Brokers and Order Flow Leakage

By Barbon, Di Maggio, Franzoni, and Landier

ECB Conference Discussion:

Marcin Kacperczyk (Imperial College)

May, 2018

Motivation

- How does information get disseminated in financial markets?
  - A standard learning model posits learning from public signals (prices, volume, etc.)
  - Inside information as an alternative way of learning
- Does informed trading destabilize markets?
  - Welfare implications of insider trading (DeMarzo, Fishman, Hagerty, 1998)
  - Evidence of front running of fire-sales trades (Cai, 2002; Coval and Stafford, 2007); Chen, Hanson, Hong, and Stein (2009)
- **This paper:**

(1) Using trade-level data and brokers' order flow information

(2) Look at large liquidation events as a shock to private information

(3) Study the consequences of predatory trading for price formation

Main Results

- Result 1: Brokers' best clients tend to predate on the liquidating funds: a long-short position of selling holdings and buying them back generates 50bps over a 10-day period
- Result 2: The liquidation costs of the distressed funds double around the shock
- Result 3: "Aware brokers" subsequently generate higher commissions from executing predators' trades

Summary of Comments

- Very interesting paper!
- Several clever analyses

- Information content
- Mechanism
- Implications for stability

Comment 1: Information content

- Paper postulates traders learn order flow information from brokers
- What is the incremental value of individual order flow relative to prices and aggregate volume?
- Is there predictability of order flow for these trades?
  - If so, then it maybe possible for others to take advantage of it
- Only a subset of brokers become aware of distress
  - How much of the market do they cover? Are fire sales really a concern here?
  - How much of the trade is done before the broker becomes aware?
  - Can you separate price impact due to liquidators' and predators' trades?

Comment 2: Mechanism

- On distress, informed traders sell assets at higher prices and buy back at lower prices later on
  - Is this selling of existing inventory or short selling? If short-selling, would not security lenders price in the demand for stocks? Risky arbitrage opportunity?
  - Is there any reason why their holdings are correlated with those of distressed funds?
  - Wouldn't the distressed fund manage its price impact? (Hau & Lai, 2017)
- What would be a counterfactual behavior of prices in the absence of brokers' leakage?
  - Paper postulates significant price impact on selling by distressed funds
  - Why would not other traders benefit from that as well by simply observing price impact as well?

Comment 3: Implications for Stability

- Paper shows convincing evidence on the profitability of trading driven by brokerage links
  - Predators make money and the prey loses money
  - A bit of an every-day life of asset managers (short squeeze, algos, etc.)
- Less evidence on the aggregate implications of the behavior
  - Does predatory trading destabilize financial markets or is this just an idiosyncratic phenomenon for specific institutions?
  - Can you relate the implications to the size of distress?
  - Are there any implications for the subsequent behavior of distressed funds? Do they learn or are they as vulnerable as before?