FROM THE
Managing Editor

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This issue of *JASSA* contains articles which provide insights into three areas of topical interest: stock market trading strategies — particularly high-frequency trading (HFT); bank liquidity management and regulation; and the provision of information and advice in superannuation and financial planning. It also contains an overview of developments in the global financial regulation agenda and implications for Australia.

Apart from the first three articles, which focus on HFT and momentum trading strategies, the journal contains papers presented at the 17th Melbourne Money and Finance Conference — Recent Developments in Financial Regulation: An Assessment — held in July 2012 by the Australian Centre for Financial Studies. While not subject to the usual double-blind review process, each of these papers has been reviewed by the Managing Editor and a member of the Editorial Board prior to inclusion.

What are the costs and benefits of HFT? Stephen Satchell examines claims and empirical evidence regarding the effects of HFT on price discovery (efficiency) and on liquidity and trading costs. While there has been extensive public debate about, and regulatory interest in, the desirability of HFT, the evidence available to guide policy is somewhat sparse. It does suggest that HFT is of benefit to the traders involved, the exchanges and the providers of products whose use is intrinsic to the HFT process. But whether there are benefits to fund managers and retail/private investors is not clear-cut. It undoubtedly makes the task of regulators more complex. Satchell concludes that, in attempting to assess the overall welfare effects of new trading strategies such as HFT it may be appropriate to rely on simulations or experiments using artificial markets.

The second article, by Carole Comerton-Forde, is in response to an invitation from the Managing Editor for a paper to accompany the Satchell paper, providing an Australian perspective on HFT. Comerton-Forde notes that there is currently limited reliable data available to assess the role of HFT in Australia, although it appears to have grown considerably in recent years and may now account for around 20 per cent of trading. We hope to have several contributions on this topic in the next issue of *JASSA*, as better data becomes available. Comerton-Forde focuses on whether the characteristics of the Australian equity market are as favourable to the growth of HFT as those in major overseas markets. She considers the role of factors such as: fragmentation of markets; availability of low-latency trading systems; size of explicit trading fees; market liquidity; tick size limits; and 'trade-through' protection of limit orders. While generally favourable to the development of HFT, the Australian market has some characteristics (fee arrangements and lack of trade-through protection) which may make HFT less pervasive than in the United States.

Next, the paper by Bruce Vanstone, Tobias Hahn and Gavin Finnie examines returns to momentum strategies (buying past winners and selling past losers) in the context of the S&P/ASX 100. The authors note that previous Australian studies of momentum (for which they provide a concise overview) have generated mixed results. Vanstone et al. find support for the use of momentum-based investment strategies within the S&P/ASX 100, with long positions in large stocks underpinning the results. They indicate that their results are in contrast with some prior US work, which finds that the momentum effect is primarily driven by the smaller, illiquid stocks in a portfolio. These results are also in contrast with some prior Australian work, which finds that the momentum effect is largely due to short selling of smaller stocks.

In the first of the papers from the 17th Melbourne Money and Finance Conference, Ian Beckett examines the plethora of financial regulation since the GFC. He examines the development, and implications for Australia, of the international regulatory agenda which aims for improvement in four key areas: national supervision/oversight arrangements; crisis management/resolution arrangements; resilience of core prudentially regulated institutions; transparency/resilience of wholesale markets and the 'shadow banking' sector. He notes that the involvement of Australian officials in the work of international standard setters has increased markedly since the GFC, and that within the G20 context they have sought to emphasise the importance of active supervisory oversight (rather than an excessive focus on detailed rules).

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He suggests that the area where new global standards may have the greatest impact on Australia's regulatory regime in the longer term is in wholesale financial markets and shadow banking.

The next three papers address various aspects of 'liquidity', which has returned to centre stage following the experiences of the GFC. The paper by Alexandra Heath, Mark Manning and Greg Moran highlights the extent to which regulatory changes (including the need to prepare for Basel III) and market discipline in the aftermath of the GFC are producing increased demand for high-quality liquid assets (HQLA). The authors indicate that despite some increase in the stock of government securities over recent years, this will not be sufficient to cover additional demands from the introduction of new liquidity standards that will come into force in 2015 and the demand for collateral to support derivatives market activity. They note that, in response, the RBA has committed to provide liquidity to ADIs against a very broad range of collateral in return for a fee, and has revised its policy around access to central bank facilities. The authors also point to concerns that HQLA may become very expensive. As an editorial aside, it is worth noting one possible implication of this — that regulatory induced demand may mean that government bond yields reflect a 'liquidity premium', such that they underestimate the underlying risk-free rate of time preference.

Joel Grant seeks to build on the empirical evidence surrounding the determinants of Australian deposit-taking institutions (ADIs) liquidity buffers, focusing on the question of how macro-economic and ADI-specific factors influence Australian-owned ADIs' holdings of liquid assets. His results provide strong evidence that for ADIs' subject to liquidity regulation based on scenario analysis (SA) liquidity buffers are higher in high economic growth periods and when short-term interest rates are lower. He finds that SA ADIs build up their liquidity buffers during economic downturns and draw them down during economic upturns, which may give rise to pro-cyclical effects. However, no such relationship is evident among (generally smaller) ADIs which are subject to liquidity regulation based on minimum liquidity ratios.

Grant's results are based on the period 2002 to 2012, and use a definition of liquid assets (as was common over that period) which includes some private sector securities. As the Basel III liquidity regulation changes (discussed by Heath et al.) take effect for the SA ADIs, based on a different, more limited liquidity definition, it will be interesting to examine how liquidity buffer behaviour changes.

The Basel III liquidity requirements are of two types — the liquidity coverage ratio (LCR) which relates to the liquidity buffers studied by Grant, and the net stable funding ratio (NSFR) requirement which relates the maturity composition of funding to asset portfolio maturity characteristics. The paper by David Tripe SF Fin and Jinyue Shi, which examines the effects of the new liquidity ratios implemented in New Zealand in April 2010 (prior to, but similar in nature to, the Basel requirements), focuses primarily on the likely effects of that latter requirement. It finds that, generally, the new liquidity rules have put pressure on banks to change the structure of their funding, resulting in increased use of retail funding and funding for longer maturities. While the authors identify an increase in banks' cost of funds relative to benchmarks, they note that this may be partly explained by the very significant reductions in benchmark interest rates since the onset of the GFC.

Shifting the focus towards superannuation reform, Alex Erskine and Clare Marlin explore the potential benefits and challenges of superannuation funds disclosing the composition of portfolio holdings to members. They note that portfolio disclosure by Australian managed funds (not just superannuation) is low (reflecting an absence of mandatory requirements) relative to international peers. Improved disclosure is arguably becoming more pressing as savings for retirement accumulated in defined contribution superannuation funds grow and the number of members approaching retirement age increases. They suggest that greater information can be made available for member–investors without necessarily overburdening members with information (such as by placing it on a website). Other arguments against requiring transparency (such as revealing private information about strategies etc.) are also reviewed, but none are seen as compelling. Given the increasing importance of defined contribution superannuation, the issue of mandatory disclosure by these, and other, managed funds is one which warrants further analysis and study.

Disclosure is of value if investors can understand it, take notice of it, and act upon it. Many would argue that the involvement of investors with their superannuation, and general financial literacy, is low, such that disclosure may add little value. In that regard, two pieces of federal legislation passed in 2012 under the headings of The Future of Financial Advice (FoFA) and MySuper are particularly relevant and are summarised and appraised in the paper by Hazel Bateman and Geoffrey Kingston. They suggest that the default super fund model of MySuper can be interpreted as de facto mass financial advice for the large part of the population which does not engage with financial planners. For such a scheme, they argue that portfolio allocation should change systematically with investor age and they suggest an explicit glidepath on percentage exposure to growth assets that would see growth assets drop from 60 per cent to 40 per cent of default accounts once a MySuper accountholder reaches 55 years of age.

Financial advice is particularly relevant for the rapidly growing self-managed super fund sector, and Bateman and Kingston examine, inter alia, the consequences of FoFA for typical fee structures of financial planners. They argue that a significant number of traditional fee arrangements could be 'conflicted'. They also note the potential conflict between an optimal portfolio near retirement being of lower risk, and the financial incentives for financial planners to advise a more 'growth-oriented' portfolio on which fees for assets under management are typically higher.

Finally, with extensive research indicating that investors do not have consistent and rational attitudes to risk, the paper by Tom Valentine seeks to determine whether risk profile questionnaires used by financial planners lead to more rational investment decisions being made by clients. One immediate result is that in assessing investor risk tolerance, a small number of questions appear to provide most of the valuable information — suggesting that the merits of long questionnaires can be questioned.

But more importantly, Valentine also observes that individuals save for different motives with different time frames, such that attempting to identify a specific, unchanging, level of risk aversion may be inappropriate, and that advisers should take these different motives into account. In particular, even though investors may appear from questionnaire results to be quite risk averse regarding possible short-term returns, Valentine argues that advisers should help educate their clients regarding the appropriate nature of growth assets for long-term savings such as superannuation.

I would like to thank both the sponsors of the Melbourne Money and Finance Conference — Finsia, Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA) — and the authors for their contribution to the important insights provided in this issue of *JASSA*. ■

JASSA articles

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