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CAPITAL MANAGEMENT

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> ***"Technology is a gift of God. After the gift of life it is perhaps the greatest of God's gifts. It is the mother of civilizations, of arts and of sciences."***
> ***— Freeman Dyson***

Are the markets rigged? The topic of high frequency trading (HFT) appears heated and full of debate. At Lake Hill, we are often asked how HFT affects our industry. The short answer is: technology, automation and tighter spreads helps in the form of lower transaction costs. However, technology used to simply "front run" orders hurts.

While the issue can be complex, we believe that one must first define HFT. Using computers to quickly make trading decisions and transact - even in the microsecond timeframe - is no different from any other advancement in technology. If one player is faster than another is, while remaining compliant, how can we protest?

If HFT is simply defined as fast trading, we have no issue. If unethical players are using technology as a means of breaking laws or bending regulations designed to protect the integrity of markets, then we do have an issue.

Most would agree that using technology to automate the ability to front run - an age old problem - should clearly be regulated. The authorities have always squelched front running and why should this time be any different?

Not too long ago, prior to HFT, we called a floor broker to execute an order on the exchange. The floor broker legally traded for his own account ahead of his client order flow. Clearly, this was a form of front running and the regulators correctly put a stop to it.

After that, brokers created "arms-length" relationships with "floor traders," or "locals," who were legally able to "position" ahead of client order flow. This was just another form of front running. Once again, the regulators correctly put a stop to this.

Currently, high frequency traders are electronically able to identify an order being routed to an exchange and trade ahead of it. This is no different from before, when the broker had knowledge of an order and traded in front of it. As regulators take a closer look, the rules will undoubtedly change.

Technology is not the villain in the HFT debate. Today, locals, liquidity providers, market-makers, brokers and customers are able to interact on exchanges electronically from *anywhere*. This has made a profoundly positive impact on spreads and liquidity. Technological advancement, which includes speed, has certainly resulted in significantly reduced trading costs.

If high frequency trading is electronic trading that allows for greater and more efficient connectivity to exchanges, it is a good thing. If high frequency trading is really just an exercise in automated front-running, it is a bad thing.

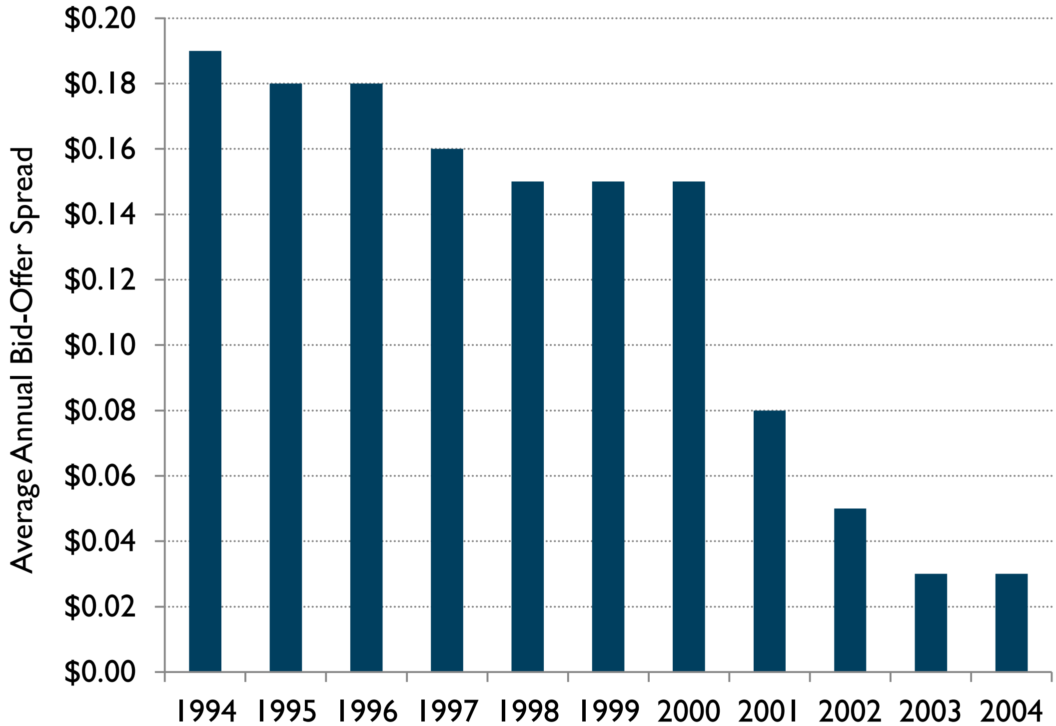

Figure 1: Average annual bid-offer spread for all stocks on the NYSE (http://www.nyxdata.com/)

The transaction cost per unit of stock is lower than it has ever been. Ultimately, the folks most shocked by "risk-free" profits of some HFT firms would be equally shocked by the hidden fees, commissions, and spreads paid when the industry was less technologically advanced. We are not defending malfeasance in the system, but we are defending the clear benefits that technology brings all market participants.

At Lake Hill we rely heavily on technology. It is a critical piece of our business that integrates risk management, portfolio construction, trading execution, transaction reconciliation, compliance and investor transparency.

In order to stay competitive, one must continuously adapt to evolving technology. Some players will be faster than others. Some rules will have to be updated. Irrespective of how one defines HFT, the combined overall impact of technology and innovation appears positive.

Electronification has had a big positive impact on investing. Everyone must adapt to this new world or become marginalized. Businesses across many industries need to be on the forefront of technology – including the finance industry– to remain competitive.

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