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

E.g., Jagannathan, Malakhov, and Novikov (2010), Agarwal, Jiang, Tang, and Yang (2013), Cao, Chen, Liang, and Lo (2013), Akbas, Armstrong, Sorescu, and Subrahmanyam (2015)

Fire sales during crisis, destabilize market

E.g., Boyson, Stahel, and Stulz (2010), Aragon and Strahan (2012), Ben-David, Franzoni, and Moussawi (2012), Mitchell and Pulvino (2012)

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

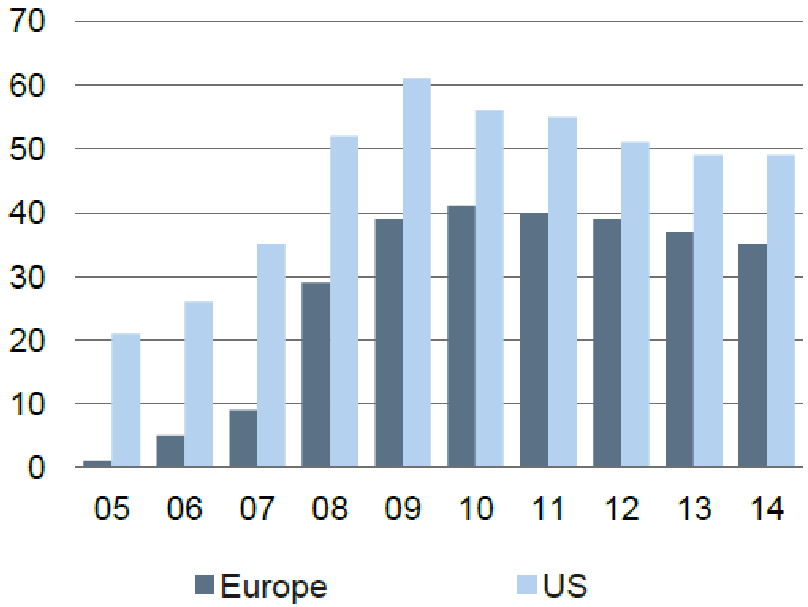
- Very interesting and important question, careful, detailed analysis, novel insights
- Some suggestions/challenges to improve the paper (or for future papers)
  - Proxies on institutional order flow
  - Alternative explanations
  - Extensions and additional tests

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.

CRS Proxy on Institutional Order Flow

% Share of HFT in Total Equity Trading



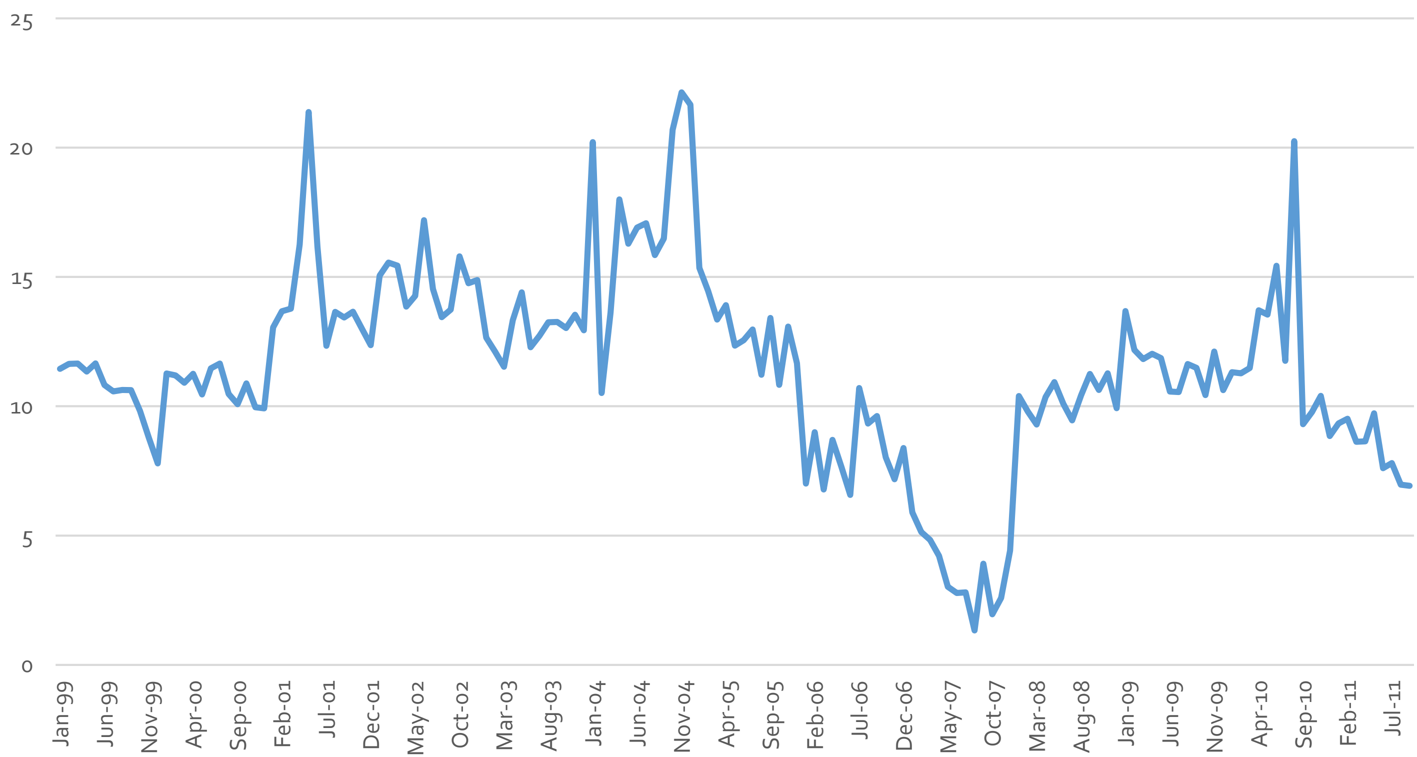
Sources: TABB Group, Deutsche Bank Research (2016)

- 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

ANcerno Proxy on Institutional Order Flow

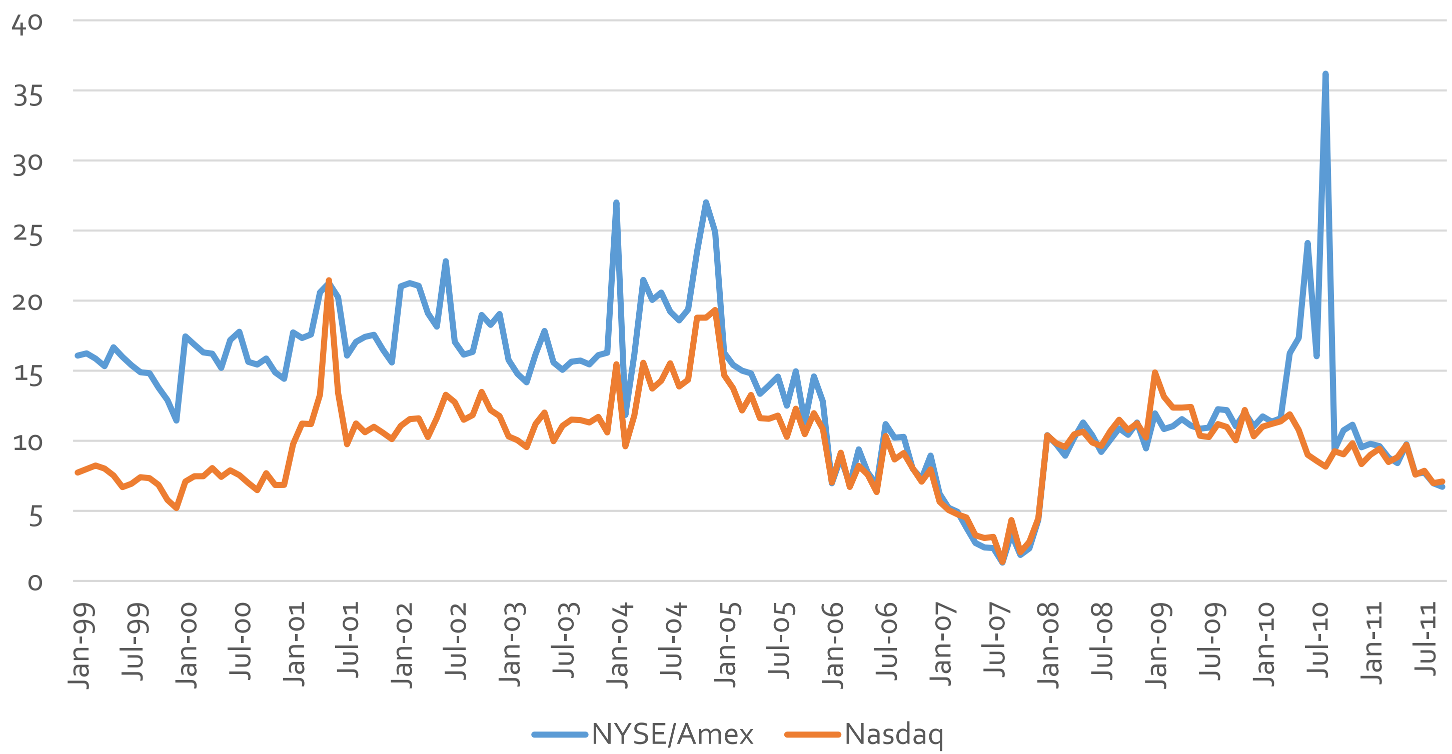
- Proxy II: ANcerno institutional trading data
- ANcerno is a consulting firm that provides transaction cost analysis for its institutional clients.
- Do ANcerno institutions represent all institutions?
  - Self-selection: concerned with execution costs
  - Smart on average? This paper: ANcerno hedge 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.

% Dollar Volume from ANcerno



- 11% of total CRSP dollar volume

% Dollar Volume from ANcerno



- 14% (10%) of NYSE/Amex (Nasdaq) dollar volume
- Other institutions might trade in opposite direction?

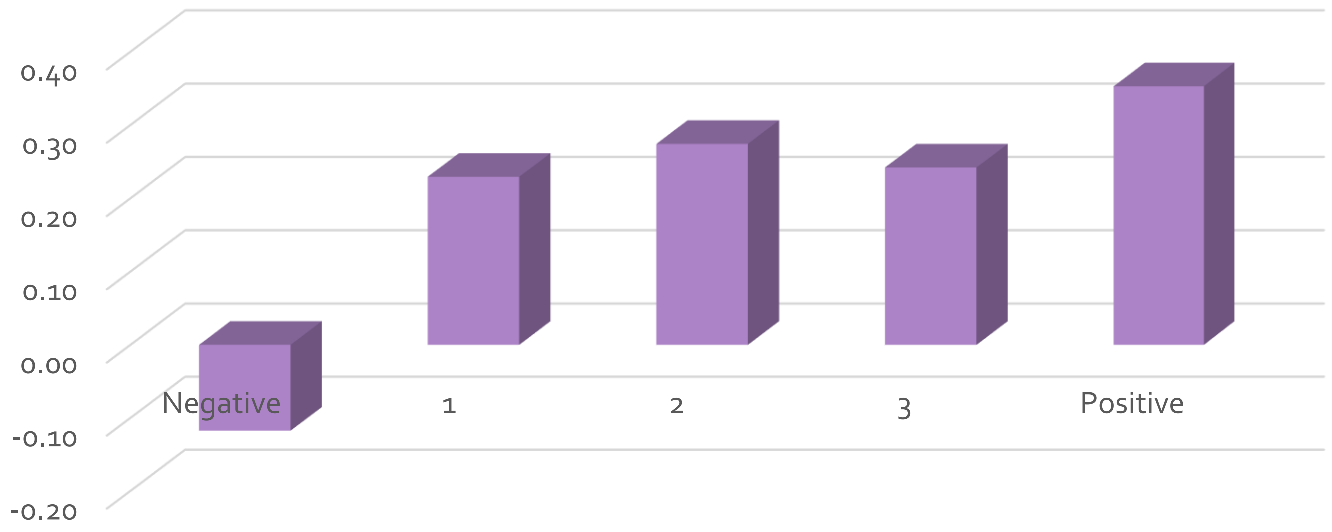
Alternatives on Smart Order Flow

- 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

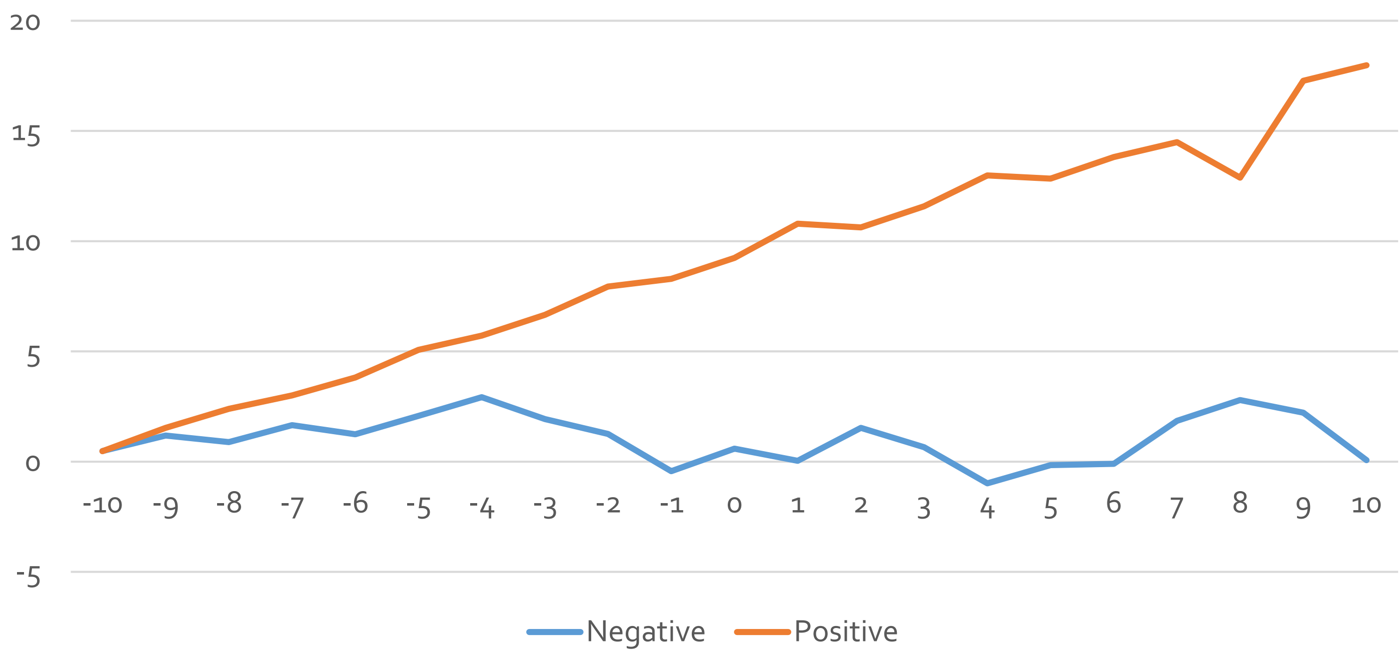
- This paper: hedge fund order flows [−6, −2] do not predict CAR [−1, +1] around earnings announcements and analyst revisions → not informed.
- Do hedge fund order flows predict earnings surprises and analyst revisions?
- Do hedge funds trade on this information more than one week in advance?
- Does 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.