Quantifying the Impact of Latency on High Frequency Trading

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Quantifying the Impact of Latency on High Frequency Trading

Research Thesis

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Abstract

Establishing a low network latency connection to stock exchanges has been the desire of trader for years. A well-known example is the extremely expensive construction of an ultra-low latency fiber optic cable between New York and Chicago just for reducing three millisecond in the round trip time. Yet, the exact possible usage and potential profitability of such high end network connection remains mostly unclear.

In this Thesis, we address this point by studying the impact of latency on the profitability of traders. We concentrate on the single security, single exchange case and use the Geometric Brownian Motion (GBM) model as the underling model for stock prices. Using this model, we are able to quantify the potential profit of traders as a function of their latency. This is done by presenting the possible earning increase as a result of reducing latency based on the intra-day security prices of the AAPL and the GOOG shares. One outcome of this work is that the HFT trading race in the single security single exchange case is not a zero one game, and profit can be made also by slower players.
Abbreviations and Notations

\begin{itemize}
\item $W$: Wiener process, may also be referred to as Brownian motion
\item $S_t$: value of a security at time $t$
\item $X_t$: natural logarithm of the value of a security at time $t$
\item $\mu$: drift coefficient, used as a parameter for the geometric brownian motion
\item $\sigma$: diffusion coefficient, used as a parameter for the geometric brownian motion
\item AAPL: refers to the Apple company securities
\item GOOG: refers to the Google company securities
\item $\mathcal{L}$: maximum likelihood function
\item $\hat{\mathcal{L}}$: log of maximum likelihood function
\end{itemize}
Chapter 1

Introduction

The fast development of computer communication and networking technology over recent decades created a major shift in the way stocks are traded in stock exchanges. The manual interaction of talking (shouting), note writing and hand shaking was replaced by a very fast communication infrastructure that allows sophisticated trading algorithms to perform actions within milliseconds without any human intervention.

The goal of this thesis is to quantify the possible earnings that may be made by traders based solely on their low network latency (speed of trade).

Stock exchange is an entity which allows trading of shares or securities. Transaction is an event where a certain amount of shares (or other securities) are sold by the owner to a buyer at a certain price. For this to happen the security has to be listed at a specific exchange and the price the buyer is willing to pay, should at the very least, be the price the owner requests.

There are more than 10 registered stock exchanges and dozens of private venues in New York city, in which a single type of stock may be traded. The common scenario is that in all of these locations, each of the major stocks has quotes for both buying and selling.

In order to fully grasp the importance of low latency connection to high frequency traders, consider the case of “Spread Networks”. “Spread Networks” is a fiber optic cable company that at 2010 finished constructing a new cutting edge fiber optic cable connection between New York and Chicago financial venues. The Price of the construction is estimated to be 300 million dollars and the outcome was the shortening of the prior latency from roughly 16 milliseconds to about 13 milliseconds [1].

The extent of the race for low latency is not limited to inter cities or cross state distances. Today, most trading venues including the registered ones, offer market members the ability to “co-locate” their servers next to the trading floor. This means that the
exchange members may place their own servers inside the exchange’s building in order to shorten the connecting cable. Furthermore, due to member’s demand, these venues have evolved to the following “co-location” service guaranty: Each member that uses the “co-location” services of the exchange will be connected to the exchange server using an equal length cable \[3\].

In their seminal work, Budish Cramton and Shim \[9\] focus on the profit that can be made relaying strictly on speed. They do so by describing a scenario with \(N\) equal high frequency traders; one of which is chosen randomly to be the market maker, and the other \(N - 1\) are said to be the “snipers”. Their results indicate that after every price change which is greater than half the market spread, an arbitrage opportunity arises and each of the \(N\) traders tries to catch it first. The \(N - 1\) “snipers” try to act on the old quote while the single market maker tries to cancel it.

This simplistic scenario leads the authors of \[9\] to raise a flag regrading inherent flaws in current exchange market design. Those arbitrage opportunities represent a large amount of money that can be made by the fastest trader; this leads the industry to substantial spending on high end hardware which is capable of enabling such fast trade. Eventhough the hardware spending is not a problem in and of itself, the reason for its existent - an artificially made race for speed, rather than a race for best financial offer, is a problem.

The above mentioned conclusion leads the authors to believe that major changes must take place in current market design. The proposed solution is a switch to batch auctions being conducted every \(t\) time units, where \(t\) is constant, known in advance and small enough to allow for undisturbed trade.

In order to develop the mathematical model that is used to explain the profit making process, few simplifying assumption are made in \[9\]. The first assumption is that there exists a signal \(y\) for each security \(x\) whose price is (I) perfectly correlated with the price of \(x\) and (II) publicly and simultaneously known to all. Such an assumption may seem small at first glance but in fact it may be too powerful.

The authors use high end data at millisecond granularity of the ES and SPY indexes to show how correlation between those two otherwise heavily correlated indexes breakdown as the interval goes down to millisecond level. It demonstrates how even though arbitrage opportunities remain “open” for a shorter amount of time as the years go by, the number of these opportunities remains constant. Thus, supporting the authors claim as to the existence of inherent speed arms race.

As mentioned above, our goal is to quantify HFT potential profitability as a function of the network latency. We do this by studying the well known Geometric Brownian Motion (GBM) model and developing a model that quantifies the HFT earnings as a function of network latency. The main contribution of this work is the mathematical
analysis of HFT possible earnings in the context of network latency. Our works novelty lies in the practical mathematical analysis of HFT earnings as a functions of their time delay from the stock exchanges.

In our process of validating profitability derived solely from network latency, we differ from [9] by (I) not using the simplifying assumption regarding the existence of the public signal $y$, and (II) we attempt to explicitly quantify how fast a trader has to be in order to make profit solely from network latency.

Using our tool for profitability analysis, we are able to compare the potential profit of traders with different network latency. Our results indicates that HFT is not a zero one game but rather an arena in which an algorithmic trader can make profit even if he isn’t the fastest.

This thesis is structured as follows. In Chapter 2 we describe relevant related works. In Chapter 3 we introduce the Brownian motion concept. Chapter 4 consists of a study of the Geometric Brownian motion model from both a mathematical perspective and a real life data perspective. In Chapter 5 we verify the underline assumption of the GBM model regarding price changes behaviour. Chapter 6 consists of the methods we use to fit the model parameters to real data. In Chapter 7 we show an algorithm for parameter extraction from a given data set and verify the model behaviour using its results. In Chapter 8 we analyse the accuracy of the model both on a full given data set and on future data. Chapter 9 consists of an analysis as to the potential profit that can be made by using the trading technique we propose. In Chapter 10 we conclude the research and its results.
Chapter 2

Related Work

2.1 Social effects

The social affects of high frequency trading was the subject of several academic studies in recent years [5, 9, 11, 23, 19, 24, 1, 8, 25]. One key question is whether the high frequency traders are socially beneficial or not. In this context, high frequency traders are the traders that use superior technology which relays on high end infrastructure supplied by the stock exchanges. A major part of the earnings of these traders is based on technology (speed) rather than on financial expertise.

As described in [23], high frequency traders may have some beneficial effects on the market, such as increasing liquidity, shortening execution time and narrowing the spreads. The congressional hearing report [25] claims that HFT techniques are divided into two - passive and active. Active strategies rely mainly on attempting to force other algorithm based traders into wrong action which will result in profit for the traders that employ the active strategy. Such actions may include flooding the market with bid requests and cancellations.

The second HFT technique is the passive one. According to [25], this method is based on passive market making with attractive price offers that the traders are capable of suggesting due to their superior knowledge at the time of the bidding. Due to this method of operation, HFT traders have the beneficial effects on the market of narrowing the prices spreads.

Another beneficial effect of HFT traders on the market that is described in [7] is based on their superior access to information. Where this issue is usually used against these traders to claim adverse selection, it is claimed in [7] that this issue might be beneficial to the economy as it leads the market towards the “real” price a security should have and helps avoid pricing errors.
Adverse selection is caused when one side of a transaction (seller or buyer) has better information about the quality of the goods than the other side. As described by Akerman’s market for lemons [2], adverse selection may very well cause the deterioration of the market’s goods quality and even lead to a total collapse of the market.

A major issue raised by the authors of [5] is the case of possible adverse selection in the securities market caused by HFT traders. This claim has two supporting pillars. First, HFT traders have a better and more up to date view of the market condition. Second, HFT traders also tend to invest in technologies which allow them a faster knowledge of real world events which are likely to affect securities quality.

The authors of [5] continue by dealing with the question of how should the negative externalities caused by such adverse selection be dealt with. Several approaches are being investigated, including the complete ban of all high frequency practices. Since HFT has social benefits, a more relaxed approach is proposed in the form of Pigouvian taxes executed upon high frequency technology investments.

### 2.2 Securities prices modeling

Finding a way to model (with accuracy) the dynamic behaviour of securities values over time gained a considerable amount of attention from the academic community [9, 11, 17, 28, 21, 13, 22, 14].

One classical approach for the prediction of security prices is the chartist method. This approach is based on the believe that history tends to repeat itself, and thus the study of past patterns may predict future behavior [10]. To use this method one analyses the sequence of past price changes in order to forecast future price changes. This approach is inline with current trends in machine learning. Yet, Fama write in [10]: “The techniques of the chartist have always been surrounded by a certain degree of mysticism...”.

Another method is the intrinsic value approach. The underline assumption of this approach is that every security has an intrinsic value and its actual value tends to move towards it [10]. The endeavor to find this intrinsic value is what leads many mega sized firms to maintain entire divisions of analysts who’s job is to asses the quality of many aspects in companies such as the value of its assets, quality of the management and other such attributes. The end game agenda is that knowledge of the intrinsic value is similar to predicting the future price of a security.

It is not surprising to discover that the raise of artificial intelligence algorithms in practically every aspect of our lives had not left the world of forecasting securities prices untouched. Different machine learning and artificial intelligence approaches were used
in the context of security price forecasting, see [14] for a recent survey. The authors of [4] use Neuro-Fuzzy system to predict stock prices. The authors study several stocks to determine the best model for prices prediction. The paper claims that the Neuro-Fuzzy model indeed supply for relatively accurate results which were superior to other investigated models. Another surveyed paper is [20]. In this paper, the authors use stochastic time effective neural network in order to improve price prediction. This method is based on adding weights to the training set so the more recent the price change, the more important it is. This paper also concludes by stating that this model improves accuracy of securities prices forecasting.

A different approach for the modeling of securities prices is called random walk. The bulk part of [10] discusses this approach. It is distinctively different from other methods since it is heavily rely on a random process. It assumes the market is unpredictable, as stated in the paper: “the future path of the price level of a security is no more predictable than the path of a series of cumulated random numbers.”

The underling assumptions of the random walk method about a sequence of an individual security prices are (I) Price changes are uncorrelated and (II) Each individual price change does not strive towards an intrinsic value or social optimal welfare. This approach conflicts with the other more classic approaches that assume logic in price changes.

Are the price changes really independent? according to [10], the answer is probably yes, or at least independent enough in the sense that the dependency level is not sufficient to make a profit. This firm claim is based upon substantial research which was conducted and reviewed in [10] to examine price changes. Due to the importance of this question for the legitimacy to use random walk, we also conduct a small study in this work in order to validate this property on the data we use.

We use the random walk approach in this thesis since it allows us to conduct several empirical studies with strong mathematical reasoning. This method is backed by a substantial amount of academic studies such as [10, 9, 17, 22].
Chapter 3

Introduction to Brownian motion

3.1 Definition of Brownian motion

Brownian motion (or Wiener process) is frequently used in modeling of stock prices. It is a stochastic process with stationary and independent increments. It may be observed as the continues time version of a random walk. The notion, Brownian motion, was coined after the botanist Robert Brown who in 1828 observed the movements of particles in a plant [18]. Later, the Brownian motion was formally characterized as the Wiener process in the following way [22][12]:

\begin{equation}
\begin{array}{l}
1. W_0 = 0 \\
2. W \text{ is continues} \\
3. W's \text{ increments are independent, assuming they are not overlapping. } \forall t_0, t_1, s_0, s_1 \in \mathbb{N} : t_1 > t_0 \land s_1 > s_0 \text{ if } (t_0, t_1) \text{ and } (s_0, s_1) \text{ are not overlapping, than } W_{t_1} - W_{t_0} \text{ is independent of } W_{s_1} - W_{s_0} \\
4. W's \text{ increments size are normally distributed with mean zero and the standard deviation is the length of the interval. } \forall t, s \in (\mathbb{N}) : t > s : \\
W_t - W_s \sim \mathcal{N}(0, t - s)
\end{array}
\end{equation}

Since Brownian motion increments are independent and identically distributed (iid) (points 3 and 4), Brownian motion is by definition a Markov process.
3.2 Martingale

Intuitively, a Martingale process is a process in which the best prediction for the future is the present. Formally, if process $X_t$ is a Martingale process, then $\forall t, s \in (\mathbb{N}) : t > s : E[X_t - X_s] = 0$. From a financial point of view, if a stock price behaves as a Martingale process, then the best prediction for the stock price in the future is the current stock price. Namely, all past knowledge is irrelevant.

From the definition, Brownian motion (Wiener process) is a Martingale.
Chapter 4

Geometric Brownian motion

4.1 Overview

In order to analyze the impacts of delay on traders, we need an underlying model for stock prices. We use the Geometric Brownian Motion model, where we examine several properties of the model and validate them on real data. Then, we use it to quantify latency affect on traders.

Brownian motion captures the desired essence of the “jittery movement” of stock prices, but, since stock prices tend to raise over time (at least on average) Martingale process is insufficient. Thus, instead of using classic Brownian motion, we use the Geometric Brownian Motion (GBM) model that is more common in the context of security prices modeling [10] [17].

GBM is formulated using the following Stochastic Differential Equation (SDE):

\[
    dS_t = \mu S_t dt + \sigma S_t dW_t
\]  

(4.1)

\(S_t\) is the value of the stock at time \(t\), \(\mu\) is the drift coefficient, \(\sigma\) is the diffusion coefficient (or the volatility) and \(W_t\) is the standard Brownian Motion (Wiener process) with \(E[W_t] = 0\) and \(Var[W_t] = 1\).

4.2 The intuition behind the GBM SDE equation

The upper mentioned SDE Equation provides the change of the modeled object size [17]. Namely, the left hand side of the equation, \(dS_t\), stands for the delta in \(S_t\) size during time \(t\).

The right hand side is composed of two parts that capture prices incline to raise over
time and prices volatility. The first part, $\mu S_t dt$, is a multiplication of $\mu$, the drift coefficient, by the size of the object and the amount of time elapsed. Intuitively, this means each price change size is dependent on the market’s tendency to grow (drift coefficient $\mu$), the object absolute size, and the elapsed time.

The second part, $\sigma S_t dW_t$, is a multiplication of the diffusion coefficient $\sigma$ which stand for “how jittery the movement is” by the size of the object and $W_t$, the Brownian Motion. The motivation for this part is to add the randomness of the changes received from the Brownian motion. The randomness becomes more significant as the market’s volatility represented by the diffusion coefficient, $\sigma$, grows.

### 4.3 Deriving GBM SDE

The GBM Equation 4.1 is a SDE, the solution for which is well investigated [17, 27] and will not be discussed at length in this thesis.

The derivation of Equation 4.1 relays on Ito’s lemma that allows for the derivation of an Ito process:

$$dx = a(x,t)dt + b(x,t)W_t$$

(4.2)

$x$ is the Ito process, $t$ represent time, $W$ is a wiener process and $a, b$ are functions of $x$ and $t$. One may notice the GBM SDE is inline with the requirements for an Ito process.

Using Ito’s lemma its possible to rewrite the Equation as:

$$S_t = S_0 e^{(\mu - \frac{\sigma^2}{2})t + \sigma W_t}$$

(4.3)

### 4.4 Expected value and variance

$S_t$ in Equation 4.3 describes the price of a security at time $t$ according to the GBM model. For ease of use, we define $X_t = \ln S_t$ (see for example [17]). Thus receiving:

$$X_t = \ln S_t = \ln S_0 + (\mu - \frac{\sigma^2}{2})t + \sigma W_t$$

(4.4)

Thus, $X_t$ stands for the natural logarithm of the security price. Next, we evaluate the expected value of $X_t$

$$E[X_t] = E[\ln S_0 + (\mu - \frac{\sigma^2}{2})t + \sigma W_t] = E[\ln S_0] + E[(\mu - \frac{\sigma^2}{2})t] + E[\sigma W_t]$$

(4.5)
Since $\mu$ and $\sigma$ are constants and using basic expected value properties, we get:

$$E[X_t] = \ln S_0 + (\mu - \frac{\sigma^2}{2})E[t] + \sigma E[W_t]$$

(4.6)

By definition, the expected value of a Wiener process equals to 0 and since $t$ is a simple variable (as oppose to a random variable) we get:

$$E[X_t] = \ln S_0 + (\mu - \frac{\sigma^2}{2})t.$$  

(4.7)

As to the variance, 

$$V(X_t) = V((\mu - \frac{\sigma^2}{2})t) + V(\sigma W_t),$$  

(4.8)

where $\mu$ and $\sigma$ are constants. Thus,

$$V(X_t) = V(\sigma W_t) = \sigma^2 V(W_t).$$  

(4.9)

By the definition of the Wiener process, the variance of $W_t$ is $t$ (Equation 3.1), thus:

$$V(X_t) = \sigma^2 t.$$  

(4.10)

Since our main focus is security price changes, rather than absolute price values at given time, we use $X_{\Delta t}$ to indicate the difference in $X$ values between time $t_1$ and $t_2$, more formally, $X_{\Delta t} = X_{t_2} - X_{t_1}$ when $\Delta t = t_2 - t_1$.

We then get that for a time elapsed $\Delta t$:

$$E[X_{\Delta t}] = (\mu - \frac{\sigma^2}{2})\Delta t$$  

(4.11)

$$V(X_{\Delta t}) = \sigma^2 \Delta t$$  

(4.12)

From a financial point of view, the meaning of Equation 4.11 is that according to the GBM model, stock price expected change over time correlates with the markets incline to grow (drift coefficient $\mu$) and negatively with the market volatility (diffusion coefficient $\sigma$). While according to Equation 4.12 the stock price variance over time correlates only with the market volatility.
4.5 The affect of the different parameters

The current market trend is captured in the GBM model using the market coefficient - $\mu$ and $\sigma$. In order to better understand their impacts on the model behaviour, we present the behaviour of the model for different values of $\mu$ and $\sigma$.

Figures 4.1 and 4.2 depict the reaction of the GBM model to these values.

![Figure 4.1: GBM reaction to different values of $\sigma$](image)

Figures 4.1 and 4.2 depict the prices a certain security would have according to the GBM model over a time period of 30 time units. In Figure 4.1 the drift coefficient is fixed ($\mu = 1$) and the volatility coefficient ($\sigma$) changes. In Figure 4.2 the volatility coefficient is fixed ($\sigma = 1$) and the drift coefficient ($\mu$) changes.

In Figure 4.1 the line that correlates to $\sigma = 0$ is smooth. This is because $\sigma$ is the volatility coefficient and when it’s equal to 0 the price change values are without a random factor. The line that correlates to $\sigma = 1.6$ remains flat and the prices are unable to grow. This is because the expected value of the price change is with negative correlation to the size of $\sigma$ (Equation 4.11).

In Figure 4.2 the line that correlates to $\mu = 0$ is flat, that is since $\mu$ represent the market prices incline to grow. From Equation 4.11 we can take that only when $\mu > \frac{\sigma^2}{2}$ the Expected value is positive. When observing this figure, were $\sigma = 1$, indeed we can see that only for the lines that correlates with $\mu > 0.5$ the price grows.
Figure 4.2: GBM reaction to different values of $\mu$
Chapter 5

Ascertaining independence in real data price changes

An important underline assumption of the Brownian motion model is that the price changes are independent, as explained in Section 3.1.

As indicated also in [6], one should verify that the property of price changes independence hold in the data used for the research. The technique we use to verify this property is autocorrelation.

The examined prices are 3 day long, 1-minute interval closing prices of the Apple company (AAPL) stock. More details about this data, its source and samples are thoroughly elaborated in Subsection 7.1. The test is done upon almost 1200 data points and lag of up to 1000 minutes.

In order to check for hidden patterns inside this data, we apply lags and check the correlation coefficient between the relevant sequences. Figure 5.1 depicts the autocorrelation inside the data as a function of different lags.

As the graph implies, the prices changes do not exhibit significant autocorrelation for any size of lag, thus supporting the GBM underline assumption of independent price changes.

We can see that for the largest lags in Figure 5.1 there exist more points with slightly

---

1 Autocorrelation is a statistical instrument used to check whether there are internal patterns within a sequence of numbers. This is done by applying different lags inside the sequence and verifying the size of the correlation coefficient between those parts of the sequence.

For a series of number \(x_1, x_2, ..., x_n\) generated from \(X_1^n\) the autocorrelation is defined as:

\[
R_{X_iX_j} = E[X_iX_j]
\]  (5.1)

When the expected value is the multiplication of the expected value of \(X_1^{n-lag}\) and \(X_1^{lag}\) where \(j = lag\).
bigger autocorrelation. This is because these lags are close to the overall size of the data series, making the number of points measured smaller and thus the results are more noisy.

The Python function used in order to find the coefficient between two sequence is “corrcoef” from the “numpy” library\textsuperscript{2}. The data used is the APPL stock price during the 17-22/04/2019 and the execution itself took 0.36 seconds.

\begin{figure}[ht]
\centering
\includegraphics[width=0.6\textwidth]{autocorrelation AAPL 3 days price}
\caption{Autocorrelation - AAPL 3 days price}
\end{figure}

\textsuperscript{2} The formal documentations from the SciPy project \url{https://docs.scipy.org/doc/numpy/reference/generated/numpy.corrcoef.html}
Chapter 6

Fitting the coefficients to real data

The main challenge with fitting the GBM formula to real data is that the GBM model assumes knowledge of market key features. As explained in Chapter 4 these features are the market trend (or drift coefficient) $\mu$ and the volatility (or diffusion coefficient) $\sigma$. Moreover, since these features represent the market state they are evolving over time.

In this section we study ways of finding these market features for a certain security, based on real data. We do so using two different methods to extract the values of $\mu$ and $\sigma$ from the data.

6.1 Linear least square

The first method is Linear Least Square for a given data set. This method attempts to generate our first equation between $(\mu, \sigma)$ and the data set.

Studying Equation 4.7 describing the expected value for $X_t = \ln(S_t)$, we can see that the expected value as a function of $t$ behaves like a straight line where the slope of the line is $(\mu - \frac{\sigma^2}{2})$ and the conjunction with the $y$ axis is in $\ln(S_0)$.

Applying Linear Least Square to the natural logarithm of the real prices gives us such a line where the conjunction with the $x$ axis is in fact $\ln(S_0)$ and its slope we can calculate. Figure 6.1 is an example; we also provide the actual values of the first few points in Table 6.1.

The slope of the Linear Least Square line shown in Figure 6.1 is 0.00007838704. Which means that for this time segment $(\mu - \frac{\sigma^2}{2}) = 0.00007838704$. Using the method in
<table>
<thead>
<tr>
<th>time</th>
<th>price</th>
<th>ln(price)</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/22/2019 14:07</td>
<td>203.71</td>
<td>5.316697</td>
</tr>
<tr>
<td>4/22/2019 14:08</td>
<td>203.66</td>
<td>5.316452</td>
</tr>
<tr>
<td>4/22/2019 14:09</td>
<td>203.76</td>
<td>5.316943</td>
</tr>
<tr>
<td>4/22/2019 14:10</td>
<td>203.7022</td>
<td>5.316659</td>
</tr>
<tr>
<td>4/22/2019 14:11</td>
<td>203.69</td>
<td>5.316599</td>
</tr>
<tr>
<td>4/22/2019 14:12</td>
<td>203.75</td>
<td>5.316894</td>
</tr>
<tr>
<td>4/22/2019 14:13</td>
<td>203.74</td>
<td>5.316845</td>
</tr>
<tr>
<td>4/22/2019 14:14</td>
<td>203.77</td>
<td>5.316992</td>
</tr>
<tr>
<td>4/22/2019 14:15</td>
<td>203.8273</td>
<td>5.317273</td>
</tr>
</tbody>
</table>

Table 6.1: Data sample for Linear Least Square

Figure 6.1: Linear Least Square prices log

general gives us the following equation,

\[ \text{Slope}(\text{Linear List Square}) = (\mu - \frac{\sigma^2}{2}). \]  \hspace{1cm} (6.1)

6.2 Maximum likelihood estimation

Maximum Likelihood Estimation (MLE) is a common method for statistical parameters inference. It uses the probability function of the model to find the parameters which maximises the likelihood of observing the actual data [6].

The MLE function is commonly denoted by \( \mathcal{L}(\mu, \sigma) \) where \( (\mu, \sigma) \) is the model parameters set. For a Markovian process \( X_t \) with parameters \( (\mu, \sigma) \) and PDF function \( f_x \)
whose random variables are iid, the MLE function is given by

\[ L(\mu, \sigma) = \prod_{i=1}^{n} f_{\mu, \sigma}(x_i). \]  

(6.2)

For ease of computation, it is common to work with the log likelihood function which is denoted by \( \hat{L} \), thus producing the equation:

\[ \hat{L}(\mu, \sigma) = \sum_{i=1}^{n} \ln f_{\mu, \sigma}(x_i). \]  

(6.3)

We construct the usual \( x_i \) to be:

\[ x_i = \ln S_i - \ln S_{i-1}, \]  

(6.4)

thus converting the GBM model into a process which holds all the upper mentioned conditions for Equation 6.3 with \((\mu, \sigma)\) and the probability density function is the one of normal distribution with the expected value \((E)\) and variance \((V)\) as mentioned in Section 4.4.

Deducing the equations for \( E, V \) based on MLE is done by a derivation of \( \hat{L} \) with respect to each of \( \mu \) and \( \sigma \) in an attempt to find the maxima points for each. A detailed solution to this derivative appears in [15], where the resultant closed form method to find \( E \) and \( V \) is:

\[ E = \frac{\sum_{i=1}^{n} x_i}{n} \]  

(6.5)

and

\[ V = \frac{\sum_{i=1}^{n} (x_i - E)^2}{n} \]  

(6.6)

When analyzing an actual data set, the series of \( x_i \)'s can be extracted easily using simple python program. Thus, equations 6.5 and 6.6 generate results which using equations 4.11 and 4.12 allow us to extract two additional formulas:

\[ \frac{\sum_{i=1}^{n} x_i}{n} = \mu - \frac{\sigma^2}{2}, \]  

(6.7)

\[ \frac{\sum_{i=1}^{n} (x_i - E)^2}{n} = \sigma^2. \]  

(6.8)

Studying Equation 6.5 one can notice that since \( x_i = \ln S_i - \ln S_{i-1} \) it forms a telescopic sum resulting with

\[ E = \frac{\sum_{i=1}^{n} x_i}{n} = \ln(S_n) - \ln(S_0), \]  

(6.9)

considering only the first and last point of the data set. Thus deducing Equation 6.5 to a simple average of the first and last point of the data. This leads us to prefer the Linear Least Square method depicted by Equation 6.1 which also relays on the value
of $E$ as shown in Equation 4.11.
Chapter 7

Feature Extraction

7.1 Overview of the data

Complete intra-day tick by tick prices data is insurmountably hard to acquire, even for a single stock during a short amount of time. Hence, we use Yahoo finance API which allows free access to substantial amount of accurate financial data. We use the 1-minute interval stock prices accessible through this API which contains for each interval the volume, open, close, max and low prices.

In order to test our analysis we decided to use active stocks such as Apple (AAPL) and Google (GOOG) for which there is plenty of trade and changing of market trends during each day. Table 7.1 provides an example for a 10 minutes data of the AAPL stock during 22.04.2019:

<table>
<thead>
<tr>
<th>time</th>
<th>close</th>
<th>high</th>
<th>low</th>
<th>open</th>
<th>volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/22/2019 13:31</td>
<td>203.42</td>
<td>203.45</td>
<td>202.54</td>
<td>202.54</td>
<td>255422</td>
</tr>
<tr>
<td>4/22/2019 13:33</td>
<td>203.71</td>
<td>204.05</td>
<td>203.45</td>
<td>203.715</td>
<td>250866</td>
</tr>
<tr>
<td>4/22/2019 13:34</td>
<td>203.58</td>
<td>203.9205</td>
<td>203.4525</td>
<td>203.71</td>
<td>136420</td>
</tr>
<tr>
<td>4/22/2019 13:35</td>
<td>203.7391</td>
<td>203.7391</td>
<td>203.37</td>
<td>203.6289</td>
<td>110056</td>
</tr>
<tr>
<td>4/22/2019 13:36</td>
<td>203.82</td>
<td>203.97</td>
<td>203.59</td>
<td>203.74</td>
<td>163986</td>
</tr>
<tr>
<td>4/22/2019 13:37</td>
<td>203.98</td>
<td>203.99</td>
<td>203.6</td>
<td>203.818</td>
<td>86007</td>
</tr>
<tr>
<td>4/22/2019 13:38</td>
<td>203.88</td>
<td>203.98</td>
<td>203.68</td>
<td>203.98</td>
<td>71172</td>
</tr>
<tr>
<td>4/22/2019 13:39</td>
<td>203.97</td>
<td>204.1</td>
<td>203.8</td>
<td>203.8638</td>
<td>110658</td>
</tr>
</tbody>
</table>

Table 7.1: 10 minutes data of the AAPL stock

1It is interesting to note that Yahoo is one of the only free services remained out there.
### 7.2 Algorithm for feature extraction

Using the results of Section 6, we can extract the \((\mu, \sigma)\) features necessary for the GBM model from a data set. The procedure is as follows. First, we calculate the slope of the Linear Least Square (LLS) line and compare it with the Expected Value Equation. Then, we compare the Variance Equation to the MLE derived solution to \(V\) extracted from the data.

**Algorithm 1: Features extraction**

**Data:** \(x_1, \ldots, x_n\)

**Result:** GBM market features \((\mu, \sigma)\)

1. Find LLS of \(x_1, \ldots, x_n\);
2. \[ V = \frac{\sum_{i=1}^{n} (x_i - E)^2}{n} \]
3. Solve:
   1. Slope of LLS \((x_1, \ldots, x_n) = \mu - \frac{\sigma^2}{2}\)
   2. \[ \frac{\sum_{i=1}^{n} (x_i - E)^2}{n} = \sigma^2 \]
4. Return \((\mu, \sigma)\)

### 7.3 Verifying observation fit to model - AAPL

In order to verify that the observation (real data) fit to the model, we make use of the log of the price ratios, formally called the “log returns” as used in Section 4.4.

\[
X_{\Delta t} = \ln S_{t+1} - \ln S_0 = \ln \left( \frac{S_{t+1}}{S_0} \right), \quad (7.1)
\]

We study the frequencies of the values of the observations log returns compared to the frequencies of the values in the GBM generated price series. The series is generated using

\[
GBM(x_1, \mu, \sigma, n), \quad (7.2)
\]

where \(x_1\) is the log of the observation’s initial price, \(\mu, \sigma\) are the result of executing Algorithm 1 on the observation and \(n\) is the prices series length.

As one can see, the two log returns series follow a normal distribution. In order to measure the significance of the difference between the means of those series, we use the t-test. The results are depicted in Table 7.2.

As one can see, the t-test results for the series in figures 7.1 and 7.2 indicates a low t-value (below 5%) and a high p-value (above 90%) indicating high likelihood that the

\[^{2}\text{“t-test” is a test designated to measure the significance of the difference between the means of two normally distributed data samples.}^{[16]}\]
7.4 Verifying observation fit to model - GOOG

Conducting a similar experiment on the log return values of the GOOG security, yields the following frequencies:

Table 7.2: The results of a t-test on the values depicted in figures 7.1 and 7.2

<table>
<thead>
<tr>
<th>t-statistics</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.1127769602512468</td>
<td>0.9102367031676524</td>
</tr>
</tbody>
</table>

Here also, the t-statistics result is low absolute value smaller than 5% and the p-value
Table 7.3: The results of a t-test on the values depicted in figures 7.3 and 7.4

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>t-statistics</td>
<td>-0.1265631600773214</td>
</tr>
<tr>
<td>p-value</td>
<td>0.8993198087993637</td>
</tr>
</tbody>
</table>

results is high almost 90%. Thus, indicating high likelihood that the log returns values fit the GBM model.

The Python function used in order to find the t-statistics and p-value values is the “ttest_ind” from the “scipy.stats” library. The data used is the AAPL stock prices during the 22.04.2019 and the GOOG stock prices during the 17.04.2019 accordingly, the execution itself took 0.3 seconds.

### 7.5 Analysis of a single trend market price changes

The Apple stock prices, during the day of 22.04.2019 demonstrates several market trends changes as presented in Figure 7.5. The prices incline to raise/fall shift several times during this day. Thus, we take only specific time frame of this trading day - the 22.04.2019 from 2:05:00 PM until 3:18:00 PM (UTC time), time units 36 to 109 on Figure 7.5. The prices during this time frame are shown in Figure 7.6.

![AAPL stock prices - 22.4.19](image)

**Figure 7.5: AAPL stock prices - 22.4.19**

![Stock prices for minutes 35 to 110](image)

**Figure 6: Stock prices for minutes 35 to 110**

Applying Algorithm 1 for finding \((\mu, \sigma)\) on the specific time frame displayed on Figure 7.6 yields the following results: \(\mu = 0.0000819070, \sigma = 0.00034\).

Figure 7.7 contains the price series and their fitted lines. The first price series shows the original data as displayed on Figure 7.6. The second price series is an execution of the GBM model using the coefficients \((\mu, \sigma)\) calculated before and the initial price equals

---


30
to the one of the original data. As one can see, the generated price series behaviour is quite similar to the original one.

![Figure 7.7: AAPL prices from figure 7.6 with GBM results](image)

Using the t-test for this single trend time fragment yields the following results:

<table>
<thead>
<tr>
<th>value</th>
<th>t-statistics</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>t-statistics</td>
<td>-0.022339169292526523</td>
<td>0.9822074941845582</td>
</tr>
</tbody>
</table>

As we can see, when carefully choosing specific time segment with a single trend the resultant t, p values indicates a much better match of the data to the GBM model.

**Fitting parameters to different security - Google**

In order to ascertain overfitting is not the issue in this case, we perform a similar test using the prices of the Google (GOOG) stock during the date of 17.4.2019 as shown in figures 7.8 and 7.9.
Applying Algorithm 1 yields:

Studying the figures that correlates to the GOOG share prices (original data), we can see that the market trend changes throughout the day several times and consists of much trading activity. As we can see in Figure 7.10 when the prices consists of many trends, the GBM results starts “tight” around the real data, however, it doesn’t manage to last for longer periods under market trend changes. As expected, the results of the t-test for this single trend time fragment also demonstrate a significant improvement.
7.6 Observation fit as a function of sequence length

The third experiment we conduct to check how the data fits the model is to measure the quality of the fit as a function of the sequence length. We score the fit level using the p-value of a t-test.

Our test works as follows: First, we take a random subsequence of the data set of length \( l \) time units. Then, we use Algorithm 1 to extract the market features \((\mu, \sigma)\) that fits the subsequence. Then, we conduct the t-test on the GBM model for the given subsequence of length \( l \) and \((\mu, \sigma)\). For each length \( l \), we chose several different subsequences from the data set for which the entire test is done and the result is the average p-value. This is done in order to randomize the investigated subsequences for each length \( l \) and thus to reduce noising affects such as stronger or weaker prices fluctuations in a specific subsequence.

![Figure 7.12: Model p-value as a function of sequence length](image)

Figure 7.12: Model p-value as a function of sequence length

Figure 7.12 depicts the results of the described test. We perform this test three times - with increasing amount of repetitions. The number of repetitions is the amount of different subsequences of prices being chosen for each length \( l \), and for the amount of executions of the GBM model for each such subsequence (\( r \) stands for repetitions). The test was conducted using the GOOG security price during the dates of the 17,18,22/04/2019.

One can see that the ability of the GBM model to describe the data degrade with the length of the sequence. This is due to the fact that the parameters \((\mu, \sigma)\) change over time and thus the probability that a short sequence matches a specific GBM model is higher.
The Python function used in order to find the p-values is the “ttest_ind” from the “scipy.stats” library[^4]. The data used is the GOOG stock prices during the 17-22.04.2019, the execution itself took 13 minutes and 58.18 seconds. The amount of repetitions is as mentions on the graph itself (10, 50, 150).

Chapter 8

Forecasting accuracy

8.1 Accuracy as a function of delay

A crucial part of this thesis goal is to assess the impact of HFT delay on their ability to estimate securities prices correctly. In the previous sections, we investigated how to use the GBM model and the feature extraction algorithm. In this section, we measure the accuracy of our model as a function of the delay.

Assuming a security price is known at time $t_0$ and we wish to act according to this price (buy or sell). Our ability to “catch” this exact price is limited by our delay from the stock exchange. Thus, our action will only take place on time $t_d$. The measurements conducted in this section estimate the error size. We measure the effect of the standard deviation of the GBM model in order to quantify its accuracy.

From Equation 4.12 and by the definition of standard deviation, we get that the standard deviation of GBM is

$$\text{Standard Deviation}(GBM) = \sigma \sqrt{\Delta t}. \quad (8.1)$$

We perform an empirical test to check the actual behaviour of the model’s standard deviation. We do so by executing the model multiple times. Each execution yields a series $x_1, \ldots, x_n$ where $x_i$ is the value estimated for time $t = i$. Then, we find the standard deviation for all the values $x_i$ in all the executions.

Since the examined standard deviation is merely an attribute of the model, the actual values being assigned are of no significant and are only necessary in order to execute the model. Thus, we perform the measurements using the $(\mu, \sigma)$ features found for the time fragment in Figure 7.5 using Algorithm 1.
As one can see in Figure 8.1, the standard deviation of the GBM model behaves as expected and correlates with $\sigma \sqrt{\Delta t}$.

The importance of this result is that now we have a way to quantify the difference between the price a trader see and the price this trader can realistically use as a function of it’s time delay. From financial point of view, Equation 8.1 means that the price difference grows linearly with the root of the trader’s time delay.

### 8.2 Accuracy of forecast

Since the prime goal of this thesis is to analyse potential HFT profitability with respect to their latency, we measure the forecast mistake size as a function of the trader’s delay. Namely, if one attempts to use the GBM model in order to estimate future security prices, we want to quantify the size of the mistake in their estimates as a function of their delay. Thus, in this section we focus on quantifying the mistake size as a function of the delay.

This task might seem similar to the evaluation of the mistake as a function of the sequence length in Section 8.1. However, this is not the case. The analysis in the previous section was done using a fully known data set; That is, we considered the full sequence to extract the market features. In contrast, the analysis in this section is done using only the available data at the relevant time.

Our method to perform this check is as follows; First, we take a random sequence of values of length $l$ time units. Then, we divide it into two consecutive sequences. The
first, is used to extract the market features using Algorithm 1. The second is compared to the synthetic price series generated by applying the market features to the GBM model $GBM(x_1, \mu, \sigma, n)$\(^1\). The result is the average difference between $x_i = \ln S_i$ and the log of the actual price at time $t = i$\(^2\). The first time sequence used for the feature extraction is named the “train set” and the second consecutive sequence is called the “test set”.

This study allows us to simulate a scenario in which a trader has access to a security price data and is about to perform an action (buy/sell). Namely, the trader knows the train set and the test set remains unknown. Since this trader is aware of having a certain delay, he is required to estimate the future price of the security after a certain time delay, when his order is executed in practice. The results of this study depicts the average error between the log of the forecasted price the trader asses and the log of the actual price.

![Figure 8.2: Conducted on the AAPL security prices during the 22.04.2019.](image)

![Figure 8.3: Conducted on the GOOG security prices during the 17.04.2019.](image)

![Figure 8.4: Forecast Average accuracy as a function of time units amount](image)

Figures 8.2 and 8.3 depicts the results of our study. We use a train set of 150 time units, test set of 50 time units and 100 repetitions\(^3\). As one can see, the size of the mistake behaves like $\sigma \sqrt{\Delta t}$. This is especially interesting since it the same behaviour observed for the growth of standard deviation in Section 8.1, in spite the fact that the data was not analysed while the market features were extracted (test set VS train set). From these results, we conclude that for a short term, the accuracy of the GBM model remains constant.

Next we want to study the effect of the sizes of the test sets on the results. Figure

---

\(^1\) $x_1$ is the last price of the first sequence.

\(^2\) The average is done by both choosing several different data sequences and by executing the $GBM(x_1, \mu, \sigma, n)$ several times for each data sequence.

\(^3\) 100 different data sequences were used and for each of this data sequences 100 executions of the GBM model were conducted.
Figure 8.5: Forecast accuracy for longer test set. Conducted on GOOG prices during the 17,18,22.04.2019

8.5 depicts the forecast accuracy behaviour for longer test set. As expected, one can see that the $\sigma \sqrt{\Delta t}$ behaviour breaks down as longer delays are exercised. In this experiment, we also used 100 repetitions and train set of 150 time units. The 50 time units vertical line indicates the point where the previous study ended. Also, one should note that after the 150 time units vertical line, the average difference size starts to grow faster.

We also check the effect of the train set length on how accurate the model forecast is. In order to do so, we check the mistake size between the actual price and the forecasted prices after three fixed time units amount - 5, 10, 20. Namely, we attempt to forecast the price after each of this time units amount. This test results are depicted in Figure 8.6. As one can notice, the significance of the train set size is crucial at the beginning; However, it decays quickly and then becomes irrelevant.
Figure 8.6: Forecast mistake as a function of train set length. Conducted on GOOG prices during the 17,18,22.04.2019
Chapter 9

Potential profitability due to low latency

In this Section we use the AAPL security prices and the GOOG security prices as a test case to examine the potential profit that can be made by HFT during a single day. Note that our profit analysis is based on the time unit interval size of the data. In this section two different methods to quantify potential profits are examined, both of which rely on price changes size and frequency.

Our first goal is to answer the following basic question - “How likely is the GBM model to correctly foresee a price change?” Namely, if a HFT uses the sequence of prices until the current price and then uses the GBM model to forecast whether the prices is about to go up or down, how likely is the GBM model to be correct? In practice though, a trader has a certain time delay before it can access prices information and/or execution orders (we assume information access and execution order submission time delay is equal). Thus, using a model to forecast whether a price is about to go up or down immediately is of no use to the trader. Rather, the trader needs to know whether the price is about to go up or down at a certain time in the future (specifically $d$ time units in the future, $d$ being the size of the trader’s delay). Thus, if the traders submit an execution order at time $t = 0$ it is actually executed at time $t = d$ then we check how accurate the GBM model is in forecasting a price change at this time range.

Figures 9.1 and 9.2 depict the accuracy percentage as a function of the delay. The results obtained by taking a data sequence and dividing it into a train set and a test set. Then, after using Algorithm 1 to extract the market features, we executed the GBM model, and then we checked for each time delay whether the model forecasts an incline or decline compared to the last known price (the end of train set). Using the test set we checked whether this forecast is correct or not. To remove noise, we choose multiple data sequences and for each data sequence we executed the model several times, the
Figure 9.1: Conducted on the AAPL security prices during the 22.04.2019.

Figure 9.2: Conducted on the GOOG security prices during the 17/18/22.04.2019.

Figure 9.3: Accuracy percentage as a function of the delay results being the overall average. As one can see, for small time delays values the accuracy percentage is quite high and declines with the delay. The horizontal line in the figures indicates the 50% accuracy level.

From a financial point of view, the meaning of these results is that using the GBM model with sufficiently low delay one can forecast price changes correctly with greater accuracy than 50%. This is a strong indication that correct financial statements can be made using nothing but low network connection to a stock exchange server, a smart learning algorithm with previous security prices as its input and a fast computer.

In order to quantify the potential profit that can be made from the forecast accuracy using the traders low network latency, we propose the following trading technique, which makes use of the results mentioned in figures 9.1 and 9.2. Our trading technique assumes the trader is in possession of sufficient shares of the security and liquidity allowing him to buy and sell shares at will.

We define the making of profit from a transaction as selling a share for a higher price than the price at the beginning of the transaction or buying a share for a lower price than the price at the beginning of the transaction.

Our intentionally simplistic technique is as follows. First, the trader checks whether the price is about to increase after it’s time delay \( t \). Then, the trader issues a sell order. If the forecast was correct, then at time \( t = 0 \) the price was \( p_0 \) and at time \( t = d \) the price was \( q_d \) where \( q_d > q_0 \). This means that the trader made a profit of \( q_d - q_0 \). If the forecast was wrong, the loss caused to the trader is \( q_0 - q_d \). The cycle resumes after the shares sell/purchase.

\footnote{The opposite case for a price decrease is symmetric.}
Assuming the average price change over a single time unit is \(a\), the amount of possible transactions during a single day is \(n\), the traders delay is \(d\) and the model accuracy percentage is \(p_{delay}\) then the average profit a trader stands to make through out a day from a single stock unit is

\[
profit = p_{delay} \cdot \frac{n}{d} \cdot a \cdot d - ((1 - p_{delay}) \cdot \frac{n}{d} \cdot a \cdot d) = a \cdot n(2p_{delay} - 1) 
\]

(9.1)

Figures 9.4 and 9.5 depicts the assigning of \(p_{delay}\) into Equation 9.1. The Y-axis values indicates the potential profit as a function of the average price change size and the amount of price changes (\(a\) and \(n\)). This study shows a quantification of profit low network latency can generate. The results address the case in which the transactions involve a single security unit. The reason for this is that in practice the amount of securities offered for each security price varies and the better the price the less is offered. Analysis of profitability which includes the amount of securities is outside the scope of this thesis.

Figure 9.4: Conducted on the AAPL security prices during the 22.04.2019.

Figure 9.5: Conducted on the GOOG security prices during the 17/18/22.04.2019.

Figure 9.6: profitability as a function of delay

From a financial point a view, this is a formal quantification of the possible profit a trader can make during a single day using his network speed.

Studying the results of figures 9.4 and 9.5 from a different perspective yields further insight. We consider the ratio between the profitability of two imaginary HFT players. One with delay of \(d = x\) and the second with smaller delay \(d = x', x' < x\). From figures 9.4 and 9.5 one can extract the relation between the delay (\(x\)), the delay reduction (\(l\)) and the ratio between the possible profitability.

Figures 9.7 and 9.8 depicts this analysis. The X axis in the figures stands for the delay of the slower trader of the two, while the Y axis stands for the ratio in their
Figure 9.7: Conducted on the AAPL security prices during the 22.04.2019.

Figure 9.8: Conducted on the GOOG security prices during the 17/18/22.04.2019.

Figure 9.9: impact of superior delay

possible profitability (faster trader’s profit divided by the slower trader’s profit). Each of the lines in the figures stands for a different value of the delay difference $x - x'$. The meaning of a point $(x, y)$ on a line which correlates to difference $l$ is that a trader with delay $x - l$ would have earned $y$ times more than a trader with delay $x$ (based on the relevant data). As one can see from these figures, the impact of the difference between the values is more significant for the lower delay values and becomes indifferent for the larger delay values.

There are two important conclusions to be made of this results. The first relates to assisting a trader in his decision as to whether he should purchase faster connectivity to the stock exchange. Using those graphs, we quantify the added potential profit a trader stands to make in case he chooses to improve his network connectivity’s speed. As expected, the graphs show that the shorter the delay, the more profitable it is to get it even shorter. This is inline with the case of the “Spread Networks” company mentioned in the introduction in which a large amount of money was invested in the construction of an infrastructure shortening a few milliseconds in the connection between New York and Chicago. For instance, as we can see in Figure 9.7, if a trader with delay $d = 6$ will improve it’s delay to $d = 4$, he potentially double his profit.

It is commonly assumed that the world of HFT is a zero one game. Namely, the winner is the fastest trader and he takes it all. The main earning technique described in [9] of HFT is such a zero one game technique. Here, using figures 9.7 and 9.8 we formally show a distribution of the profits between the traders according to their network latency. In other words, the race indeed yields better results for the fastest trader, but it is not a zero one game.
Chapter 10

Conclusion

In this Thesis we investigate the relation between a trader’s network connection latency to the stock exchange and his ability to make profit using strictly analytical tools (as appose to financial tools). In order to do that, we use the Geometric Brownian Motion to model security price changes. The model, relays on the Brownian Motion which models chaotic movement and thus fits to the underline financial assumption, assumes that two consecutive security price changes are uncorrelated. We describe an algorithm that finds the parameters of the GBM model that best approximate a specific observation.

We use this algorithm for parameter extraction and apply the results over real stock prices data, successfully verifying that the GCM model is a good fit to real stock values. This is done by comparing the synthetic price changes behaviour with the real price changes and analyse the differences.

We use both the GBM model and the parameter extraction algorithm in order to forecast future price changes. We do this by “training” the algorithm on a given train set of price changes and then executing the GBM model in order to generate a continuation to the train set in the form of a synthetic prices series. Measuring the forecast level of accuracy provide an indication that for short term ranges our model is capable of correctly forecasting the market likelihood to raise or fall with probability well above 50%. By suggesting a realistic way to define profit from a trading we can also analyze the relation between network delay and traders expected profit.

Using the results for the quantification of the potential profitability, we compare the profits of two different traders with different network latency (delay). This provides us with a tool to quantify the impact of network latency improvement for a trader as a function of his current network latency. This tool clearly indicates that the faster the trader currently is, the more effective each small improvement in latency. Another significant result that can be concluded from this profitability analysis is that HFT is
not a zero one game and profit is distributed among different traders according to their network latency.
Appendix A

Validity of the used data granularity

The model we use, GBM, is a continuous model describing infinite amount of data points for each time frame. Using such a model to analyze any natural phenomena requires making simplifying assumption on the data. Using the GBM model to forecast real prices may generate data points at any granularity. Even the most complete transaction book data is discrete and thus coarse comparing to the possible infinity approaching granularity of the continues model.

Moreover, in order to convince ourselves as to the legitimacy of using the 1-minute interval data in the analysis (and not a more smaller interval data), we make the following experiment - comparing to a bigger interval data. Specifically, 10 minutes interval data.

Figure [A.1] is an illustration of experiment similar to the one presented in Figure [7.7]. As we can see in Figure [A.1] the graph generated by the GBM model succeeds in scaling to the new interval without the need of any changes.
Figure A.1: GBM behavior with X 10 interval
Bibliography


The study was conducted, and the results showed a significant improvement in the accuracy of the predictions. The error rate increased by 50% compared to the initial model. As expected, the accuracy of the predictions improved by 2% in many cases.

The study concluded that with the use of this new model, it is possible to estimate the improvement in the potential profit of the order, which was previously significantly underestimated. The results showed that the improvement is significant, especially in terms of milli-seconds.

The study also considered the potential investment required by companies to improve their network speed. The analysis showed that the companies are investing a large amount of money in small improvements, which is not efficient. Also, some factors, such as the type of network, can affect the potential profit.

In conclusion, the study showed that the use of this new model can significantly improve the potential profit of the order. The results are encouraging and open new possibilities for further research in this field.
המחק בעניין ביהנמיות של פורסום דני, רב קולצないように המוחשב.

תודה

ברצוני להודות לעצמי, לפרופסור דני, על שיתומיה ההודים של כל השלבים בדרכו האורכה והשובה עצונה בודד.

ברצוני להודות לעצמי, על כל שבחים ופקדים, על כל שדריך והוויך ואתיי בכלי מעלה הדרכ.

וכן, בידינו ל듯י שיתומם היה של אחד:}

הכרת תודה מוסירה לעכני על קים מחקר זה.
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