

Trading in Financial Markets

Rob Hayward

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Outline

- 1 What is trading?
- 2 Institutional features
- 3 Trading techniques
- 4 Future directions

What is trading?

- Market-making
- Proprietary trading
- Investment

Market-Making

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- Dealer (bid-ask)

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- Electronic (order-driven)

Open Outcry

London Metal Exchange

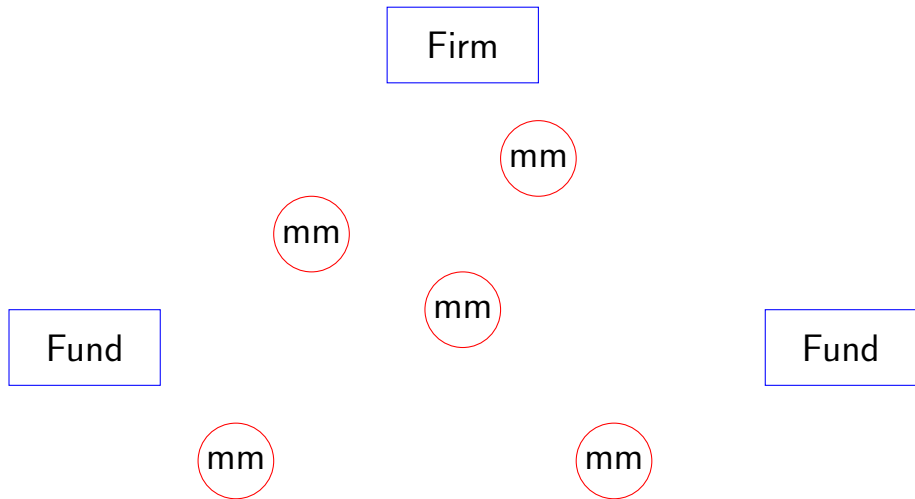
Market-making: Dealer

Firm

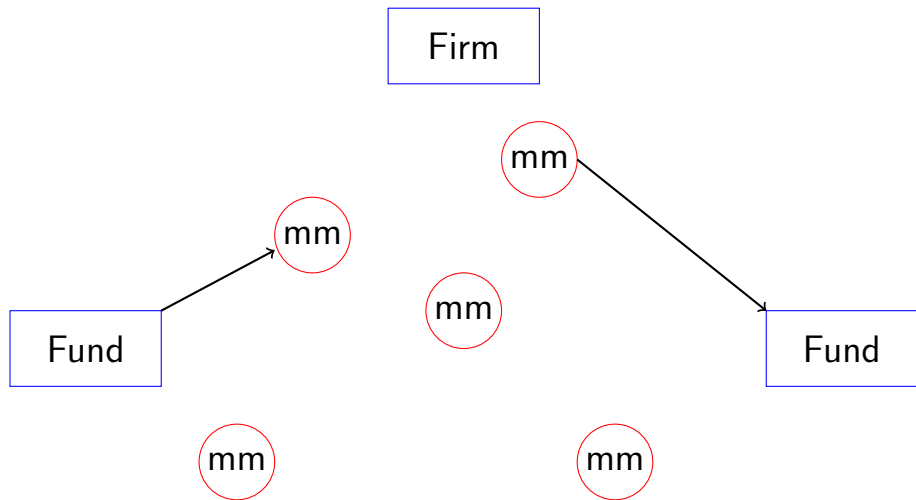
Fund

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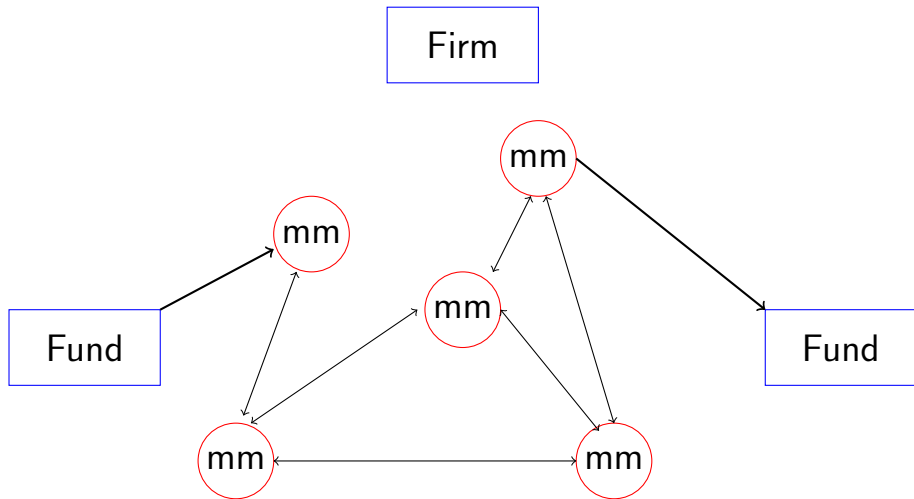
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Bid-Ask

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- Liquidity can be an issue

Proprietary trading

- Using institution's capital

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- Risk-adjusted return relative to cost of funds

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- Arbitrage opportunities

Carry trade

Investment

■ Long term

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- *Versions of Value Investment*

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 - Currency overlay

Institutional features

- Commercial banks
- Investment banks
- Funds
- Exchanges
- Government

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- Divergence UK and Continental Europe

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- *The Volcker Rule*

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- Aim to extend monopolistic power from trading to other activities such as settlement and custody
- Post-crisis regulation aims to push more trading onto exchanges

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Trading techniques

- Value investment
- Momentum
- Contrarianism
- Carry trade
- Arbitrage
- Automation

Momentum

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 - Technical analysis: trends and moving average
 - Early identification of trend
 - Indications that the trend is ending

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- *Representativeness or Availability* heuristics

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- Bollinger bands - standard deviation of movements

Contrarianism

The Carry trade

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- UIP does not seem to hold
- Risk?
- Alternatives (Yield curve, CDO, bank lending)

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Automation

Automation of trading

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- Remove behavioural bias

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- Cover more markets and identify inefficiencies

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- Spoofing

Automation

Future directions

- Limits to automation and latency

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- Always looking for new inefficiencies