Optimal execution problem in Obizhaeva–Wang framework

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Introduction

The introduction of resiliency — the speed at which supply/demand recovers to its steady state after a trade — characterizes the beginning of a new stage in the development of optimal execution models. In our research we develop a practical way to utilize that concept. The supply/demand of financial securities is in general not perfectly elastic. This fact is true even for liquid European markets. If we talk about much less liquid Russian markets, neglecting this fact can be disastrous. The main difference between OW model and others is precisely that resiliency plays a key role in it.

Optimal execution problem

If one wants to sell or buy an amount of an asset large enough to have a significant impact on the market, he, obviously, should not do it by one order: it would be very expensive, since a large order would remove all the upper levels in the limit order book. Therefore, in practice, all large orders are split into a large number of small ones. For example, one can simply divide an order into N equal parts and sell them at regular intervals (this is called TWAP). To find a better solution, we consider the OW model, in which terms the problem has the following form:

$$J_0 = \min_{\{x_0 \cdots x_N\}} E_0 \left[\sum_{n=0}^{N} [A_{t_n} + x_n/(2q)] x_n \right], \tag{1}$$

$$A_{t_n} = F_{t_n} + \lambda(X_0 - X_{t_n}) + s/2 + \sum_{i=0}^{n-1} x_i \kappa e^{-\rho\tau(n-i)}, \tag{2}$$

where:

- The trader has to buy $\mathbf{X_0}$ units of a security over a fixed time period $[0, T]$;
- x_{t_n} is the trade size at $t_n = \tau n$, where $\tau = T/N$;
- $X_{t_n} := X_0 - \sum_{t_k < t_n} x_{t_k}$;
- B_{t_n} and A_{t_n} are bid and ask prices at t_n;
- $V_{t_n} = \frac{A_{t_n} + B_{t_n}}{2}$ is the mid-quote price;
- s is the bid–ask spread;
- F_t is the fundamental value of the security;
- q, λ and ρ is a LOB density, the permanent price impact and the resiliency. $\kappa = \frac{1}{q} - \lambda$

Optimal execution strategy

Proposition 2 from [OW13] gives a solution to the optimal execution problem (1). The first step of our research is implementing the following formula (that is a limit of a discrete solution, which may be used for big N). The next step is implementing the discrete solution and considering those strategies.

The limit of the optimal execution strategy in OW framework

As $N \to \infty$, the optimal execution strategy becomes:

$$\lim_{N\to\infty} x_0 = x_{t=0} = \frac{X_0}{\rho T + 2},$$
$$\lim_{N\to\infty} x_n/(T/N) = \dot{X}_t = \frac{\rho X_0}{\rho T + 2}, \qquad t \in (0, T),$$
$$\lim_{N\to\infty} x_n/(T/N) = x_{t=T} = \frac{X_0}{\rho T + 2},$$

where x_0 is the trade at the beginning of trading period, x_N is the trade at the end of trading period, and $\dot{X}_t$ is the speed of trading in between these trades.

The key question: how to find ρ?

We provide our methodology to find ρ. We find it, considering the time series of elements of the model that can be calculated from market data. As an example, we are going to consider the regression:

Our method to find parameters

$$\frac{\Delta A_{k+2}}{\Delta t_{k+2}} - \frac{\Delta A_{k+1}}{\Delta t_{k+1}} = -\rho \Delta A_{k+1} + \rho\lambda x_{k+1} + (\kappa+\lambda)\left(\frac{x_{k+2}}{\Delta t_{k+2}} - \frac{x_{k+1}}{\Delta t_{k+1}}\right).$$

Where all the information needed can be extracted from the l3 data:

- ΔA_k is an ask change after execution of the limit order with the depth x_k.
- Δt_k is a time between k and $k+1$ orders of dataset.

Problems

- The task formulated in the KPI is not directly related to the article [OW13]. [OW13] and [Vel20] pose the problem significantly differently. Similar terminology we have found in [Web23], but we did not find the theory to work with in that framework.
- The data we previously had did not have a sufficient level of detail to extract accurate model values. It was necessary to make assumptions and results that significantly distorted the final result. New data will require significant time to parse and research. Anyway, data work is very complicated.
- This area is very rich and complicated. It is very hard to do even easy steps in the theoretical research, because we did not have courses on that theory.

Objectives

- Develop methodology for fitting OWM parameters and use it to get optimal execution strategy.
- Compare different approaches of measuring resiliency on l3 data.
- Compare discrete and limit OW execution strategies.
- Propose a backtest procedure for the optimal execution algorithm, implement it, and compare the algorithm with TWAP on real market data.

References

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