DISCUSSION OF “HOW SMART IS INSTITUTIONAL TRADING?”

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Big Picture Question

• How smart is institutional trading?
  • Hedge funds VS. Other institutions

Hedge funds: lightly regulated, trading flexibility, incentive fees, use leverage, limit redemptions, sophisticated clientele

Managerial skill: stock selection and market timing

Fire sales during crisis, destabilize market
Summary

• Empirical Strategy: *high frequency* institutional order flow
  • Campbell, Ramadorai, and Schwartz (2009) methodology
  • ANcerno institutional trading

• Findings: hedge funds are smarter than other institutions — their order flows
  • Generate smaller price impact
  • Better predict future stock returns
  • Attenuate mispricing
Comments

• Very interesting and important question, careful, detailed analysis, novel insights
• Some suggestions/challenges to improve the paper (or for future papers)
  • Proxies on institutional order flow
  • Alternative explanations
  • Extensions and additional tests
CRS Proxy on Institutional Order Flow

• Proxy I: Campbell, Ramadorai, and Schwartz (CRS, 2009)
  • Identify buy/sell order from TAQ (Lee and Ready (LR, 1991)), and compute order imbalance in 19 trade size bins
  • Infer daily IOF from quarterly 13F institutional holding change and TAQ order imbalance
• CRS: NYSE/Amex, 1993 – 2000
• This paper: NYSE/Amex/Nasdaq + ANcerno, 1999 – 2012
• Applying LR algorithm to Nasdaq data introduces biases for trades executed inside the spread (Ellis, Michaely, and O’Hara (2000)).
• The trading mechanics and process are evolving over time.
Algorithmic trading → order flow matters much more than individual orders.

Institutions trade dynamically with limit orders → introduces noises to LR algorithm.

NYSE/Amex and pre-2000 sample, compare the coefficient estimates

Sources: TABB Group, Deutsche Bank Research (2016)
ANcerno Proxy on Institutional Order Flow

- Proxy II: ANcerno institutional trading data
- ANcerno is a consulting firm that provides transaction cost analysis for its institutional clients.
- Do ANcerno institutions represent all institutions?
  - Self-selection: concerned with execution costs
  - Smart on average? This paper: ANcerno hedge funds and other institutions are similar in trading skills.
- Account for 8% of total CRSP dollar volume and 10% of all institutional trading volume (Puckett and Yan (2011)), from 1999 to 2005.
• 11% of total CRSP dollar volume
• 14% (10%) of NYSE/Amex (Nasdaq) dollar volume
• Other institutions might trade in opposite direction?
Alternatives on Smart Order Flow

• This paper: hedge fund order flows display low execution cost and exploit mispricing → smart.
• Managerial skill or by construction?
• Hedge funds impose *redemption restrictions* → more patient in trading, less price impact
  • Do hedge funds have better trading skills in crisis / fire sales?
• Hedge funds are loosely regulated and can take *short positions* → act as arbitragers
  • Mispricing is driven by overpricing, do hedge funds mainly profit from the short-leg? Impact on short-sale constraint?
• Do smart and dumb order flows behave differently in the Internet bubble (run-up) period and crash period?
Corporate Events

• This paper: hedge fund order flows \([-6, -2]\) do not predict CAR \([-1, +1]\) around earnings announcements and analyst revisions \(\rightarrow\) not informed.

• Do hedge fund order flows predict earnings surprises and analyst revisions?

• Do hedge funds trade on this information more than one week in advance?

• Does PEAD diminish with smart order flows?

• Any difference on good VS. bad news?

• High frequency event: corporate news releases
ANcerno Institutional Trading: News Release Day

- IOF = (Buy – Sell)/MV
- CSS: composite sentiment score between 0 and 100, from RavenPack News Analytics
ANcerno Institutional Trading: $[-10, +10]$ 

- Cumulative IOF around news announcements
- Use the ability to predict news to define smart and dumb institutions?
Additional Tests

• Use transaction cost from actual fund trades, e.g., execution shortfall
• Adjust for the fund styles in order flows
• How do institutional order flows interact with investor sentiment in affecting the mispricing?
What I Learned...

• Address a critical shortcoming in empirical analyses, and construct *daily* institutional order flow

• Hedge funds are smarter than other institutions in various ways.

• Important research question, carefully executed empirical work.