Tech-sawy investors to put a squeeze on the professionals

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For all the articles, television stories, speeches and cocktail party chatter about the threats to and from the hedge fund world, the business is still taking in a lot of money - more than $126bn in the US last year, according to Hedge Fund Research of Chicago.

Less talked about is a *set* of developments in technology and regulation that is taking away the competitive edge the hedge funds have over the general public. The techniques available to the hedge funds are becoming available to the investing public - or at least to the more technically skilled members of the public. This is part of a rapid democratisation of financial management that will, sooner rather than later, cost the hedge fund community its claim on the 2 per cent fees and 20 per cent profit shares that it believes is its natural right.

Two imminent developments in the US will be vital to the acceleration of investment management democratisation: the end of the "short sale price test" in the US equity markets and the imminent approval of portfolio margining accounts for customers of US broker-dealers.

Coupled with the availability of low-cost software development tools for setting up arbitrage programs, it becomes possible for sophisticated individual investors to compete directly with hedge funds and commodities trading advisers.

Thomas Petterfy, the chief executive of Interactive Brokers, a large, deep-discount electronic brokerage that is favoured by tech-sawy, price-conscious individual traders, notes that more of the firm's volume is coming from individuals doing program trading.

"Statistical arbitrage is a high-volume, low-profit-per-share strategy. For this reason, fast and best execution [along with] low commissions and financing rates are even more important to this strategy than other trading strategies. Most of our arbitrage customers use our Application Program Interface to programme their strategies, but some simply use an Excel spreadsheet through a Dynamic Data Exchange link. These one-man, or one-woman, trading operations can successfully compete with broker dealer trading desks, which often have less advanced technological capabilities and higher overhead."

Much of the rest of the competitive advantage held by statistical arbitrage and other hedge fund managers came from regulatory quirks rather than superior analysis or data. One was their ability to get round the restrictions in US markets on short sales of stock. The other was their ability to get round Reg T, the 50 per cent minimum margin requirement for public buyers of US stocks.

For the past seven decades, you were only supposed to be able to sell a stock short if the last sale had been an "uptick", or price increase, or a zero-plus tick, or no change. In recent years, the hedge funds, through their prime brokers, weren't too restricted by these rules. Now the Securities and Exchange Commission is proposing to abolish the short sale price test rules. In fact, yesterday was the last day for the public to file comments on the proposed rule change.

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Professional marketmakers, such as specialists on the New York Stock Exchange floor, were supposed to provide liquidity - be the buyers of shares when there were not enough among the public, or sellers when the public did not want to sell.

The idea of recent reforms of the markets has been to look for liquidity from higher order flow rather than expensive intermediaries. That has worked well for larger stocks; the contention has been that liquidity is harder to come by for smaller stocks as the marketmakers have supposedly abandoned them.

Joe Gawronski, the president of Rosenblatt Securities, a brokerage firm in New York that has been adapting to the rule changes, says: "To me, the lack of marketmakers is made up by new marketmakers, such as the stat arbs. I think the markets will work more efficiently without the [short selling] rules in place."

With desktop stat arbs quickly buying cheap stocks and short selling expensive stocks, the liquidity from order flow should migrate down to the less frequently traded stocks.

Steve Sanders of Interactive Brokers says the proposed changes in portfolio margining rules are even more important to the democratisation of investment management. "If you were a hedge fund you could go to your prime broker and use techniques such as offshore accounts or 'joint back offices' to get the benefit of 15-20 per cent margins," a big advantage over the 50 per cent rule that has applied to individuals.

By applying statistical techniques, and measuring the risk of a portfolio, new rules set by the SEC and the exchanges will allow investment banks and other brokers to offer individuals the same 15 per cent minimum margin on stocks that hedge funds enjoy.

"This is going to lead to more competition in the prime broker field," says Mr Sanders. That means the desktop traders will be able to go head-to-head with the hedge funds.

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