,  $f = 0.003$ ,  $\theta = 0.0005$ . Colors correspond to different order outflow distributions - exponential with means 2200 and 2500 and Pareto with mean 2200 and a tail index 5.

18. Optimal Market Size  $\lambda_U$  Dependency: In contrast, the optimal market order size increases with  $\lambda_U$ .



19. Ratio Determining Market/Limit Split: The optimal split between market and limit orders depends on the ratio  $\frac{2s+f+r}{\lambda_U+s+r}$  which balances marginal costs and savings from a market order.
20. Ratio Dependence on  $F/Q$ : It also depends on the distribution  $F$  and the queue length  $Q$  – keeping all else constant, a trader would submit a larger limit order if its execution is more likely and vice versa.
21. Optimal Limit Size  $\lambda_U$  Dependence: The optimal limit order size decreases with  $\lambda_U$  and it becomes more expensive to underfill the order and increases with  $f$  as market orders become more expensive.
22.  $L^*$  Independent of  $S$ : Another interesting feature is that  $L^*$  is fully determined by  $Q$ ,  $F$ , and pricing parameters  $s$ ,  $r$ ,  $f$ , and  $\lambda_U$  while  $M^*$  increases with  $S$ .
23.  $M^*$  increases with  $S$ : As a consequence of this solution feature, as the order size  $S$  increases, a larger fraction  $\frac{M^*}{S}$  of that order is executed with a market order.
24. Dependence on Distribution of  $\xi$ : The solution  $(M^*, L^*)$  depends on the entire distribution of  $\xi$  and not just its mean, as illustrated on the above figure for a pair of exponential and Pareto distributions with equal means.

## Optimal Routing of Limit Orders across Multiple Exchanges

1. More Venues Greater Fill Likelihood: When multiple trading venues are available, dividing the target quantity among them provides better execution quality by reducing the risk of not filling the order.
2. More Venues, Size Breach Likelihood: However, sending too many orders leads to an undesirable possibility of exceeding target size.
3. Optimality Criterion for Multiple Exchanges: Proposition 4 gives a criterion for optimality of an order allocation

$$X^* = (M^*, L_1^*, \dots, L_K^*)$$



that balances these risks.

## Proposition 4

1. General Criteria for Solution: Assuming

$$\lambda_U > 0$$

$$\lambda_O > 0$$

$$\lambda_O > s + \max_k \{x_k\}$$

$$\lambda_O > -(s + f)$$

and

$$s + \max_k \{x_k\} > 0$$

also assume that the distribution of  $\xi$  is continuous:

$$\max_k \{F_k(Q_k + s)\} < 1$$

and

$$\lambda_U < \max_k \left\{ \frac{2s + f + r_k}{F_k(Q_k)} - (s + r_k) \right\}$$



Then:

2. Optimal Positive Market Order Quality: Any optimal allocation  $X^*$  has a positive market order quantity

$$M^* > 0$$

if

$$\lambda_U \geq \frac{2s + f + \max_k \{x_k\}}{\mathbb{P}[\cap_k \{\xi_k \leq Q_k\}]} - \left( s + \max_k \{x_k\} \right)$$

3. Optimal Positive Limit Order Quality: Any optimal allocation  $X^*$  has a positive limit order quantity

$$L_j^* > 0$$

if

$$\mathbb{P} \left[ \bigcap_k \{\xi_k \leq Q_k\} \mid \xi_j > Q_j \right] > \frac{\lambda_o - (s + r_j)}{\lambda_U + \lambda_o}$$

4. Necessary/Sufficient Conditions for Optimality: If the above criteria for

$$M^* > 0$$

and

$$L_j^* > 0$$

holds for all exchanges



$$j = 1, \dots, K$$

a necessary and sufficient condition for optimality of an order allocation

$$X^* \in \mathcal{C}$$

is that it solves the following equations:

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} < S \right] = \frac{\lambda_o + f + s}{\lambda_U + \lambda_o}$$

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} \mid \xi_j > Q_j + L_j \right] = \frac{\lambda_o - (s + r_j)}{\lambda_U + \lambda_o}$$

$$j = 1, \dots, K$$

5. Proof Start - Existence of Optimal Order Allocation: Proposition 2 implies the existence of an optimal order allocation

$$X^* \in \mathcal{C}$$

6. Non-optimality of Naïve Allocation: First, one defines

$$X_M \triangleq (S, 0, \dots, 0)$$

and proves that

$$X \neq X_M$$



by contradiction.

7. Implication of the Naïve Allocator: If  $X_M$  were optimal in the problem

$$\min_{X \in \mathbb{R}_+^{K+1}} \mathbb{E}[v(X, \xi)]$$

it would also be optimal in the same problem with a consistent

$$L_k = 0$$

$$k \neq j$$

for any one  $j$ .

8. Optimal Solution for Single Exchange: In other words, the solution  $(S, 0)$  would be optimal for any one-exchange problem, defined by using only exchange  $j$ .
9. Proof by Contradiction of Naïve Allocation Optimality: But by earlier assumption, there exists a  $J$  such that

$$\lambda_U < \frac{2s + f + r_J}{F_J(Q_J)} - (s + r_J)$$

and Proposition 3 implies that  $(S, 0)$  is not optimal for the  $J^{th}$  single-exchange sub-problem, leading to a contradiction.

10. Bounded, Differentiable Nature of  $v(X, \xi)$ : The function  $v(X, \xi)$  is bounded for

$$X \in \mathcal{C}$$

and for all  $\xi$ , differentiable with respect to  $M$  and  $L_k$

$$k = 1, \dots, K$$





for

$$X \in \mathcal{C} \setminus \{X_M\}$$

for almost all  $\xi$ .

11. Differentiability of the Expected Cost: Applying the same theorem as in the proof of Proposition 3, one concludes that  $V(X)$  is differentiable for

$$X \in \mathcal{C} \setminus \{X_M\}$$

one can compute all of its partial derivatives by interchanging the order of differentiation and integration.

12. KKT Criteria for Expected Cost: The KKT conditions for problem

$$\min_{X \in \mathbb{R}_+^{K+1}} \mathbb{E}[v(X, \xi)]$$

and

$$X \in \mathcal{C} \setminus \{X_M\}$$

are

$$s + f - \lambda_U \mathbb{P}[A(X^*, \xi) < S] + \lambda_O \mathbb{P}[A(X^*, \xi) > S] - \mu_0 = 0$$

$$\begin{aligned} & -(s + r_k) \mathbb{P}[\xi_k > Q_k + L_k^*] - \lambda_U \mathbb{P}[A(X^*, \xi) < S, \xi_k > Q_k + L_k^*] \\ & + \lambda_O \mathbb{P}[A(X^*, \xi) > S, \xi_k > Q_k + L_k^*] - \mu_k = 0 \end{aligned}$$

$$k = 1, \dots, K$$



$$M \geq 0$$

$$L_k \geq 0$$

$$\mu_0 \geq 0$$

$$\mu_k \geq 0$$

$$\mu_0 M = 0$$

$$\mu_k L_k = 0$$

$$k = 1, \dots, K$$

13. Necessary and Sufficient Conditions for Optimality: Since the objective function  $V(\cdot)$  is convex, the KKT criteria above are both necessary and sufficient for optimality.

14. Optimal Positive Market Order Proof: The final result of this proposition follows from considering any  $\tilde{X}$  with

$$\tilde{M} = 0$$

$$\begin{aligned} V(\tilde{X}) &\geq \lambda_U S \mathbb{P} \left[ \bigcap_k \{\xi_k \leq Q_k\} \right] - \left( s + \max_k \{x_k\} \right) S \mathbb{P} \left[ \overline{\bigcap_k \{\xi_k \leq Q_k\}} \right] \geq (s + f) S \\ &= V(X_M) \end{aligned}$$

and it has already been argued that  $\exists X^*$  with

$$V(X^*) < V(X_M)$$



so

$$X^* \neq \tilde{X}$$

and therefore

$$M^* > 0$$

15. Re casting the Exchange KKT Criterion: Re-arranging terms in a  $j^{th}$  equality in

$$\begin{aligned} -(s + r_k)\mathbb{P}[\xi_k > Q_k + L_k^*] - \lambda_U \mathbb{P}[A(X^*, \xi) < S, \xi_k > Q_k + L_k^*] \\ + \lambda_O \mathbb{P}[A(X^*, \xi) > S, \xi_k > Q_k + L_k^*] - \mu_k = 0 \end{aligned}$$

$$k = 1, \dots, K$$

one obtains

$$\begin{aligned} \mathbb{P}[\xi_k > Q_k + L_k^*] \{ \lambda_O - (s + r_j) + (\lambda_U + \lambda_O) \mathbb{P}[A(X^*, \xi) < S \mid \xi_k > Q_k + L_k^*] \} - \mu_j \\ = 0 \end{aligned}$$

16. Optimal Positive Limit Order Proof: The term in the curly brackets above is negative for any

$$X \in \mathcal{C} \setminus \{X_M\}$$

with

$$L_j = 0$$



because

$$\mathbb{P}[A(X^*, \xi) < S \mid \xi_j > Q_j + L_j^*] > \mathbb{P}\left[\bigcap_k \{\xi_k \leq Q_k \mid \xi_j > Q_j\}\right] > \frac{\lambda_o - (s + r_j)}{\lambda_U + \lambda_o}$$

by assumption and since

$$\mu_j \geq 0$$

the condition

$$\begin{aligned} & -(s + r_k)\mathbb{P}[\xi_k > Q_k + L_k^*] - \lambda_U \mathbb{P}[A(X^*, \xi) < S \mid \xi_k > Q_k + L_k^*] \\ & + \lambda_o \mathbb{P}[A(X^*, \xi) > S \mid \xi_k > Q_k + L_k^*] - \mu_k = 0 \end{aligned}$$

$$k = 1, \dots, K$$

cannot be satisfied with

$$L_j^* = 0$$

17. Proof End - Complementary Slackness implies KKT Multiplier  $\mu_j = 0$ : It was shown earlier that

$$M^* > 0$$

$$L_j^* > 0$$

for all

$$j = 1, \dots, K$$



and therefore

$$\mu_0 = \mu_1 = \dots = \mu_k = 0$$

by complementary slackness. Then the KKT conditions

$$s + f - \lambda_U \mathbb{P}[A(X^*, \xi) < S] + \lambda_O \mathbb{P}[A(X^*, \xi) > S] - \mu_0 = 0$$

$$\begin{aligned} -(s + r_k) \mathbb{P}[\xi_k > Q_k + L_k^*] - \lambda_U \mathbb{P}[A(X^*, \xi) < S, \xi_k > Q_k + L_k^*] \\ + \lambda_O \mathbb{P}[A(X^*, \xi) > S, \xi_k > Q_k + L_k^*] - \mu_k = 0 \end{aligned}$$

$$k = 1, \dots, K$$

$$M \geq 0$$

$$L_k \geq 0$$

$$\mu_0 \geq 0$$

$$\mu_k \geq 0$$

$$\mu_0 M = 0$$

$$\mu_k L_k = 0$$

$$k = 1, \dots, K$$

reduce to



$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} < S \right] = \frac{\lambda_o + f + s}{\lambda_U + \lambda_o}$$

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} \mid \xi_j > Q_j + L_j \right] = \frac{\lambda_o - (s + r_j)}{\lambda_U + \lambda_o}$$

$$j = 1, \dots, K$$

18. Target Breach Probability as Bounds: The equations

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} < S \right] = \frac{\lambda_o + f + s}{\lambda_U + \lambda_o}$$

and

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} \mid \xi_j > Q_j + L_j \right] = \frac{\lambda_o - (s + r_j)}{\lambda_U + \lambda_o}$$

$$j = 1, \dots, K$$

show that an order allocation is optimal as long as it sets the probabilities of falling behind the target quantity equal to specific thresholds computed with pricing parameters.

19. Challenges generating Closed-Form Solutions: When the number of exchanges  $K$  is large, the probabilities

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} < S \right] = \frac{\lambda_o + f + s}{\lambda_U + \lambda_o}$$



and

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} \mid \xi_j > Q_j + L_j \right] = \frac{\lambda_o - (s + r_j)}{\lambda_U + \lambda_o}$$

$$j = 1, \dots, K$$

are difficult to compute in closed-form.

20. Analyzing the Two-Exchange Case: However, before turning to numerical procedures, the next section investigates how these equations can be solved in a tractable case of two exchanges.

## Optimal Routing of Limit Orders Across Multiple Exchanges -

### Proposition 4 Corollary

1. Treating the Two-exchange Case: Consider the case of two exchanges with  $\xi_1, \xi_2$  that are independent and have continuous distributions. Assume the following conditions apply.
2. Condition #1 - Bounding  $F_k(Q_k + s)$ :

$$\max_{k=1,2} F_k(Q_k + s) < 1$$

3. Condition #2 - Lower/Upper Bounds on  $\lambda_U$ :

$$\lambda_U < \max_{k=1,2} \left\{ \frac{2s + f + r_k}{F_k(Q_k)} - (s + r_k) \right\}$$



$$\lambda_U \geq \frac{2s + f + \max_{k=1,2} \{r_k\}}{F_1(Q_1)F_2(Q_2)} - \left(s + \max_{k=1,2} \{r_k\}\right)$$

4. Condition #3 - Bounds on  $F_1$  and  $F_2$ :

$$F_1(Q_1) < 1 - \frac{s + r_2}{\lambda_o}$$

$$F_2(Q_2) < 1 - \frac{s + r_1}{\lambda_o}$$

5. Existence of Optimal Order Allocation: Then there exists an optimal order allocation

$$X^* = (M^*, L_1^*, L_2^*) \in \text{int}\{\mathcal{C}\}$$

and it verifies the following.

6. Explicit Expression for Optimal  $L_1$ :

$$L_1^* = Q_2 + S - M^* - F_2^{-1}\left(\frac{\lambda_o - [s + r_1]}{\lambda_U + \lambda_o}\right)$$

7. Explicit Expression for Optimal  $L_2$ :

$$L_2^* = Q_1 + S - M^* - F_1^{-1}\left(\frac{\lambda_o - [s + r_2]}{\lambda_U + \lambda_o}\right)$$

8. Mixed Integral for Solving  $M^*$ :

$$\begin{aligned} & \bar{F}_1(Q_1 + L_1^*) \bar{F}_2(Q_2 + S - M^* - L_1^*) \\ & + \int_{Q_1 + S - M^* - L_2^*}^{Q_1 + L_1^*} \bar{F}_2(Q_1 + Q_2 + S - M^* - x_1) dF_1(x_1) = \frac{\lambda_o - (s + f)}{\lambda_U + \lambda_o} \end{aligned}$$





where  $F_1(\cdot)$  and  $F_2(\cdot)$  are the CDF of  $\xi_1$  and  $\xi_2$  respectively.

9.  $L^*$  as Linear Function of  $M^*$ : In this solution the optimal limit order quantities  $L_1^*$ ,  $L_2^*$  are linear functions of an optimal order quantity  $M^*$ .
10.  $M^*$  Non-linear on  $\xi$  Distribution: When

$$L_1^* = Q_2 + S - M^* - F_2^{-1}\left(\frac{\lambda_o - [s + r_1]}{\lambda_U + \lambda_o}\right)$$

and

$$L_2^* = Q_1 + S - M^* - F_1^{-1}\left(\frac{\lambda_o - [s + r_2]}{\lambda_U + \lambda_o}\right)$$

are substituted into

$$\begin{aligned} & \bar{F}_1(Q_1 + L_1^*) \bar{F}_2(Q_2 + S - M^* - L_1^*) \\ & + \int_{Q_1 + S - M^* - L_2^*}^{Q_1 + L_1^*} \bar{F}_2(Q_1 + Q_2 + S - M^* - x_1) dF_1(x_1) = \frac{\lambda_o - (s + f)}{\lambda_U + \lambda_o} \end{aligned}$$

one obtains a non-linear equation for  $M^*$ , which can be solved for a given distribution of  $(\xi_1, \xi_2)$ .

11. Proof Start – Non-optimal  $M^*/L^*$  at Boundaries: Solutions on the boundary of  $\mathcal{C}$  are sub-optimal:

$$M^* = 0$$

and

$$M^* = S$$



are ruled out by the assumptions

$$\lambda_U < \max_{k=1,2} \left\{ \frac{2s+f+r_k}{F_k(Q_k)} - (s+r_k) \right\}$$

and

$$\lambda_U \geq \frac{2s+f+\max_{k=1,2}\{r_k\}}{F_1(Q_1)F_2(Q_2)} - \left( s + \max_{k=1,2}\{r_k\} \right)$$

$$L_1^* = S - M$$

and

$$L_2^* = S - M$$

are ruled out by the assumptions

$$F_1(Q_1) < 1 - \frac{s+r_2}{\lambda_o}$$

and

$$F_2(Q_2) < 1 - \frac{s+r_1}{\lambda_o}$$

and

$$\begin{aligned} & -(s+r_k)\mathbb{P}[\xi_k > Q_k + L_k^*] - \lambda_U \mathbb{P}[A(X^*, \xi) < S, \xi_k > Q_k + L_k^*] \\ & + \lambda_o \mathbb{P}[A(X^*, \xi) > S, \xi_k > Q_k + L_k^*] - \mu_k = 0 \end{aligned}$$



$$k = 1, \dots, K$$

12. Non optimal  $M/L$  at Boundary: Solutions with

$$M^* + \sum_{k=1}^K L_k^* = S$$

are ruled out by directly checking

$$\begin{aligned} & -(s + r_k) \mathbb{P}[\xi_k > Q_k + L_k^*] - \lambda_U \mathbb{P}[A(X^*, \xi) < S, \xi_k > Q_k + L_k^*] \\ & + \lambda_O \mathbb{P}[A(X^*, \xi) > S, \xi_k > Q_k + L_k^*] - \mu_k = 0 \end{aligned}$$

$$k = 1, \dots, K$$

13. Non optimality of  $L_1^* = 0$  and  $L_2^* = 0$ : Finally

$$L_1^* = 0$$

and

$$L_2^* = 0$$

are ruled out by

$$\begin{aligned} & -(s + r_k) \mathbb{P}[\xi_k > Q_k + L_k^*] - \lambda_U \mathbb{P}[A(X^*, \xi) < S, \xi_k > Q_k + L_k^*] \\ & + \lambda_O \mathbb{P}[A(X^*, \xi) > S, \xi_k > Q_k + L_k^*] - \mu_k = 0 \end{aligned}$$

$$k = 1, \dots, K$$



14. Proof of  $L^* = 0$  non-optimality: For example, if

$$L_1^* = 0$$

then by Proposition 1

$$M^* + L_2^* = S$$

and in

$$\begin{aligned} & -(s + r_k)\mathbb{P}[\xi_k > Q_k + L_k^*] - \lambda_U \mathbb{P}[A(X^*, \xi) < S, \xi_k > Q_k + L_k^*] \\ & + \lambda_O \mathbb{P}[A(X^*, \xi) > S, \xi_k > Q_k + L_k^*] - \mu_k = 0 \end{aligned}$$

$$k = 1, \dots, K$$

$$\mu_2 = 0$$

by complementary slackness

$$\mathbb{P}[A(X^*, \xi) < S, \xi_2 > Q_2 + L_2^*] = \mathbb{P}[A(X^*, \xi) > S, \xi_2 > Q_2 + L_2^*] = 0$$

But then

$$\begin{aligned} & -(s + r_k)\mathbb{P}[\xi_k > Q_k + L_k^*] - \lambda_U \mathbb{P}[A(X^*, \xi) < S, \xi_k > Q_k + L_k^*] \\ & + \lambda_O \mathbb{P}[A(X^*, \xi) > S, \xi_k > Q_k + L_k^*] - \mu_k = 0 \end{aligned}$$

$$k = 1, \dots, K$$

cannot hold, because



$$\mathbb{P}[\xi_2 > Q_2 + L_2^*] > 0$$

15. Necessary Criteria for Excess Allocation: For any

$$X \in \text{int } \{\mathcal{C}\}$$

$$A(X^*, \xi) > S$$

the following inequalities need to be satisfied:

$$\xi_1 > Q_1 + S - M - L_2$$

$$\xi_2 > Q_2 + S - M - L_1$$

$$\xi_1 + \xi_2 > Q_1 + Q_2 + S - M$$

16. Verifying Scenarios Resulting in Excess Allocation: These inequalities give a simple characterization of the event

$$\{A(X, \xi) > S\}$$

and their equivalence is directly verified by considering subsets  $\{\xi_1, \xi_2\}$  forming a complete partition of  $\mathbb{R}_+^2$ .

17. Case I - Both Limit Orders Completely Filled:

$$\xi_1 > Q_1 + L_1$$

$$\xi_2 > Q_2 + L_2$$

18. Trivial Fulfillment of Excess Criteria: Since



$$L_1 + L_2 + M > S$$

one has

$$A(X, \xi) = L_1 + L_2 + M > S$$

and at the same time, all of the inequalities

$$\xi_1 > Q_1 + S - M - L_2$$

$$\xi_2 > Q_2 + S - M - L_1$$

$$\xi_1 + \xi_2 > Q_1 + Q_2 + S - M$$

are satisfied, so they are trivially equivalent in this case.

19. Case II - Second Limit Order Partially Filled:

$$\xi_1 > Q_1 + L_1$$

$$Q_2 \leq \xi_2 \leq Q_2 + L_2$$

20. First Limit Order Completely Filled: Because of the condition

$$\xi_1 > Q_1 + L_1$$

$$\xi_1 > Q_1 + S - M - L_2$$

is satisfied.

21. Condition where Allocation exceeds Target: In this case, one has that



$$A(X, \xi) = L_1 - \xi_2 - Q_2 + M$$

and thus

$$A(X, \xi) > S$$

if and only if

$$\xi_2 > Q_2 + S - M - L_1$$

is satisfied.

22. Fulfillment of Excess Allocation Criteria: Finally

$$\xi_1 > Q_1 + L_1$$

together with

$$\xi_2 > Q_2 + S - M - L_1$$

imply

$$\xi_1 + \xi_2 > Q_1 + Q_2 + S - M$$

so

$$A(X, \xi) > S$$

and



$$\xi_1 > Q_1 + S - M - L_2$$

is also satisfied.

23. Case III - First Limit Order Partially Filled:

$$\xi_2 > Q_2 + L_2$$

$$Q_1 \leq \xi_1 \leq Q_1 + L_1$$

24. Treatment Mirrors the Previous Case: Similar to Case II, it can be shown that the inequalities

$$\xi_1 > Q_1 + S - M - L_2$$

$$\xi_2 > Q_2 + S - M - L_1$$

$$\xi_1 + \xi_2 > Q_1 + Q_2 + S - M$$

are satisfied if and only if

$$A(X, \xi) > S$$

25. Case IV - Both Limit Orders are Partially Filled:

$$Q_1 + S - M - L_2 < \xi_1 \leq Q_1$$

$$Q_2 + S - M - L_1 < \xi_2 \leq Q_2 + L_2$$

26. Valid Scenario in this Case: This set is non-empty because





$$0 < S - M - L_1 \leq L_2$$

and, similarly, for  $L_1, L_2$  reversed.

27. Criterion that needs Verification: The inequalities

$$\xi_1 > Q_1 + S - M - L_2$$

$$\xi_2 > Q_2 + S - M - L_1$$

hold trivially, only

$$\xi_1 + \xi_2 > Q_1 + Q_2 + S - M$$

needs to be checked.

28. Verification of the Third Criterion: One can write

$$A(X, \xi) = \xi_1 - Q_1 + \xi_2 - Q_2 + M > S$$

if and only if

$$\xi_1 + \xi_2 > Q_1 + Q_2 + S - M$$

holds, so

$$A(X, \xi) > S$$

is equivalent to all the necessary criteria.

29. Case V - The Residual Scenario: This captures the case outside of 1-4, and neither

$$\xi_1 > Q_1 + S - M - L_2$$



nor

$$\xi_2 > Q_2 + S - M - L_1$$

is satisfied.

30. First Criterion Violation + Partial Second Fill: If

$$\xi_1 \leq Q_1 + S - M - L_2$$

and

$$\xi_2 \leq Q_2 + L_2$$

then

$$A(X, \xi) \leq S - M - L_2 + L_2 + M = S$$

31. Converse to the Case above: The case

$$\xi_2 \leq Q_2 + S - M - L_1$$

$$\xi_1 \leq Q_1 + L_1$$

is completely symmetric, and it shows that neither

$$A(X, \xi) > S$$

nor the necessary excess allocation criteria hold in this case.



32. Relating Excess Allocation Criteria to Optimality: Next, the necessary excess allocation criteria are used to characterize the set

$$\{A(X, \xi) > S\}$$

in the first order conditions

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} < S \right] = \frac{\lambda_o + f + s}{\lambda_U + \lambda_o}$$

and

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} \mid \xi_j > Q_j + L_j \right] = \frac{\lambda_o - (s + r_j)}{\lambda_U + \lambda_o}$$

$$j = 1, \dots, K$$

33. Excess Allocation to Outflow Probabilities: One observes that in the two-exchange case

$$\{A(X, \xi) > S, \xi_1 > Q_1 + L_1\} = \{\xi_1 > Q_1 + L_1, \xi_2 > Q_2 + S - M - L_1\}$$

$$\{A(X, \xi) > S, \xi_2 > Q_2 + L_2\} = \{\xi_2 > Q_2 + L_2, \xi_1 > Q_1 + S - M - L_2\}$$

and then use the independence of  $\xi_1$  and  $\xi_2$  to compute

$$\mathbb{P}[A(X, \xi) > S \mid \xi_1 > Q_1 + L_1] = \bar{F}_2(Q_2 + S - M - L_1)$$

$$\mathbb{P}[A(X, \xi) > S \mid \xi_2 > Q_2 + L_2] = \bar{F}_1(Q_1 + S - M - L_2)$$



34. Solution to the Limit Order Allocations: Together with

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} < S \right] = \frac{\lambda_o + f + s}{\lambda_U + \lambda_o}$$

and

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} \mid \xi_j > Q_j + L_j \right] = \frac{\lambda_o - (s + r_j)}{\lambda_U + \lambda_o}$$

$$j = 1, \dots, K$$

this leads to a pair of equations for limit order sizes:

$$\bar{F}_2(Q_2 + S - M - L_1) = \frac{\lambda_U + s + r_1}{\lambda_U + \lambda_o}$$

and

$$\bar{F}_1(Q_1 + S - M - L_2) = \frac{\lambda_U + s + r_2}{\lambda_U + \lambda_o}$$

whose solution is given by  $L_1^*, L_2^*$  using the inequalities of the necessary excess allocation criteria.

35. Non-linear Equation for  $L^*$ : To obtain the equation

$$\begin{aligned} & \bar{F}_1(Q_1 + L_1^*) \bar{F}_2(Q_2 + S - M^* - L_1^*) \\ & + \int_{Q_1 + S - M^* - L_2^*}^{Q_1 + L_1^*} \bar{F}_2(Q_1 + Q_2 + S - M^* - x_1) dF_1(x_1) = \frac{\lambda_o - (s + f)}{\lambda_U + \lambda_o} \end{aligned}$$



one re-writes

$$\mathbb{P} \left[ M^* + \sum_{k=1}^K \{(\xi_k - Q_k)_+ - (\xi_k - Q_k - L_k^*)_+\} < S \right] = \frac{\lambda_o + f + s}{\lambda_U + \lambda_o}$$

using the necessary excess allocation criteria.

36. Excess Allocation to Quadrature Space: Then

$$\mathbb{P}[A(X, \xi) > S]$$

may be computed as the integral of the product measure  $F_1 \otimes F_2$  over the region defined by

$$U(Q, S, M, L_1, L_2) = \left\{ \begin{array}{l} (x_1, x_2) \in \mathbb{R}^2 \\ x_1 > Q_1 + S - M - L_2 \\ x_2 > Q_2 + S - M - L_1 \\ x_1 + x_2 > Q_1 + Q_2 + S - M \end{array} \right\}$$

37. Explicit Form for the Quadrature: This integral is given by

$$\begin{aligned} \mathbb{P}[A(X, \xi) > S] &= F_1 \otimes F_2(U(Q, S, M, L_1, L_2)) \\ &= \bar{F}_1(Q_1 + L_1) \bar{F}_2(Q_2 + S - M - L_1) \\ &\quad + \int_{Q_1 + S - M - L_2}^{Q_1 + L_1} \bar{F}_2(Q_1 + Q_2 + S - M - x_1) dF_1(x_1) = \frac{\lambda_U - (s + f)}{\lambda_U + \lambda_o} \end{aligned}$$

## Optimal Routing of Limit Orders Across Multiple Exchanges – Example



1. Explicit Form for Exponential Distribution: If  $\xi_1, \xi_2$  are exponentially distributed with means  $\mu_1, \mu_2$  respectively, then an optimal order allocation is given by

$$M^* = Q_1 + Q_2 + S - z$$

$$L_1^* = z - Q_1 + \mu_2 \log \frac{\lambda_U + s + r_1}{\lambda_U + \lambda_o}$$

$$L_2^* = z - Q_2 + \mu_1 \log \frac{\lambda_U + s + r_2}{\lambda_U + \lambda_o}$$

where  $z$  is a solution to the transcendental equation

$$1 + \log \left( \frac{\lambda_U + s + r_2}{\lambda_U + \lambda_o} \cdot \frac{\lambda_U + s + r_1}{\lambda_U + \lambda_o} \right) + \frac{z}{\mu} = \frac{\lambda_U - (s + f)}{\lambda_U + \lambda_o} e^{\frac{z}{\mu}}$$

if

$$\mu_1 = \mu_2 = \mu$$

or

$$\begin{aligned} & \frac{\mu_1}{\mu_1 - \mu_2} e^{-\frac{z}{\mu_1}} \left( \frac{\lambda_U + s + r_1}{\lambda_U + \lambda_o} \right)^{\frac{\mu_1 - \mu_2}{\mu_1}} + \frac{\mu_2}{\mu_1 - \mu_2} e^{-\frac{z}{\mu_2}} \left( \frac{\lambda_U + s + r_2}{\lambda_U + \lambda_o} \right)^{\frac{\mu_2 - \mu_1}{\mu_2}} \\ &= \frac{\lambda_U - (s + f)}{\lambda_U + \lambda_o} \end{aligned}$$

if

$$\mu_1 \neq \mu_2$$



2.  $X^*$  Dependence on Queue Size: Similar to the case of single exchange, in this example an optimal market order size  $M^*$  is an increasing linear function of queue sizes  $Q_1, Q_2$  and the target quantity  $S$ , while optimal limit order sizes  $L_i^*$  are decreasing functions of the corresponding queue sizes  $Q_i$ .
3. Optimal Limit/Market Dependence on  $S$ : As in the case of a single exchange, the optimal order sizes do not depend on the target quantity, but the optimal market order size increases with it.
4. Dependence of  $L^*$  on  $\mu$ : In addition, it is to be noted that each  $L_i^*$  depends on the order flow distributions on both exchanges through  $\mu_{1,2}$  and  $z$ .

## Numerical Solution to the Optimization Problem

1. Objective Function and its Gradient: Computing the objective function in the order placement problem

$$\min_{X \in \mathbb{R}_+^{K+1}} \mathbb{E}[v(X, \xi)]$$

or its gradient at any point requires calculating an expectation – a multi-dimensional integral – which, aside from specific examples, is generally not analytically tractable.

2. Approach using the Stochastic Approximation: Stochastic approximation methods, developed specifically for problems where the objective function is an expectation, turn out to be very useful for this problem.
3. Order Placement without Outflow Distribution: This section proposes a procedure for computing the order placement problem which does not require specifying an order outflow distribution.
4. The Stochastic Approximation Method: The stochastic approximation approach and the specific method used are briefly described here.
5.  $V(X)$  and the Gradient  $g(X, \xi)$ : Consider an objective function



$$V(X) \triangleq \mathbb{E}[v(X, \xi)]$$

to be minimized and denote by

$$g(X, \xi) \triangleq \nabla v(X, \xi)$$

where the gradient is taken with respect to  $X$ .

6. Robbins and Monro Stochastic Approximation Algorithm: The Robbins and Monro (1951) stochastic approximation algorithm tackles the problem in the following way.
7. Initial Allocation and Step Size: Choose  $X_0$  and a sequence of ‘step sizes’  $\{\gamma_n\}$ .
8. For  $n = 1, \dots, N$ : Do the next 2 steps.
9. Simulating Random Variables from its Distribution: Simulate an independent random variable  $\xi^n$  with a distribution  $F$ .
10. Stepping to the Next Objective Value: Set

$$X_n = X_{n-1} - \gamma_n g(X_{n-1}, \xi^n)$$

11. Convergence to the Optimal Allocation: This algorithm produces an estimate

$$\hat{X}^* \triangleq X_N$$

which converges to the optimal point  $X^*$  as

$$N \rightarrow \infty$$

under some technical assumptions.

12. Technical Conditions needed for Convergence: Specifically,  $V(X)$  need to be strongly convex, twice continuously differentiable and





$$X^* \in \text{int}\{\mathcal{X}\}$$

where  $\mathcal{X}$  is a non-empty bounded closed convex set, then

$$\mathbb{E}[V(X_n) - V(X^*)] \rightarrow 0$$

Kushner and Yin (2003) contain more details.

13. Constants Impacting Rate of Convergence: The sequence of constants  $\{\gamma_n\}$  affects the rate of convergence.
14. Reducing the Step Size Sensitivity: This sensitivity can be overcome by using, for example, the robust stochastic approximation of Nemirovski, Juditsky, Lan, Shapiro (2009) which follows the same sequence as above with a constant step size

$$\gamma_n = \gamma$$

and uses an average of iterates

$$\hat{X}^* = \frac{1}{N} \sum_{n=1}^N X_n$$

instead of  $X_N$  as an estimate of the optimal point.

15. Performance Bound for the Convergence: Under some weak assumptions, this method achieves a performance bound

$$V(\hat{X}^*) - V(X^*) \leq \frac{D\mathcal{M}}{\sqrt{N}}$$

for a finite  $N$ , where

$$D = \max_{X, X' \in \mathcal{C}} \|X - X'\|_2$$



and

$$\mathcal{M} = \sqrt{\max_{X \in \mathcal{C}} \mathbb{E}[\|g(X, \xi)\|^2]}$$

with  $\|\cdot\|$  defining the  $L_2$  norm.

16.  $V(X)$  as a Well-behaved Function: This method assumes that

$$\min_{X \in \mathcal{X}} \{V(X)\}$$

is sought, where  $V(X)$  is a well-defined and finite-valued expectation for every  $X \in \mathcal{X}$  and  $\mathcal{X}$  is a non-empty bounded closed convex set.

17. The Optimal Iteration Step-size: Moreover  $V(X)$  needs to be continuous and convex in  $\mathcal{X}$ . The optimal step size is

$$\gamma = \frac{D}{\sqrt{N} \cdot \mathcal{M}}$$

18. Robustness to Step Size Mis-specification: Multiplying the optimal step size  $\gamma$  by a constant

$$\theta > 0$$

leads to a performance bound of the same order of magnitude

$$\max(\theta, \theta^{-1}) \cdot \frac{D\mathcal{M}}{\sqrt{N}}$$

i.e., the method is *robust* to step-size mis-specifications.



19. Step Size from “Secular” Bounds: For the current problem one can further bound

$$D \leq \sqrt{K} \cdot S$$

and

$$\mathcal{M} = \sqrt{(s + f + \lambda_o + \lambda_U)^2 + \sum_{k=1}^K (s + r_k + \lambda_o + \lambda_U)^2}$$

20. Explicit Formula for the Stochastic Gradient: It is assumed that on each iteration

$$X_n \in \text{int}\{\mathcal{C}\}$$

– this is enforced by rescaling  $X_n$  when needed and does not affect the convergence –  
then the stochastic gradient in the current problem is given by:

$$\begin{aligned} g(X_n, \xi) &= \begin{pmatrix} s + f - \lambda_U \mathbb{I}_{\{A(X_n, \xi) < S\}} + \lambda_O \mathbb{I}_{\{A(X_n, \xi) > S\}} \\ -(s + r_1) \mathbb{I}_{\{\xi_1 > Q_1 + L_{1n}\}} - \lambda_U \mathbb{I}_{\{A(X_n, \xi) < S, \xi_1 > Q_1 + L_{1n}\}} + \lambda_O \mathbb{I}_{\{A(X_n, \xi) > S, \xi_1 > Q_1 + L_{1n}\}} \\ -(s + r_K) \mathbb{I}_{\{\xi_K > Q_K + L_{Kn}\}} - \lambda_U \mathbb{I}_{\{A(X_n, \xi) < S, \xi_K > Q_K + L_{Kn}\}} + \lambda_O \mathbb{I}_{\{A(X_n, \xi) > S, \xi_K > Q_K + L_{Kn}\}} \end{pmatrix} \end{aligned}$$

21. Gradient Dependence on Outflow Variate: Note that  $g(X_n, \xi)$  depends on random variables  $\xi$  only through the indicator functions, which have a simple economic meaning.

22. Economic Meanings of Indicator Functions: For example

$$\mathbb{I}_{\{A(X_n, \xi) < S\}} = 1$$



if the target quantity was not fully executed on the  $n^{th}$  step and  $\mathbb{I}_{\{\xi_k > Q_k + L_{kn}\}}$  if there was an opportunity to execute a larger limit order at exchange  $k$  on that step.

23. Corresponding Interpretation of Numerical Iterations: This leads to a simple interpretation of numerical iterations – at each step order sizes are increased or decreased depending on whether or not the executed quantity was smaller or larger than the target size and whether or not a larger limit order can be filled at the given exchange.
24. Explicit Model for Outflow Distribution: If a model for  $\xi$  is available, one can use it to simulate  $\xi$  and compute a numerical solution that takes into account specific order flow assumptions, e.g., forecasts of future trading volumes.
25. Historical Model for Outflow Distribution: Alternatively, one can use past order fill data to compute indicator functions in  $g(X_n, \xi)$  and obtain a non-parametric numerical solution to the order placement problem, using the empirical distribution of past order fills instead of assuming a functional form for  $F$ .
26. Comparing Numerical and Analytical Solutions: The numerical stability and convergence estimates for  $\hat{X}^*$  are analyzed by comparing them with an analytical solution in the case of a single exchange.
27. Quantifying the Process Parameters: This computation uses

$$Q = 2000 \text{ shares}$$

$$\xi \sim \text{Poisson}(\mu T)$$

$$\mu = 2200 \text{ shares per minute}$$

$$T = 1 \text{ minute}$$

and

$$S = 1000 \text{ shares}$$



28. Pricing Parameters Used in Comparison: The pricing parameters in dollar per share are

$$s = 0.02$$

$$r = 0.002$$

$$f = 0.003$$

and fall in a typical value range for US equities.

29. Overfill and Underfill Penalty Costs: Finally, the penalty costs, also in dollars per share, are set to

$$\lambda_O = 0.024$$

$$\lambda_U = 0.026$$

30. Optimal Allocation from Analytical Expression: According to

$$M^* = S - F^{-1} \left( \frac{2s + f + r}{\lambda_U + s + r} \right) + Q$$

$$L^* = F^{-1} \left( \frac{2s + f + r}{\lambda_U + s + r} \right) - Q$$

the optimal allocation is

$$(M^*, L^*) = (728, 272) \text{ shares}$$



31. Starting Allocation and Step Size: Numerical estimates  $\hat{X}^*$  were computed for five initial points  $X_0$  and different number of iterates  $N$  in the stochastic approximation, using a step size

$$\gamma \triangleq \frac{\sqrt{K} \cdot S}{\sqrt{N(s + f + \lambda_O + \lambda_U)^2 + N \sum_{k=1}^K (s + r_k + \lambda_O + \lambda_U)^2}}$$

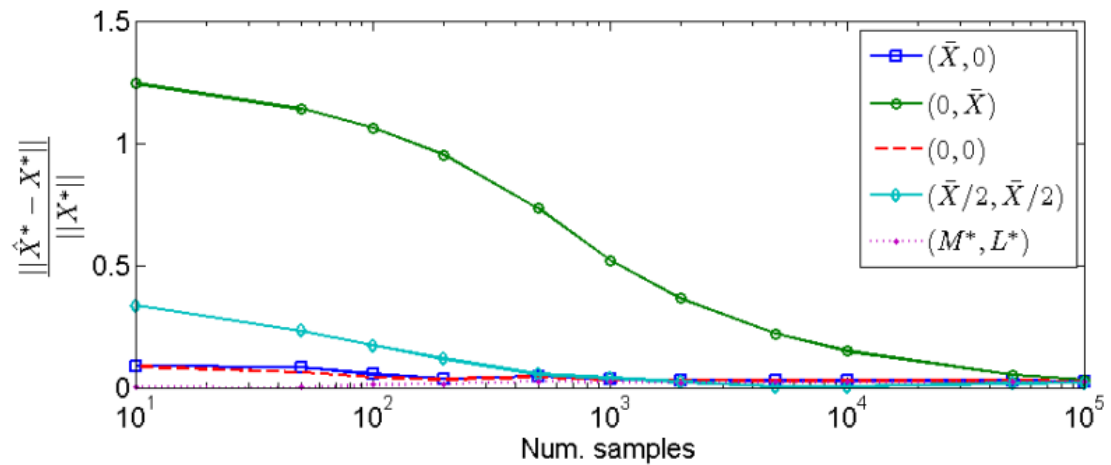
32. Averaging the Cost over Observations: For each choice of  $X_0$  and  $N$ , an additional

$$L = 1000 \text{ observations}$$

of  $\xi$  are simulated to estimate the objective values  $V(X)$  with sample averages

$$V(X) = \frac{1}{L} \sum_{i=1}^L v(X, \xi_i)$$

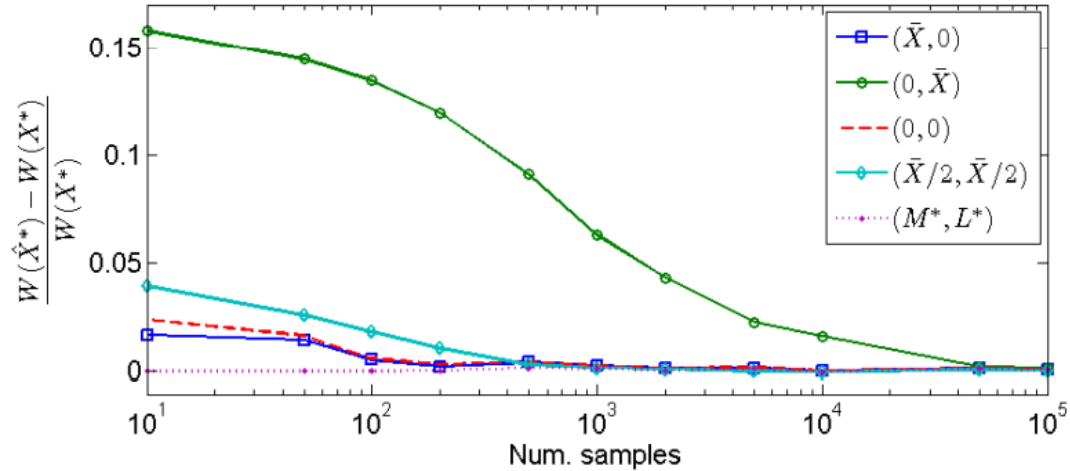
33. Convergence of Order Allocation Vectors:



Convergence of order allocation vectors to an optimal point for different initial points.



### 34. Convergence of Objective Values:



Convergence of order allocation vectors to an optimal point for different initial points.

35. Illustration of the Allocation Convergence: The above figures show that estimates converge to  $X^*$  regardless of  $X_0$ . When

$$X_0 = X^*$$

estimates remain close to that point.

36. Speed of the Allocation Convergence: Convergence is also quite fast – after as few as 50 samples the algorithm can be within 2% of the optimal objective value.

37. Starting Allocation at the Boundary: In the worst case of initial points at the boundary it can take a few thousand samples to converge.

38. Convergence of the Execution Cost: It is also worth noting that the convergence in terms of the objective value occurs significantly faster than convergence in terms of order allocation vector.

39. Limit Order across Multiple Exchanges: The savings from optimal limit order and from dividing a limit order across multiple exchanges was also estimated.



40. Comparison across Naïve Allocation Schemes: A pure market order allocation is denoted by

$$X_M = (S, 0, \dots, 0)$$

single limit order allocation by

$$X_L = (0, S, \dots, 0)$$

and an equal split allocation by

$$X_E = \left( \frac{S}{K+1}, \frac{S}{K+1}, \dots, \frac{S}{K+1} \right)$$

41. Table - Savings from Order Splitting:

$K$	Order allocation in % of $S$							Average cost, in cents per share			
	$M^*$	$L_1^*$	$L_2^*$	$L_3^*$	$L_4^*$	$L_5^*$	Total	$W(X_M)$	$W(X_L)$	$W(X_E)$	$W(X^*)$
$S = 500$											
1	82%	18%					100%	2.35	2.19	0.83	1.54
2	15%	44%	44%				103%	2.35	2.22	-0.57	-0.85
3	1%	34%	34%	34%			102%	2.35	2.21	-1.02	-1.99
4	0%	26%	25%	26%	26%		102%	2.35	2.20	-1.25	-2.06
5	0%	22%	21%	20%	20%	20%	103%	2.35	2.22	-1.40	-2.05
$S = 1000$											
1	94%	6%					100%	2.35	3.65	2.27	2.07
2	56%	27%	27%				111%	2.35	3.64	1.28	0.77
3	35%	23%	23%	23%			104%	2.35	3.65	0.09	-0.07
4	15%	23%	23%	22%	23%		106%	2.35	3.64	-0.88	-0.90
5	1%	21%	21%	21%	21%	21%	106%	2.35	3.65	-1.29	-1.64
$S = 5000$											
1	97%	3%					100%	2.35	4.81	3.44	2.22
2	88%	8%	8%				104%	2.35	4.81	3.60	2.10
3	83%	9%	9%	9%			110%	2.35	4.81	3.55	1.95
4	79%	11%	11%	11%	11%		124%	2.35	4.81	3.39	1.79
5	75%	11%	11%	11%	11%	11%	129%	2.35	4.82	3.22	1.62





42. Simulation using Equal Allocation Start: The table above presents outputs from the numerical algorithm with

$$X_O = X_E$$

$$N = 1000$$

$$L = 1000$$

for different order sizes  $S$  and number of exchanges

$$K = 1, \dots, 5$$

43. Process and Exchange Parameters: The parameters  $s, f, r, \lambda_U$ , and  $\lambda_O$  are same as in the previous simulation and exchanges are identical replicas of each other:

$$r_k = r$$

$$Q_k = Q$$

and

$$\xi_{nk} \sim \text{Poisson}(\mu T)$$

are i.i.d. copies of each other, where

$$k = 1, \dots, K$$

$$n = 1, \dots, N$$



44. Cost Comparison with Naïve Allocation: Order allocations produced by stochastic approximation clearly outperform the naïve benchmarks, especially when the target quantity  $S$  is relatively small and cost savings of limit orders can be fully explained.
45. Comparing  $X_L$  and  $X_E$  Allocations: Comparing  $W(X_L)$  and  $W(X_E)$  one can also see that splitting a limit order across multiple exchanges can be very advantageous when limit order fills are independent.
46. Equal Limit Split across Exchanges: Since multiple exchanges in this example are copies of each other, the algorithm splits the total limit order amount equally among them.
47. Distinction between  $X_E$  and  $X^*$ : This is not the same as the allocation  $X_E$  because the latter sets the market order size to  $\frac{S}{K+1}$ , which may be too large or too small depending on  $S$  and the number of exchanges available.
48. Optimal Order is Over-allocated: Another interesting feature of the numerical solution  $\hat{X}^*$  is the tendency to oversize the total quantity of limit orders, which is clearly observed for

$$S = 1000, 5000$$

and

$$K = 4, 5$$

49. Consequence of Outflow Distribution Independence: This may be a consequence of assumed independence between  $\xi_k$  – by submitting large orders to multiple exchanges the algorithm reduces the probability of falling behind the target quantity with a relatively low probability of exceeding it.
50. Sensitivity Analysis on Two-Exchanges: To illustrate the structure of a numerical structure, Cont and Kukanov (2017) performed a sensitivity analysis with

$$K = 2$$



exchanges and parameters

$$Q_1 = Q_2 = 2000$$

$$S = 1000$$

$$\xi_{1,2} \sim \text{Poisson}(\mu_{1,2}T)$$

$$\mu_1 = 2600$$

$$\mu_2 = 2200$$

$$T = 1$$

$$s = 0.02$$

$$r_1 = r_2 = 0.002$$

$$f = 0.003$$

$$\lambda_U = 0.26$$

and

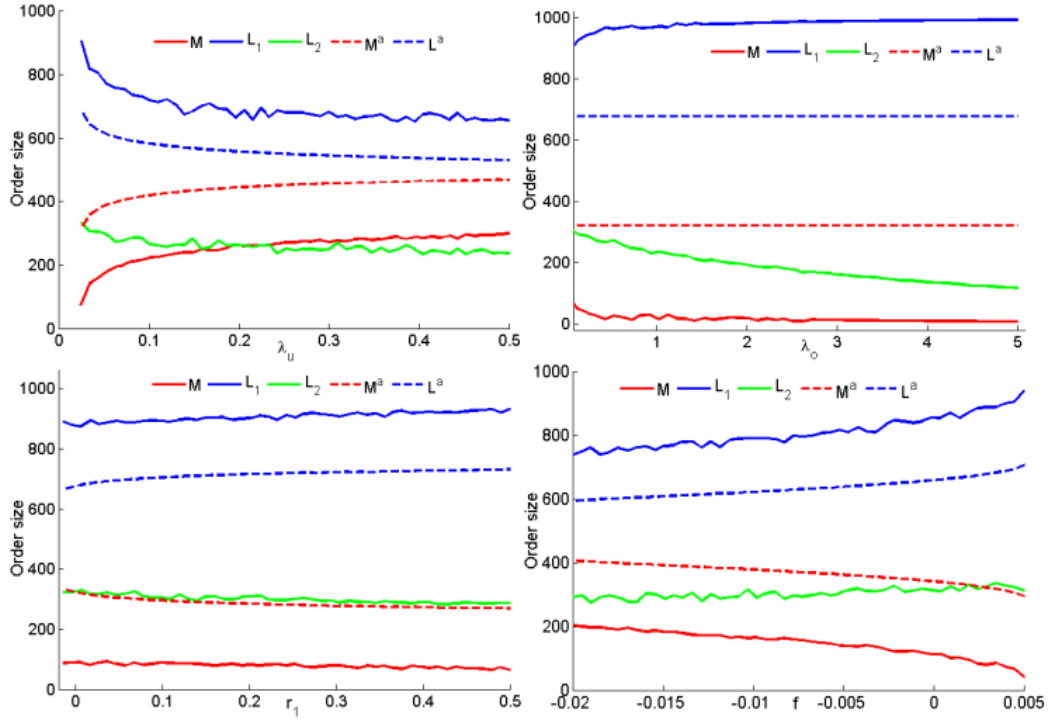
$$\lambda_O = 0.24$$

51. Parameter Sensitivity Analysis #1: Sensitivity analysis for a numerical solution

$$\hat{X}^* = (M, L_1, L_2)$$



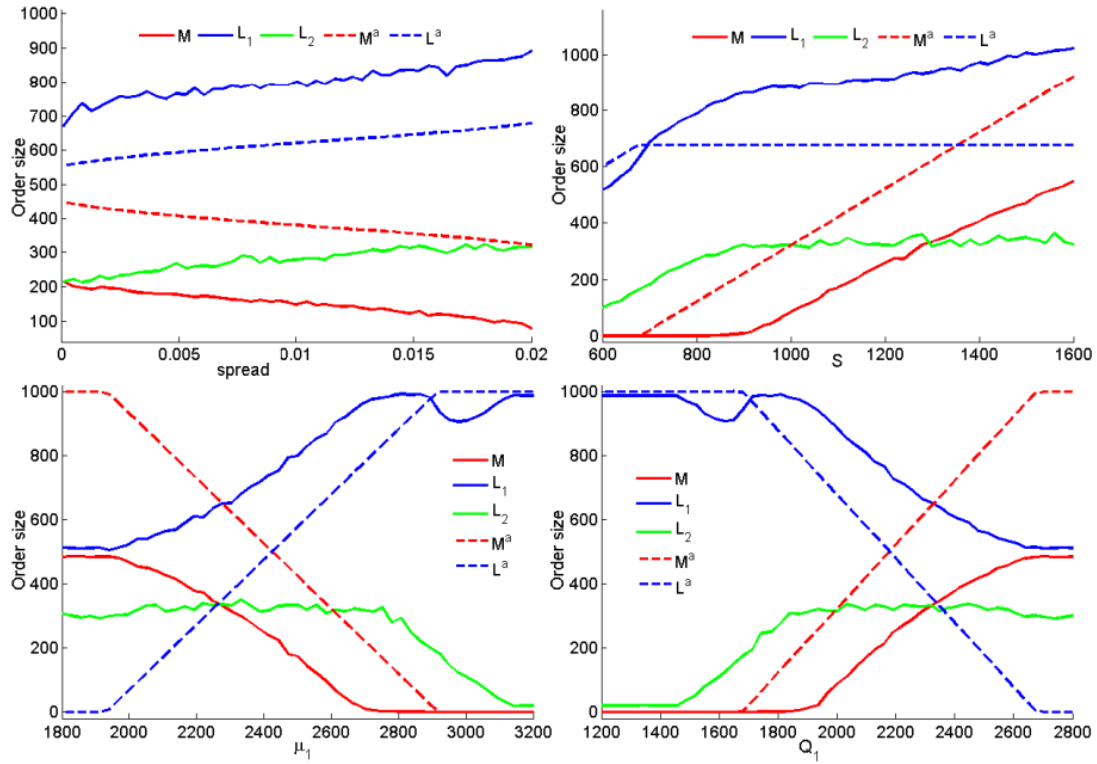
with two exchanges and an optimal solution  $(M_a, L_a)$  with the first exchange only.



## 52. Parameter Sensitivity Analysis #2: Sensitivity analysis for a numerical solution

$$\hat{X}^* = (M, L_1, L_2)$$

with two exchanges and an optimal solution  $(M_a, L_a)$  with the first exchange only.



53. Sensitivity Comparison with Single Exchange: Varying some of these parameters one at a time, the above figures show a plot of the numerical solution  $\hat{X}^*$  after

$$N = 1000$$

iterations, together with an analytical solution for a single exchange.

54. Allocation Vector Dependence on  $\lambda_U$ : Similar to the single exchange case, limit order sizes on two exchanges  $L_1, L_2$  decrease and market order size  $M$  increases as the penalty  $\lambda_U$  increases.

55.  $s, r_1$ , and  $f$  Dependence: Increasing the half-spread  $s$ , the rebate  $r_1$ , of the fee  $f$  makes a limit order on exchange number one more attractive, so  $L_1$  increases and  $M$  decreases.



56. Execution Risk Dominates with  $\lambda_U$ : Because the penalty  $\lambda_U$  is large in this example, execution risk is more important fees and rebates, therefore the queue size  $Q_1$  and the order outflow men  $\mu_1$  have a much stronger effect on the optimal solution than  $r_1$ .
57. Dependence on  $Q_1$  and  $\mu_1$ : Both decreasing the  $Q_1$  and increasing  $\mu_1$  make a limit order fill more likely at exchange manner one and  $L_1$  increases. The observed drop in  $L_1$  for large  $\mu_1$  and small  $Q_1$  is a feature of this example, Cont and Kukanov (2017) were not able to replicate it for other distributions of  $\xi$ .
58. Allocation Vector Dependence on  $S$ : Finally, as in the case of a single exchange, the target size  $S$  has a strong effect on the optimal order allocation.
59. Market Order increases with  $S$ : Only limit orders are used while  $S$  is small, but as soon as it becomes larger it is difficult to fill that amount solely with limit orders and the optimal market order size begins to grow to limit the execution risk.

## Conclusion

1. Limit Order across Multiple Names: This chapter formulated and solved the problem of placing a small batch of orders on multiple trading venues.
2. Analytical Allocation for Single Exchange: In the case when there is a single exchange, an optimal split between a limit and a market order sizes we derived.
3. Fast Converging Stochastic Approximation Scheme: For more general cases, a stochastic approximation algorithm that is shown to quickly converge to an optimal point was proposed and tested.
4. Optimal Allocation across Multiple Venues: The chapter explored the properties of an optimal order allocation policy and showed that splitting an order across multiple exchanges can lead to a substantial reduction in transaction costs.

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1. Tight Skew:  $\alpha_T$
2. Loose Skew:  $\alpha_L$
3. Tight Width:  $\omega_T$
4. Loose Width:  $\omega_L$
5. Algorithmically generated Ideal Mid Cash Price:  $\Pi_{Ideal}$
6. Position:  $P$  (expressed in cumulative net position per unit under consideration – firm/desk/trader)
7. Position Pivot:  $P_{Pivot}$ . Dimensionless ontological view of the scaling position metric – roughly equivalent to the Reynolds’ number of market making position units. Expressed in currency units.
8. Risk:  $R$  (expressed in cumulative net risk per unit under consideration – firm/desk/trader)
9. Risk Pivot:  $R_{Pivot}$ . Dimensionless ontological view of the scaling risk metric – roughly equivalent to the Reynolds’ number of market making risk units. Expressed in PV01 currency units.

## Framework Glossary

1. Equilibrium quantity: Quantity that only changes with the macro drivers/factors, and not the technical factors. Typically stable, but jumpy and undergoes changes when drivers shift – and introduces perturbations on the disequilibrium quantities.
2. Disequilibrium quantity: Quantity that changes with the technical, transient factors.

## Width/Skew/Size Estimation Models



1. Tight Models:

- Tight models estimate the market making quantities on a trader/firm/desk independent manner.
- They estimate the “secular” market making parameters – width, skew, and size for either the Market Making Outputs or the Axe Outputs – estimate them based on classes of input parameters.
- For each input parameter class, the following are needed:
  - a. A proxy that serves as a quantitative estimate of the desired parameter class.
  - b. Segmentation of the proxy over the sub-classified parameter set.

2. Input Class => Risk Profile:

- Captures all the cumulative risk components => the credit/solvency, market, and liquidity risk behind the issue.
- Proxy => CDS Spread, rating, bond basis
- Sub-classification => Issue, issuer, and sector.

3. Input Class => Liquidity:

- Captures the frequency and volume of the trade flow of a given issue, and the ease of getting in and getting out at the given side.
- Proxy:
  - i. Aggregated periodic (e.g., daily) volume for each side (buy/sell).
  - ii. Aggregated periodic (e.g., daily) notional for each side (buy/sell).
- Sub-classification => Issue, issuer, sector, and the instrument universe.

4. Firm/Desk/Trader level parameters: These provide aggregated controls for trading.

- Net Position => vital metric for inventory control.
- Risk limits => to control/manage exposure to specific granules – issue, issuer, tenor, sector, unit etc.

5. Monitor Mobility: Certain measures such as PV01 based risk, inventory, etc. are more easily human-monitored, so they are done daily. Others (such as tenor 01s) are less easily monitored, so they are done infrequently.



## **Market Making System SKU**

1. Intra day Curve Generation Scheme
2. Mid Price Estimation Models
  - i. Accommodate different mid price estimation models, and their respective parameters
3. Algorithmic Quote Construction => used for generating venue/ECN independent width/skew/size [composed of tight/loose components]. Broadly speaking achieves the following:
  - i. Specific parameters to control skew for targeted alpha generation strategies
  - ii. Accommodate different width and size estimation models, and their respective parameters
  - iii. Venue-independent base quote synthesis/construction
  - iv. Circuit breaker heuristics
  - v. Policy driven/policy enforcement/policy control applied at this level
4. Quote Management: Publishing/tailoring the constructed quote towards specific venues (possibly with order routing applied at this stage).
  - i. Venue specific rules (and thereby external vendor incorporations, like Broadway etc. at this stage).

## **Market Making Parameter Types**

1. Model Parameters: Parameters for generation of algorithmic generation of width, skew, and size.
2. Quote Generation Control Parameters
3. Quote Heuristics Control



#### 4. Quote Management Control

### **Intra-day Pricing Curve Generation Schemes**

1. Issue Benchmark Bonds: The following set of threshold criteria are used to determine the issuer specific benchmark bonds:

- ii. Threshold of daily TRACE volume/number of trades
- iii. Threshold of outstanding notional
- iv. Only senior obligations
- v. Some combination of the following threshold of the ratios:
  - $$\frac{CUMULATIVE DAILY ISSUETRACEVOLUME}{OUTSTANDINGNOTIONAL}$$
  - $$\frac{CUMULATIVE DAILY ISSUETRACEVOLUME}{CUMULATIVE DAILY ISSUERTRACEVOLUME}$$

- 2. Benchmark bonds basis tracking: Track the bid side and ask side credit basis of the benchmark bonds from each TRACE print, using EMA VWAP/TWAP from the intra-day rates/credit curves. This will be the attempt to estimate the mid credit basis for the, and it is generally well behaved.
  - Need to find a way to accommodate the institutional closing CDS mid marks and the benchmark bonds into the credit curve construction – these are highly valid points.
- 3. Liquid vs. illiquid: Typical liquid securities' quote may be proxied out of print (or at least EMA'd). Intra-day quote generation, however, is materially important for illiquid securities.
- 4. Intra-day credit curve generation inputs: Need a way to generate the credit curve from
  - i. The CDS marks
  - ii. The basis-adjusted benchmark bonds
  - iii. It always needs to be used in conjunction with tension splines.



- iv. Also need intra-day TRACE series to update the basis (direct or EMA) – will use this to establish the intra-day relationship between the CDS nodes and the TRACE cut-off threshold).
- 5. Intra-day credit curve updating:
  - a. Use the relationship grid between CDS 5Y, the off-tenors, and the benchmark bonds
  - b. Any change in any of them automatically re-adjusts using the set relationships.
  - c. CDS Curves are trader set; bond basis are EMA'd from the TRACE series using the prior credit curve
  - d. Relationships are either reviewed daily EOD
- 6. Live updating of bond prices: Use the live curve (either pure CDS, or a mixture of CDS/bond instruments) to extract the basis of each print, and then EMA that to generate the bond live prices.

## Mid-Price Models

- i. Definition: Computed theoretical mid-price, as to where the next print should be – assuming zero transaction costs, zero position/risk constraints, and infinite liquidity. Mid -Price is an *Equilibrium Quantity*.
- ii. Estimation parameters: Typical mid price estimation parameters are: the IR curve, the survival curve, and the recovery curve. The other possible drivers are: funding curve – typically for long position, and repo curve – typically for shorts.

## Width Models



1. Tight Width: Computed theoretical width, after accounting for the issue liquidity and the issue riskiness. Tight width is the first in the set of disequilibrium quantities. Tight width is:
  - a. Proportional to issue risk (combination of credit and market risk – not counter party risk).
  - b. Inversely proportional to liquidity

## Skew Models

1. Tight Skew: This measure how far the last print has been OFF from the theoretical mid-price. Thus, Tight Skew is representative of the alpha potential – for a theoretical mid-price that chases the print in a sequence, the tight skew is zero.
2. Tight Bid Skew and Tight Ask Skew: This is an alternative SKU – instead of tight width and tight skew cognitive view, tight bid/ask skew parameters are determined only from their corresponding liquidity and flow metrics (i.e., bid/ask liquidity metrics).
3. Loose Skew: Simply put, loose skew is:

$$\alpha_L = \max\left(\frac{P}{P_{Pivot}}, \frac{R}{R_{Pivot}}\right)$$

4. Heuristic Checks on Loose Skew: Following checks applied to round out quoting:
  1. Ceiling/floor applied
  2. Maximum cutoff for width
  3. Best right skew – bid becomes ask.
  4. Best left skew – ask becomes bid.

## Size Models



1. Tight bid size/tight ask size: Basically, tight size is inversely proportional to tight width, to within normalized bounds.

## Heuristics Control

1. Can Buy/Can Short: Can But/Can Short => whether the bid/ask stays within the LONGABLE/SHORTABLE cutoff.
2. ECN Threshold Cross: Check to see if there is a cross between the published bid/ask and a given ECN's bid/ask.

## Published Market Quote Picture

1. Bid/Ask Sizes: Truncated to their appropriate rounding.
2. Bid Price:  $\Pi_{ideal} - \frac{1}{2} \omega_L \alpha_L$
3. Ask Price:  $\Pi_{ideal} + \frac{1}{2} \omega_L \alpha_L$
4. Bid/Ask Prices rounded downward/upward to their appropriate increments.

## Flow Analysis

1. Dimensionless flow classifier: If the metric (ADV etc.) is greater than a specific threshold, then the flow becomes “turbulent”, else it is “laminar”.
2. Flow Potential: Skew of all kinds is related to the flow driver/equilibration strength.



## Corporate Bond Auto-Responder (CBAR)

### Summary

1. Focus of the CBAR Algorithm: The aim of this chapter is to describe the auto-response mechanism for incoming client RFQ's for corporate bond trades less than or equal to a threshold size. A number of checks are made, e.g., risk, price, macro, before the trade is accepted by the algorithm.
2. Corporate Bond Desk Trade Flow: Typically, a Corporate Bond Desk receives on average over 10,000 client RFQ's daily, many of which are less than 100K in size. Automating the flow for smaller sizes allows traders to focus on larger, higher-value tickets.

### Reference Data

1. Instruments Traded: Secured Debentures.
2. Markets/Trade Venues: Market Axess (MKA), Bloomberg (BOLT.BBG), Trade Web (TWB), Merrill Lynch Bond Markets (MLBM), ICE Bond Point (KBP), Trade Web Direct (TWD), The Muni Center (TMC), MTS Bond Pro, TruMid.

### Flow Diagram - Client RFQ Flow

1. Primary Workflow of the Algorithm: The primary workflow that the algorithm handles is responding to client inquiries – RFQ's. The path of the ticket through the credit e-trading systems is described below.





2. Customer RFQ through the ECN: Customer sends in RFQ through external ECN, e.g., Market Axess.
3. TEX Routing of the RFQ's: TEX – the Trade execution – listens for the RFQ's and routes them to the auto-responder and the traders. A waterfall logic determines whether and how the algorithm responds to RFQ's with line traders having the first refusal on whether to respond. The waterfall logic is described later.
4. Autoresponder determines Eligibility of RFQ: The Auto-responder listens to all the RFQ's and performs numerous control checks when an RFQ is received to determine auto-response eligibility. It repeats the checks with 20 seconds – configurable – left in the quoting window. Details of the checks can be found in the later sections. If and only if all checks pass, the auto-responder sends back a level that was computed by the algo pricer.
5. Trader's Ability to Overwrite RFQ: The trader can see all RFQ's and has the ability to overwrite any level before the quoting window closes.
6. Time for Client to Accept: The client has a set amount of time to accept.
7. STP Based Standard Trade Booking: If DONE, the trade is booked through standard STP.
8. High Level Architecture Diagram of CBAR:
9. Waterfall Logic Determining Algo Response:

## **Streaming Flow**

1. Streaming Algorithmic Prices to Venues: The algorithmic prices are streamed to various ECN's that support the *click-to-trade* functionality, e.g., BOLT, KBP, etc. The workflow is described below and is illustrated as follows.
2. High-Level Algo Streaming Architecture: The streamer has waterfall logic that decides which of the internal levels – algo, portfolio, or institutional – to publish to ECN's.



3. Streamer Control Checks on Algo: The streamer listens to all algo price updates and performs numerous control checks before it sends the price to TEX.
4. TEX Waterfall for Outgoing Levels: TEX utilizes a waterfall to determine whether algo, institutional, or portfolio trader levels go out to the external trading platforms. Sometimes, dealers show just a single level – bid and offer – for bonds on all ECN's.
5. Auto-price Checks on Trader Acceptance: If a trader clicks the price on the external platform within the on-the-wire time, TEX sends the request to trade to the auto-execution module where numerous checks are performed. Details of the check can be found in a later section.
6. STP on Passing Control Checks: If all control checks – including checks in common with the RFQ workflow – pass, the trade is accepted and booked through standard STP. If any control fails, the acceptance decision is passed to a manual trader.

## **Algorithm Operational Logic Description**

1. Workflows of the Auto-responder Module: The corporate bond auto-responder has two main workflows.
2. Algo Levels for Client Inquiry: An RFQ auto-responding component that responds to the client inquiry with algorithmically generated levels.
3. Broadcast Algo Levels by Streamer: A streaming component that broadcasts algorithmically generated or manually derived levels to external venues. These levels can be automatically executed.
4. High Level Algo Components Architecture: The figure below illustrates the high-level architecture of the algo components and their connectivity to the wider credit e-trading platform.
5. Schematics of Typical Credit Algo Platform: All real-time components of the algorithm that contain the business logic are part of a typical Credit Algo Platform and are illustrated above. The only exception would be the streamer waterfall logic that is part of the TEX platform.



6. Interfacing with External Venues: Connectivity to external markets, normalization of messaging, and delivery of pricing and control information is part of the TEX platform. The configuration and control of the algorithm is provided through a number of user interfaces, listed in the Table below.
7. Interfaces that Control the Algorithm:

Interface	Type	Description
Parameter Controller	Config and Control	<ul style="list-style-type: none"><li>• Desk-level Control and Enablement</li><li>• Algo Global Parameter Control</li></ul>
Trader Work Queue	Control	Trader Portfolio-level On/Off Switch
Bond Switch	Control	Bond Level On/Off Switch
Bond Controller	Config	Algo Bond-level Parameter Control

### Algorithm Processing Logic Operating Detail – RFQ Quoting

1. Algo Response to Trading Strategies: The high-level workflow for client RFQ quoting is described earlier. The algo responds on behalf of the following three separate *trading strategies*.
2. Line/Flow Traders: For bonds enabled, the algo will respond with the line trader algo price if all checks are passed – and the trade is executed – the risk will flow into the bond owner's book.
3. Portfolio Trader: For bonds that are enabled and are not responded by the line-trader algo, the client RFQ's will be answered with the portfolio algo price. Executed trades will be routed to the portfolio trading book.
4. Algo Trader: All remaining trades will be routed to the automated market making algorithm. RFQ's that pass the checks are returned to the client with the *pure* algo price, incorporating risk-management logic and trader configuration. All executed trades are routed to the algo book.



## Algorithm Processing Logic Operating Detail - Streaming

1. Role of the Streaming Component: The streaming component of the algorithm allows for the bid and the ask levels to be sent to the various ECN's, e.g., KBP, MLBM, Bloomberg BOLT, and TruMid. Internally, these are a number of possible levels that could be sent to the markets from both algorithmically and trader marked levels.
2. Waterfall Logic for Choosing Levels: The streamer contains waterfall logic to choose a single level for each side based on business preference, for example:
  - a. Institutional Trader Axe
  - b. Algo Risk Reducing Levels
  - c. Gold Levels
3. RFT's that are Auto-executable: Client RFT's based on either axed or algo levels can be auto-executed, whereas those initiated when *gold levels* – which are just the standard marked levels for gold clients – are subject to manual execution.
4. Checks to Ensure Cross-Consistency: Further rules are applied to ensure consistency between the internal levels:
  - a. If two sides are streamed, they must not cross each other;
  - b. If the algo crosses the axe or the gold level, do not send out the algo;
  - c. If gold crosses with the axe level, do not send out gold.
5. Streaming On/Off Market Checks: The streamed algo levels go through the following workflow to ensure that they are on-market and not stale.
6. Standard Checks on Algo Levels: These are performed in accordance with the criteria described for level validation for bond/algo prices/spreads below.
7. Outgoing Price Streamed Checks: Outgoing prices must pass streamed price checks, as shown in the additional level validation sequence presented later.
8. Perform E-trading and Macro Checks.
9. Pulling Back Bond Streaming Prices: Pull back the streaming prices for a bond when a price is pulled back or if a check will fail, even if there is no new price, e.g., just surpassed the DONE only limit, including 10 minute bond notional/DV01 limit or macro checks.



10. Limiting/Controlling Streamed Sizes: Limit streamed size so that DONE + stream size does not exceed DONE sizes for Notional/DV01 check at the CUSIP level.  
Stream sizes of inventory on algo topic – initially make sure it is the same direction and its absolute value is less than or equal to the auto-responder's estimate of position plus DONE but not booked.
11. Check Levels of Treasury Yields: Check Treasury Desk Yields against second source as is done for RFQ's, i.e., the level and the bid/offer spread.
12. Maximum Stream Size Per Bond: 500K initially.
13. Streaming under Risk Accepting RFQ: Streaming is turned on using the risk-accepting RFQ setting.
14. Check Timestamps on Prices Published: 10 minutes.
15. Latency Check for Stream Validation: A latency check of 2 seconds for validating streamed prices.
16. Checks for Streaming Heartbeat Signal: Check streaming heartbeat signal is within last 6 seconds.

## **Auto-Execution of Streamed Levels**

1. Checks for Auto-executed Streamed Levels: When a client clicks on a streamed level on the ECN, a *Request-for-Trade* is sent to the dealer – this is technically equivalent to an RFQ, but sent to the dealer only and where the level is already set. Assuming this is eligible for auto-execution, the usual RFQ workflow and checks are performed along with the following additions.
2. Check Trade Size versus Streamed Size.
3. Compare Price Sent out versus Clicked: Compare sent price against clicked on price and make sure they match. If there is a more recent price, make sure

$$\text{Absolute Value of the PnL} = \text{abs}(\text{Price Difference} \times \text{Notional}) < \$500$$



4. Price Currentness Check for Axes: For axes, check that the price is within last 30 minutes and ensure price does not go past algo mid. Perform algo level/price and treasury yield tests to validate mid.
5. Auto-execution 5-minute Limit: Auto-execution 5-minute limit of size sent out per CUSIP.
6. Reversion to a Manual Flow: If any of these checks fail, the ticket then reverts to a manual flow.

## Inputs

1. Message Input into Auto-responder: All the ticket information relevant to an RFQ – which includes the RFT type received when answering inquiry on streamed levels -is communicated via an RPC call to the auto-responder service. All other necessary inputs are provided to the algorithm via messaging. These are listed below.
2. List of Messaging Based Inputs into the Algorithm:
  - a. DV01
  - b. Third Party Levels (CBBT, BVAL, etc.)
  - c. ECN Levels
  - d. TRACE Prints
  - e. Treasury Levels
  - f. Trader Levels/Runs
  - g. Algo Levels
  - h. Bond Reference Data
  - i. Bond Position
  - j. STW Order
  - k. TWQ Config
  - l. Credit Macro Signals
  - m. Equity Macro Signals
  - n. TWQ Heartbeat



- o. E-trading User Control
- p. ECN Heartbeat
- q. Bond Auto-quote State
- r. Bond Control Market
- s. Accumulation Instruction

## Outputs

1. Quote-Response from Auto-Responder: The quote response is returned to TEX via an RPC call. The response includes the high-level decision on whether to quote or not as well as detailed information on the decision-making process.
2. Book Picked from Waterfall Rules: The algo can accept risk or reduce risk for a number of different trading books – as defined in the waterfall rules – so the final decision on which book to use for the RFQ is passed back to TEX to allow them to STP any done trades accordingly.
3. Outputs from Auto-responder and Streamer: In addition to the quote response, the messaging framework is used to broadcast outputs of both the auto-response and the streaming components.
4. List of Messaged Outputs from the Algorithm:
  - a. Algo Levels
  - b. Streaming Level Output
  - c. Streaming BAC Level Streaming Heartbeats

## Benchmarks

IG bonds are priced in spread-to-benchmark terms which means that accurate and timely US Treasury Levels are needed. The standard on-the-run treasuries are used in the valuation.



## Market Phases

Corporate bonds are traded in an OTC market; therefore, there are no official market phases. The algorithm is operational between 8:30 and 16:15 EST on US trading days for both the IG and the HY trading desks.

## Algorithm Operating Constraints

1. Enablement Needed for CUSIP Trading: The algorithm is used for bonds owned by the trader. The trader has to be enabled using the Parameter Controller interface. In addition, the trader must have the offerings enabled on the ECN's. The following checks are required to pass before a bond can be considered eligible for auto-response.
2. Market and Owner Group On: Checks to see if the Market and the Owner group is switched on using the Parameter controller interfaces, which also acts as a kill switch. An owner group can be turned on risk-reducing, axe-matching, and/or auto-trading.
3. Control - Trader Enabled: Checks to see if the current owner of the bond is switched on.
4. Control - Trader Logged In: Checks to see if the current owner of the bond is logged in.
5. Control - Bond Enabled: Checks to see if the bond is enabled for auto-response and/or for streaming.
6. Control - Ticket Type: Checks to see if the trade is a CLIENT trade.
7. Control - Restricted: Checks to make sure the bond is not restricted.
8. Control - TEX Heartbeat: Checks that the TEX engine for that market is heart-beating.





9. Control - Protocol: Checks that the PFQ used the BIN protocol – this control is now relaxed so that non-BIN protocol RFQ's will be in scope.

## Model Use Constraints

1. Models the Algorithm Depends on: The algorithm is not a model, but does rely on a number of models for live price and risk calculation. These are:
2. Yield to Maturity Model: Used for DV01 calculation. DV01 calculation in itself does not typically happen within the algorithm. Pre-calculated DV01 values can be fed into the algorithm from an upstream system fast pricer, within which the model is implemented. There is no ETF NAV related calculation that needs to happen within the algorithm either. This applies to both the Auto-responder and the Auto-pricer modules.
3. Signal Mixer for Corporate Bonds: This is used to generate algorithmic levels for bonds as well as for hit-rate calculations. The RFM model used for generating the algorithmic levels is implemented in the *auto pricer*.
4. State Space Model for Market Prints: The SMAP model is used to produce a clean estimate of a bond's mid-price and bid/ask spread from TRACE market prints. SMAP levels are used as part of the *auto pricer*.

## Operational Risk

1. Trades at Off-Market Levels: The key risk associated with the algorithm is that it trades at off-market levels resulting in financial loss. Off-market levels could occur due to a breakdown in the algorithmic pricing engine or due to stale pricing.
2. On-Market Level Validation Checks: The risks are mitigated by comparing algo levels with reference levels from a number of other sources. The validation checks



performed on RFQ responses are listed in the sections below for spread/yield and price marked bonds.

3. Verifying Levels sent to ECN: The outgoing streamed prices are also checked to make sure that the levels sent to the ECN are not off-market. These checks are listed in the following section.

## **Level Validation Checks for Algo Levels on Bonds Marked in Spread or Yield**

1. Notes on Level Offset Criterion: Positive means more aggressive.

$$\text{Bid Spread} \geq \text{Reference Spread} - \text{Level Offset}$$

$$\text{Ask Spread} \leq \text{Reference Spread} + \text{Level Offset}$$

2. Notes on TRADE Level Check: Last same day TRACE print with size  $\geq 0.5$  MM, 10 bp from same side, 5 bp from opposite side, 7.5 bp from dealer-to-dealer.
3. Notes on Level-Type Check: All benchmarks must match; spreads should be from the same source when possible, e.g., IBX, CBBT, TRACE.
4. Notes on Field Requirement Check: Only 2 of the mandatory Credit Level Checks need to be satisfied.
5. Reference Source - RUN:

Reference Side	Mid
Level Type (see Notes above)	Spread
Level Offset (see Notes above)	2.0
Offset Units	Basis Points
Valid Time	4 Business Days
Required?	Mandatory (see Notes above)



6. Reference Source – Trader Mark:

Reference Side	N/A
Level Type (see Notes above)	Spread
Level Offset (see Notes above)	2.0
Offset Units	Basis Points
Max Bid-Offer	15.0
Valid Time	4 Business Days
Required?	When available

7. Reference Source – IBX:

Reference Side	Mid
Level Type (see Notes above)	Spread
Level Offset (see Notes above)	2.0
Offset Units	Basis Points
Max Bid-Offer	15.0
Valid Time	2.50 hours
Required?	Mandatory (see Notes above)

8. Reference Source – IDC:

Reference Side	Mid
Level Type (see Notes above)	Spread
Level Offset (see Notes above)	2.0
Offset Units	Basis Points
Max Bid-Offer	15.0
Valid Time	2.50 hours
Required?	Mandatory (see Notes above)

9. Reference Source – CBBT:

Reference Side	Mid
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Level Type (see Notes above)	Spread
Level Offset (see Notes above)	4.0
Offset Units	Basis Points
Max Bid-Offer	15.0
Valid Time	5 minutes
Max Latency	30 seconds
Required?	When available

10. Reference Source – ECN (Top of Book 100K):

Reference Side	Mid
Level Type (see Notes above)	Spread
Level Offset (see Notes above)	2.0
Offset Units	Basis Points
Max Bid-Offer	15.0
Valid Time	15 minutes
Max Latency	30 seconds
Required?	When available

11. Reference Source – TRACE:

Reference Side	See Notes above
Level Type (see Notes above)	Spread
Level Offset (see Notes above)	See Notes above
Offset Units	Basis Points
Max Bid-Offer	See Notes above
Valid Time	Today
Required?	When available

12. Reference Source – Treasury Benchmark:

Reference Side	N/A
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Level Type (see Notes above)	N/A
Level Offset (see Notes above)	N/A
Offset Units	N/A
Max Bid-Offer	N/A
Valid Time	10 minutes
Max Latency	30 seconds
Required?	Mandatory

## Level Validation Checks on Algo Levels for Bonds Marked in Price

1. Notes on Level Offset Criteria: Positive means aggressive:

$$\text{Bid Price} \leq \text{Reference Price} + \text{Level Offset}$$

$$\text{Ask Price} \geq \text{Reference Price} - \text{Level Offset}$$

2. Notes on TRACE Print Criteria: Last Same Day TRACE Print – Size  $\leq 0.5MM$ ;  
USD 2 from same side, USD 1 from opposite side; USD 1.5 dealer-to-dealer.
3. Reference Source – RUN:

Reference Side	Mid
Level Type	Price
Level Offset (see Notes above)	0.15
Offset Units	Dollars
Max Bid-Offer	2.5
Valid Time	Today
Required?	Mandatory

4. Reference Source – Trader Mark:



Reference Side	N/A
Level Type	Price
Level Offset (see Notes above)	2.0
Offset Units	Dollars
Max Bid-Offer	N/A
Valid Time	4 Business Days
Required?	Mandatory

5. Reference Source – IBX:

Reference Side	Mid
Level Type	Price
Level Offset (see Notes above)	0.30
Offset Units	Dollars
Max Bid-Offer	2.50
Valid Time	2.50 hours
Required?	Mandatory

6. Reference Source – CBBT:

Reference Side	Mid
Level Type	Price
Level Offset (see Notes above)	0.60
Offset Units	Dollars
Max Bid-Offer	2.50
Valid Time	Today
Max Latency	30 seconds
Required?	When available

7. Reference Source – ECN (Top of Book 100K):

Reference Side	Mid
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Level Type	Price
Level Offset (see Notes above)	0.15
Offset Units	Dollars
Max Bid-Offer	2.50
Valid Time	Today
Max Latency	30 seconds
Required?	When available

8. Reference Source – TRACE:

Reference Side	See Notes above
Level Type	Price
Level Offset	See Notes above
Offset Units	Dollars
Max Bid-Offer	See Notes above
Valid Time	Today
Required?	When available

## Level Validation Checks for Outgoing Streamed Prices

1. Note #1 on Level Offset:

$$PV\ Offset = \min(DV01 \times LevelOffset / 100.0, 0.75)$$

2. Note #2 on Level Offset:

$$Price\ To\ Check = Price + DV01 \times (TSY\ Yield\ Quote\ \% - TSY\ Yield\ Now\ \%)$$

3. Note on the Required Check: Two of Three must pass.



4. Note #3 on Level Offset: In addition to the checks of Treasury Desk Yield vs. CBBT Yield, the Streamer Treasury Yield is checked against the Treasury Desk Yield.

5. Reference Source – ECN (Top of the Book 100K):

Reference Side	Mid
Level Type	Price
Level Offset	4 (See Note #1 on Level Offset above)
Offset Units	Dollars
Max Bid-Offer	2.0
Max Latency	30 seconds
Required?	When available

6. Reference Source – CBBT:

Reference Side	Mid
Level Type	Price
Level Offset	6 (See Note #1 on Level Offset above)
Offset Units	Dollars
Max Bid-Offer	2.0
Max Latency	30 seconds
Required?	When available

7. Reference Source – BMRK:

Reference Side	Mid
Level Type	Price
Level Offset	6 (See Note #1 on Level Offset above)
Offset Units	Dollars
Max Bid-Offer	2.0
Max Latency	30 seconds
Required?	Mandatory (see Notes above)

8. Reference Source – IDC:





Reference Side	Mid
Level Type	Price
Level Offset	4 (See Note #2 on Level Offset above)
Offset Units	Dollars
Max Bid-Offer	2.0
Required?	Mandatory (see Notes above)

9. Reference Source – IBOXX:

Reference Side	Mid
Level Type	Price
Level Offset	4 (See Note #2 on Level Offset above)
Offset Units	Dollars
Max Bid-Offer	2.0
Required?	Mandatory (see Notes above)

10. Reference Source – Treasury:

Reference Side	Mid
Level Type	Yield
Level Offset	1 (See Note #3 on Level Offset above)
Offset Units	Basis Points
Max Bid-Offer	2.0
Required?	Mandatory

## Reputational Risk

1. Main Source of Reputational Risk: The main source of reputational risk arises from the dealer not honoring prices streamed to ECNs. This can occur for RFT's when the last-look PnL check is triggered.



2. Streamed RFQ Level Response Monitoring: The following metrics are monitored to ensure that excessive rejects are not seen and that the checks are applied symmetrically. These are reported at regular governance forums.
3. Same Customer/Current Algo Level: RFT's that were accepted and where the level sent by the customer and the current algo level were the same.
4. Different Levels - Dealer Loss < USD 500: RFT's that were accepted and where the level sent by the customer and the current algo level were different and where the PnL represented a loss of less than USD 500 for the dealer.
5. Different Levels - Dealer Gain < USD 500: RFT's that were accepted and where the level sent by the customer and the current algo level were different and where the PnL represented a win of less than USD 500 for the dealer.
6. Customer Rejects - Dealer Gain > USD 500: RFT's that were rejected by the algo, i.e., went manual, because the level sent by the customer and the current algo level were different and the resulting PnL would have represented a win of > 500 USD for the dealer.
7. Customer Rejects - Dealer Loss > USD 500: RFT's that were rejected by the algo, i.e., went manual, because the level sent by the customer and the current algo level were different and the resulting PnL would have represented a loss of > 500 USD for the dealer.
8. Other RFT Rejects/Manual Switchover: RFT's that were rejected by the algo, i.e., went manual, for other reasons, e.g., a limit was breached.

## **Market Risk**

1. Sources of Algorithm Market Risk: Sources of market risk considered for the algorithm are the following.
2. Excessive Exposure to a Particular Bond or Ticker: These risks are mitigated by notional and position controls, as detailed in the next section.



3. Trading During Periods of Excessive Volatility: These risks are mitigated by checking that Equity, CDX, and Treasury moves have not exceeded a threshold.

## Sample Risk/Notional Controls for an IG Desk

1. Notes on the Listed Numbers: Percentages are relative to the desk/day headline in that row – for clarity, the calculated limit is in brackets.

2. Level – Desk; Time Period - Day:

Gross Notional (MM)	200
Net Notional (MM)	50
Gross DV01	USD 120K/bp
Net DV01	USD 30K/bp

3. Level – Desk; Time Period – 10 minutes:

Ticket Count	300
Gross Notional (MM)	15% (30)
Net Notional (MM)	20% (10)
Gross DV01 (USD 1K/bp)	10% (12)
Net DV01 (USD 1K/bp)	20% (6)

4. Level – Ticker:

Time Period	Day
Gross Notional (MM)	10% (20)
Net Notional (MM)	20% (10)
Gross DV01 (USD 1K/bp)	10% (12)
Net DV01 (USD 1K/bp)	20% (6)

5. Level – Bond:



Time Period	Day
Gross Notional (MM)	5% (10)
Net Notional (MM)	20% (10)
Gross DV01 (USD 1K/bp)	5% (6)
Net DV01 (USD 1K/bp)	20% (6)

## Typical Risk/Notional Controls for HY Desk

### 1. Level – Desk; Time Period - Day:

Gross Notional (MM)	112.5
Net Notional (MM)	58.5
Gross DV01	USD 58.5K/bp
Net DV01	USD 31.5K/bp

### 2. Level – Desk; Time Period – 10 minutes:

Ticket Count	113
Gross Notional (MM)	16% (18)
Net Notional (MM)	23% (13.5)
Gross DV01 (USD 1K/bp)	15% (9)
Net DV01 (USD 1K/bp)	29% (9)

### 3. Level – Ticker:

Time Period	Day
Gross Notional (MM)	12% (13.5)
Net Notional (MM)	23% (13.5)
Gross DV01 (USD 1K/bp)	15% (9)
Net DV01 (USD 1K/bp)	29% (9)

### 4. Level – Bond:



Time Period	Day
Gross Notional (MM)	12% (13.5)
Net Notional (MM)	23% (13.5)
Gross DV01 (USD 1K/bp)	15% (9)
Net DV01 (USD 1K/bp)	29% (9)

## Risk/Notional Controls

1. Algo Risk and Notional Controls: There are a number of risk and notional controls that prevent the algorithm from accumulating too much risk within a particular bond, ticker, or in total. These are measured over a single 10-minute period to mitigate against excessive client requests as well as over the whole trading day.
2. IG DV01 Normalized to LQD: For IG, the bond DV01's are normalized often to a major IG Bond ETF – LQD – by applying a *beta-adjustment* to the raw bond DV01. These betas are calculated by regression to historical spreads between the bonds and the ETF. The previous two sections show some typical control numbers.
3. Single Ticket Size Constraints: A typical maximum ticket notional handled by the algorithm is USD 3MM for the standard client RFQ flow. Streamed prices are subject to a USD 500K maximum, for instance.

## Volatility Controls

1. Checks for Market State Swings: To guard against wider market volatility, a number of checks are performed on credit, rates, and equity market benchmarks which act as indicators for wider market activity. The algorithm fails to respond if any of these conditions are violated.
2. CDX High-Low in the Past 15 Minutes: Less than 1 bp.
3. CDXIG Timestamp within Last 15 Minutes:



*Latency  $\leq$  30 seconds*

4. ESA High-Low in Past 15 Minutes: Less than 1%
5. ESA Timestamp within Last 5 Minutes:

*Latency  $\leq$  30 seconds*

6. 10-Year Treasury High-Low in Past 5 Minutes: Less than 5 bp
7. 10-Year Treasury Timestamp within Last 10 Minutes:

*Latency  $\leq$  30 seconds*



## Corporate Bond Skewer

### Major Components

1. Algo Pricer: An application that produces real-time algo levels on the data backbone.
2. Auto-responder: An application that listens for RFQ's from the Tech framework with the goal of auto-responding. It pulls levels from the data backbone, performs all control checks, and if all checks pass, responds automatically with a level when there is 20 seconds left in the BIN protocol.
3. Trader Work Queue: Application that displays RFQ's to the manual trader and enables the trader to submit levels.
4. TEX: An application that is an intermediary between the outside world and the trader. It maintains the state of the RFQ's, and interacts with manual traders via Trader Work Queue and the automated trader via the Auto-responder.
5. Streamer/Auto-execution Engine: Streamer is an application that pulls algo clean prices from the data backbone, performs all control checks, and sends it downstream to be streamed out the door for click to trade on ECNs, e.g., ALLQ, TW/BD, KBP, MLBM. The auto-execution engine performs a few checks after a client clicks on our level, e.g., ensures that the level has not changed significantly, before it accepts an automated trade.

### Maximum Auto-Responder Sizes

1. Maturity/Level/Beta DV01 Discriminator: RFQ Maximum Size = 3M for maturity  $\leq$  5Y, level  $\leq$  100 bp, BetaDV01  $\leq$  2200
2. Beta High Water Mark Discriminant: RFQ Maximum Size = 2MM, if BetaDV01  $\leq$  2200, 0 otherwise.



3. Maximum Streaming Size Discriminant: Maximum streaming size = 500K for algo generated streams.

## Waterfalls

1. Ax Request from Current Day: If a trader has an ax from today, the auto-responder responds with the trader's ax level if the ax size is greater than or equal to the RFQ size. A risk-accepting ax from today is first in the waterfall. A risk-accepting ax is ignored if it is not from today.
2. RFQ that is Risk-Reducing: If an RFQ is risk-reducing to an institutional trader, the institutional trader gets the first preference unless the RFQ is small, e.g.,  $\leq 100K$  for long end. Otherwise, the algo book gets preference if it is also risk-reducing to the algo book.
3. Level for Risk Reducing RFQ: If the auto-responder is quoting on behalf of the institutional trader for a risk-reducing RFQ, it will use the ax if it is from today. Otherwise, it will use the algo level.
4. Risk-reducing followed by Risk-accepting: The remaining waterfall in order of preference is risk-reducing for algo book, risk-reducing for portfolio book, risk-accepting for portfolio book if a set of bonds with their corresponding skews was uploaded by the portfolio trader that day, and then risk-accepting for algo book.
5. RFQs in Trader Work Queue:
  - a. Ax/Risk-reducing for institutional trader
  - b. Risk-reducing for algo or portfolio book
  - c. Risk-accepting for portfolio book
  - d. Risk-accepting for algo book
6. Overrides using Manual Trader Input: If a trader puts in a manual level, it will override all other levels and the trade will be booked into the trader's book.
7. Limits on the Algo Levels: Algo generated streams are only generated for sized up to 500K and for algo and portfolio book inventory.





8. Waterfall Sequence after the Ax: If a trader has an ax, the ax has preference over the algo on ALLQ. An ax can be auto-executed up to 500K if it passes a test against the algo mid. After the ax, the algo streams are next in the waterfall, followed by the trader's gold levels.

## **Skewing Flow**

1. Bond-level Pricing Set List: There are 5 different pricing sets for each bond. Each set has multiple client tiers. The five sets are as follows:
  - a. Institutional Trader/Portfolio Trader Risk-reducing
  - b. Portfolio Trader Risk-accepting
  - c. Algo Book Risk-reducing
  - d. Algo Book Risk-accepting
  - e. Algo Book Risk-accepting for small size
2. Small Size Risk-accepting Algo Book: The algo book risk-accepting levels for small sizes are the regular algo-book risk-accepting levels backed off a little. The reason for this initially was that when the platform first went live, RFQ's were the only mechanism to get rid of risk. Now that it streams to multiple ECNs and can exit small positions, this condition can be relaxed. This will improve the ticket count hit rate.
3. Signal Waterfall Order - ECN, CBBT, BMK: All of the signals are based upon an initial waterfall that consists of ECN, CBBT, and BMK. Since BMK is based purely on TRACE prints and not executable levels – CBBT is indirectly based on executable levels – it is not allowed to be better than the second most aggressive reference level. BMK is also further constrained by the Runs for the non-algo book levels.
4. Bid/Offer Spread Computation/Reduction: For ECN levels, the average bid and offer up to a threshold size is based upon the stack and the resulting bid/offer spread is reduced by a percentage, e.g., 30%.



5. Estimating the BO % Reduction: This percentage was set based upon looking back at historical RFQ's, backing out where they traded, and then looking at the resulting PnL profiles based upon reducing the ECN bid/offer spread by different percentages.
6. Separate BO for Different Pricing Sets: Separate percentages are used for the following three scenarios for different pricing sets.
7. Algo Book Risk-reducing: Risk-reducing for the algo books is the most aggressive as we are often trading near the mid.
8. Institutional/Portfolio Trader Risk-reducing: Risk-reducing for the institutional/portfolio trader is more about optimizing the PnL.
9. Algo Book Risk-accepting: Finally, risk-accepting for the algo book is the least aggressive and is about maximizing the PnL and constraining the balance sheet.
10. Adjusting Bid and Offer Levels: The bid and the offer levels are then adjusted in a number of different ways.
11. Improved Levels for Risk-reducing: First, for risk-reducing only, if there are more aggressive Run levels, the bid or the offer is improved up to a basis point if the Runs are recent.
12. Accuracy Impact of Incorporating Runs: The degree to which Runs are updated on a timely basis varies widely across the desk. Of course, Runs would be most accurate if there was a position in the CUSIP and hence limited this to risk-reducing RFQs.
13. Adjustments Based on Recent TRACE: The levels are then adjusted based upon TRACE. The levels are backed up in the direction of the last print if it is a 5 MM print or if the aggregate net TRACE size of the last 5 prints is greater than a threshold.
14. Constraints Placed on TRACE Prints: The level is also constrained if it is out of the range of recent TRACE prints or if it goes past the reference mids – Runs, IBOXX, IDC, BVAL – by more than a margin.
15. Non Algo-Book Risk-reducing: For all price sets other than algo-book risk reducing, if there is a Run from the last few days, the level will not go more than a threshold past the Runs mid. This may require a revision for the portfolio book as stale tuns can cause uncompetitive bids for certain bonds.



16. Idea Behind the RFM Signal: A second signal – RFM – is incorporated into pricing where the bid and the offer for each pricing source – e.g., TRACE, ECN, CBBT, IBOXX, IDC, BMRK, is reduced to minimize on average the difference between historical TRACE prints and the historical levels of a pricing source at the same point in time.
17. Proximity of Adjusted Levels to Median: The median value of these bids or offers is determined and a score is computed based upon how many of these adjusted pricing source levels are near the median.
18. Determining Hit-Rate Based Level: Based upon the historical variation of TRACE prints around this median signal, a level can be determined based on the current median level, the historical variability of the signal, and a desired hit rate. This signal is used to improve the first algo signal if there is a high score.
19. Algo Risk-accepting Liquidity Premium: For algo risk-accepting levels, a liquidity premium is added ranging from 0 to 20 bp.
20. Steering Close to Neutral Risk: The second component of pricing/skewing allows the risk to close to market neutral across the risk categories.
21. Skewing applied for Own Books: There is skewing logic only when the algo responds to its own books as it only considers risk in its own books.
22. Algo Book Risk Limit Table: A representative limit table for the algo book across different risk features is as follows:

	<b>Net (K/bp)</b>	<b>Gross (K/bp)</b>
ISIN	2.5	2.5
Ticker	3.0	6.0
Maturity Bucket per Sector	6.0	25.0
Sector	6.0	35.0
Maturity Bucket	15.0	NONE
All	25.0	NONE



23. Estimating Category-Based Risk-Fraction: The algo computes risk fractions for these risk factors. For example, if the sector risk is 3K/bp and the sector limit is 6 K/bp, then the category risk is 0.5, i.e., it is at 50% of the limit.

24. Category Risk Fraction Scaling Table: Each risk fraction is then scaled by the following factors for each bond:

<b>CUSIP</b>	1.0
<b>Ticker</b>	0.35
<b>Maturity Bucket per Sector</b>	0.075
<b>Sector</b>	0.075

25. Category Based Risk Fraction Impact: Clearly, the bond's own risk will be the largest risk factor in skewing the levels followed by the ticker, and then benchmark and sector.

26. Sum of Scaled Risk Fractions: The algo then sums up these scaled risk fractions. The sum is translated to a skew percentage using a piecewise linear skew table.

27. Weighted Sum vs Skew Table:

<b>Weighted Sum</b>	<b>Skew</b>
$\leq -0.67$	-0.50
-0.40	-0.20
-0.20	-0.20
0.00	0.00
+0.20	+0.20
+0.40	+0.20
$\geq +0.67$	+0.50

28. Adjustment for Risk-accepting RFQ: For a risk-accepting RFQ, the algo applies a small percentage improvement to the raw level, e.g., the ECN levels, to the base



signal methodology discussed above, improves upon the RFQ signal, and then applies this skew percentage to the resulting bid/offer spread to determine the skew.

29. Scenario-specific Logic Walk-through: The levels then go through a crawling logic which has a few scenarios. One such scenario sequence is laid down below.
30. Maximum Risk Fraction across Categories: The maximum risk fraction across all of the categories is above a threshold:
31. Minimum Risk Fraction across Categories: The minimum risk fraction exceeds another threshold:
32. Recent Hit-rate Threshold Breach: The hit-rate for the past hour and day is less than a threshold – say 10%:
33. CUSIP-Level Liquidity Fraction Check: The bond is liquid, i.e.

$$LiquidityFraction \geq 1$$

34. Cross Category Maximum Gross Risk: The maximum gross risk across categories is less than 0.75.
35. Actions on Scenario Criteria Match: Then: the offer side spread for that bond will be ramped up, i.e., cheaper, over the next hour by up to a percentage of the bid-offer spread.
36. Actions on Net Risk Reduction: If the algo reduces this net risk by more than a threshold, the crawler backs up and begins the cycle again, assuming all of the above conditions are still met.
37. Risk-reducing RFQ - Initial Stance: For risk-reducing RFQs, the algo starts with a more aggressive stance, improving the raw levels in the base methodology signal further.
38. Risk-reducing RFQ - Adjustment #1: It then improves the level on one side for positions that are aged more than 60 days by 15% of the bid/offer spread.
39. Risk-reducing RFQ - Adjustment #2: It then further improves the level if the maximum net risk fraction is greater than 0.33 and goes through different crawling strategies that are a function of risk across all of the categories and the hit rate.



40. Checks across the ECN Levels: The levels then go through reference checks – IBOXX, Runs, IDC, TRACE, and BVAL – as the level is not allowed to go past the second most aggressive mid by more than a threshold; however, risk-reducing is allowed to go up to 2 bp further through the mid if risk is built up on one side.
41. Final Checks for Risk-Control: The following are some final rules to control risk.
42. 80% Gross Risk Limit Threshold: If 80% of the gross limit is hit, the algo backs up all balance sheet increasing levels by 10 bp.
43. Threshold for Net Risk Limit: If 33% of the net limit is hit, it backs up 2 bp, and if 50% of the net limit is hit, it backs up 10 bp. These are clearly very constraining.
44. Impact of Imposing above Limits: The practical consequence of the above is that net limits are really half of the limits specified. So, once 10 K/bp is hit across all books, quoting is done purely for the sake of quoting.
45. Consequence of Beta-weighted Risk: These limits are further constrained by the fact that risk is beta-weighted, which prevents quoting larger sizes for long-dated, high-spread CUSIPs.
46. Migration to LQD-Based Betas: The betas used in the algo are really volatility adjustments that are dependent on the spread of the bond. A better idea would be to migrate to the LQD betas that also take into account correlation.