QV UPDATE
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What Lurks in the Dark?

It would seem that outstanding execution in regards to security trading rarely makes the newspaper. Headlines often reference a rule or law that has been accidentally or maliciously violated. This week's newspaper is no exception with the focal point being the New York Attorney-General's accusation of Barclays for dark pool fraud. In the trading world, a dark pool is an alternative market where anonymity is preserved until post trade execution. The allegations suggest that Barclays, among other things, routed a disproportional amount of trades through their own dark pool called LX Liquidity Cross while better prices were available via other venues. The complaint also puts forward that Barclays advertised protection from predatory high frequency trading (HFT) in LX Liquidity Cross while secretly providing incentives to high frequency traders (HFTs) for the opportunity to take advantage of unsuspecting victims in their dark pool.

We have traded small amounts through LX Liquidity Cross in the past. We have taken measures to avoid trading there going forward, at least until the current issue is resolved. Most of the major Canadian brokers have already stopped trading on that venue.

This lawsuit brings HFT back into the spotlight and forefront of investors' minds. HFT has many forms. Benefits such as increased liquidity and tighter spreads derived from HFT gain much less publicity than its negative attributes. The predatory trading strategies in question essentially allow firms with superior technology to decode trades on their way to markets. HFTs then transact milliseconds before the initial trade is executed, thus receiving better pricing to the detriment of legitimate investors. Despite measures taken by regulators over recent years, the release of Michael Lewis's book "Flash Boys: A Wall Street Revolt" earlier this year is what really brought issues associated with HFT into the public eye. QV Investors received questions upon the book's release from concerned investors wondering how their trades were being affected.

Our clients are right to be concerned. We are aware of the cost that predatory trading imposes on firms like ours, and we have taken steps to minimize its impact. Even the smaller firms that execute trades on our behalf have made large investments in technology to combat these strategies.

When initiating trades we often search for large blocks of stock that are advertised by other institutional investors prior to algorithmic (computer based) trading. Transactions costs are reduced by avoiding exposure of large trading volume to the markets where HFTs prowl. For example if we had 100,000 shares of a stock to buy and we found a seller through our broker network who was willing to sell 100,000 shares, we would negotiate a fair price and trade the full amount in a single transaction. Alternatively, we would have to break the trade into as many as 1,000 pieces and trade them in lots of 100. This increases the potential to tip off other investors and also would potentially expose 1,000 little transactions to HFTs.

More importantly for our clients is the benefit of our buy and hold strategy. We typically only trade about 20% to 25% of our portfolios during any given year. This is quite low by industry standards. Our reduced turnover not only defers tax bills for our clients, but it shields them to a large degree from predatory trading and transactions costs.

The bulk of our trading is done in Canada, which also bodes well for evading HFTs. The Canadian market is more tightly regulated than the American market making it comparatively difficult for HFTs to operate in. Significantly lower trading volume in Canada makes predatory trading strategies less economical. Sources vary, but roughly 30% to 35% of Canada's average volume is executed by HFTs versus approximations as high as 50% in the USA.

In summary, we are aware of the dangers that lurk in the markets we trade in. Our efforts, combined with those of the regulators and sell side firms protect our portfolios from material damage inflicted by electronic trading sharks.

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