Market impact in models of the order book

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We begin by showing that the modeling of market impact is constrained by requiring no-price-manipulation.

In particular, we write down a simple model of market impact in which:

- If the decay of market impact is exponential, market impact must be linear in quantity.
- If decay of market impact is power-law and sensitivity to quantity is also power-law, no-price-manipulation imposes inequality constraints on the exponents.

This simple model is a natural generalization of other models that have previously appeared in the literature.
Model specification

- We suppose that the stock price $S_t$ at time $t$ is given by

$$S_t = S_0 + \int_0^t f(\dot{x}_s) G(t - s) \, ds + \int_0^t \sigma \, dZ_s \quad (1)$$

where $\dot{x}_s$ is our rate of trading in dollars at time $s < t$, $f(\dot{x}_s)$ represents the impact of trading at time $s$ and $G(t - s)$ is a decay factor.

- $S_t$ follows an arithmetic random walk with a drift that depends on the accumulated impacts of previous trades.

- The cumulative impact of (others’) trading is implicitly in $S_0$ and the noise term.

- Drift is ignored.
We refer to $f(\cdot)$ as the *instantaneous market impact function* and to $G(\cdot)$ as the decay kernel.

(1) is a generalization of processes previously considered by Almgren, Bouchaud and Obizhaeva and Wang.

**Remark**

The price process (1) is not the only possible generalization of price processes considered previously. On the one hand, it seems like a natural generalization. On the other hand, it is not motivated by any underlying model of the order book.
Model as limit of discrete time process

- The continuous time process (1) can be viewed as a limit of a discrete time process (see Bouchaud et al. [5] for example):

\[ S_t = \sum_{i<t} f(\delta x_i) G(t - i) + \text{noise} \]

where \( \delta x_i = \dot{x}_i \delta t \) is the quantity traded in some small time interval \( \delta t \) characteristic of the stock, and by abuse of notation, \( f(\cdot) \) is the market impact function.

- \( \delta x_i > 0 \) represents a purchase and \( \delta x_i < 0 \) represents a sale.
- \( \delta t \) could be thought of as \( 1/\nu \) where \( \nu \) is the trade frequency.
- Increasing the rate of trading \( \dot{x}_i \) is equivalent to increasing the quantity traded each \( \delta t \).
Cost of trading

- Denote the number of shares outstanding at time $t$ by $x_t$. Then from (1), the cost $C[\Pi]$ associated with a given trading strategy $\Pi = \{x_t\}$ is given by

$$C[\Pi] = \int_0^T \dot{x}_t \, dt \int_0^t f(\dot{x}_s) \, G(t - s) \, ds$$  \hspace{1cm} (2)

- The $dx_t = \dot{x}_t \, dt$ shares liquidated at time $t$ are traded on average at a price

$$S_t = S_0 + \int_0^t f(\dot{x}_s) \, G(t - s) \, ds$$

which reflects the residual cumulative impact of all prior trading.
The principle of No Price Manipulation

A trading strategy \( \Pi = \{ x_t \} \) is a *round-trip trade* if

\[
\int_0^T \dot{x}_t \, dt = 0
\]

We define a *price manipulation* to be a round-trip trade \( \Pi \) whose expected cost \( C[\Pi] \) is negative.

**The principle of no-price-manipulation**

Price manipulation is not possible.

**Remark**

If price manipulation were possible, the optimal strategy would not exist.
A specific strategy

Consider a strategy where shares are accumulated at the (positive) constant rate \( v_1 \) and then liquidated again at the (positive) constant rate \( v_2 \). According to equation (2), the cost of this strategy is given by \( C_{11} + C_{22} - C_{12} \) with

\[
C_{11} = v_1 f(v_1) \int_0^{\theta T} dt \int_0^t G(t - s) ds
\]

\[
C_{22} = v_2 f(v_2) \int_{\theta T}^T dt \int_{\theta T}^t G(t - s) ds
\]

\[
C_{12} = v_2 f(v_1) \int_{\theta T}^T dt \int_0^{\theta T} G(t - s) ds
\]

(3)

where \( \theta \) is such that \( v_1 \theta T - v_2 (T - \theta T) = 0 \) so

\[
\theta = \frac{v_2}{v_1 + v_2}
\]
Special case: Trade in and out at the same rate

One might ask what happens if we trade into, then out of a position at the same rate $v$. If $G(\cdot)$ is strictly decreasing,

$$C[\Pi] = v f(v) \left\{ \int_0^{T/2} dt \int_0^{t} G(t - s) ds + \int_{T/2}^{T} dt \int_{T/2}^{t} G(t - s) ds - \int_{T/2}^{T} dt \int_0^{T/2} G(t - s) ds \right\}$$

$$= v f(v) \left\{ \int_0^{T/2} dt \int_0^{t} [G(t - s) - G(t + T/2 - s)] ds + \int_{T/2}^{T} dt \int_{T/2}^{t} [G(t - s) - G(T - s)] ds \right\} > 0$$

- We conclude that if price manipulation is possible, it must involve trading in and out at different rates.
Exponential decay

Suppose that the decay kernel has the form

\[ G(\tau) = e^{-\rho \tau} \]

Then, explicit computation of all the integrals in (3) gives

\[
\begin{align*}
C_{11} &= v_1 f(v_1) \frac{1}{\rho^2} \left \{ e^{-\rho \theta T} - 1 + \rho \theta T \right \} \\
C_{12} &= v_2 f(v_1) \frac{1}{\rho^2} \left \{ 1 + e^{-\rho T} - e^{-\rho \theta T} - e^{-\rho (1-\theta) T} \right \} \\
C_{22} &= v_2 f(v_2) \frac{1}{\rho^2} \left \{ e^{-\rho (1-\theta) T} - 1 + \rho (1 - \theta) T \right \} 
\end{align*}
\] (4)

We see in particular that the no-price-manipulation principle forces a relationship between the instantaneous impact function \( f(\cdot) \) and the decay kernel \( G(\cdot) \).
Exponential decay

After making the substitution \( \theta = v_2/(v_1 + v_2) \) and imposing the principle of no-price-manipulation, we obtain

\[
\begin{align*}
&v_1 f(v_1) \left[ e^{-\frac{v_2 \rho}{v_1+v_2}} - 1 + \frac{v_2 \rho}{v_1 + v_2} \right] \\
&+ v_2 f(v_2) \left[ e^{-\frac{v_1 \rho}{v_1+v_2}} - 1 + \frac{v_1 \rho}{v_1 + v_2} \right] \\
&- v_2 f(v_1) \left[ 1 + e^{-\rho} - e^{-\frac{v_1 \rho}{v_1+v_2}} - e^{-\frac{v_2 \rho}{v_1+v_2}} \right] \geq 0 \quad (5)
\end{align*}
\]

where, without loss of generality, we have set \( T = 1 \). We note that the first two terms are always positive so price manipulation is only possible if the third term \( C_{12} \) dominates the others.
Example: $f(v) = \sqrt{v}$

Let $v_1 = 0.2$, $v_2 = 1$, $\rho = 1$. Then the cost of liquidation is given by

$$C = C_{11} + C_{22} - C_{12} = -0.001705 < 0$$

Since $\rho$ really represents the product $\rho \, T$, we see that for any choice of $\rho$, we can find a combination $\{v_1, v_2, T\}$ such that a round trip with no net purchase or sale of stock is profitable. We conclude that if market impact decays exponentially, the no-price-manipulation principle excludes a square root instantaneous impact function.

Can we generalize this?
Expansion in $\rho$

Expanding expression (5) in powers of $\rho$, we obtain

$$\frac{v_1 v_2 [v_1 f(v_2) - v_2 f(v_1)]}{2(v_1 + v_2)^2} \rho^2 + O(\rho^3) \geq 0$$

We see that price manipulation is always possible for small $\rho$ unless $f(v)$ is linear in $v$ and we have

**Lemma**

*Under exponential decay of market impact, no-price-manipulation implies $f(v) \propto v$.***

**Remark**

Alla Slynko has shown that this extends to any model of the form (1) in which $G(0) < \infty$. 
Empirical viability of exponential decay of market impact

- Empirically, market impact is concave in $v$ for small $v$.
- Also, market impact must be convex for very large $v$.
  - Imagine submitting a sell order for 1 million shares when there are bids for only 100,000.
- We conclude that the principle of no-price-manipulation excludes exponential decay of market impact for any empirically reasonable instantaneous market impact function $f(\cdot)$. 
Power-law decay

Suppose now that the decay kernel has the form

\[ G(t - s) = \frac{1}{(t - s)\gamma}, \quad 0 < \gamma < 1 \]

Then, explicit computation of all the integrals in (3) gives

\[
C_{11} = v_1 f(v_1) \frac{T^{2-\gamma}}{(1-\gamma)(2-\gamma)} \theta^{2-\gamma} \\
C_{22} = v_2 f(v_2) \frac{T^{2-\gamma}}{(1-\gamma)(2-\gamma)} (1 - \theta)^{2-\gamma} \\
C_{12} = v_2 f(v_1) \frac{T^{2-\gamma}}{(1-\gamma)(2-\gamma)} \left\{ 1 - \theta^{2-\gamma} - (1 - \theta)^{2-\gamma} \right\}
\]
Power-law decay

According to the principle of no-price-manipulation, substituting \( \theta = \frac{v_2}{v_1 + v_2} \), we must have

\[
f(v_1) \left\{ v_1 v_2^{1-\gamma} - (v_1 + v_2)^{2-\gamma} + v_1^{2-\gamma} + v_2^{2-\gamma} \right\} + f(v_2) v_1^{2-\gamma} \geq 0 \tag{7}
\]

- If \( \gamma = 0 \), the no-price-manipulation condition (7) reduces to

\[
f(v_2) v_1 - f(v_1) v_2 \geq 0
\]

so again, permanent impact must be linear.

- If \( \gamma = 1 \), equation (7) reduces to

\[
f(v_1) + f(v_2) \geq 0
\]

So long as \( f(\cdot) \geq 0 \), there is no constraint on \( f(\cdot) \) when \( \gamma = 1 \).
The limit $\nu_1 \ll \nu_2$ and $0 < \gamma < 1$

In this limit, we accumulate stock much more slowly than we liquidate it. Let $\nu_1 = \epsilon \nu$ and $\nu_2 = \nu$ with $\epsilon \ll 1$. Then, in the limit $\epsilon \to 0$, with $0 < \gamma < 1$, equation (7) becomes

$$f(\epsilon \nu) \left\{ \epsilon - (1 + \epsilon)^{2-\gamma} + \epsilon^{2-\gamma} + 1 \right\} + f(\nu) \epsilon^{2-\gamma}$$

$$\sim -f(\epsilon \nu) (1 - \gamma) \epsilon + f(\nu) \epsilon^{2-\gamma} \geq 0$$

so for $\epsilon$ sufficiently small we have

$$\frac{f(\epsilon \nu)}{f(\nu)} \leq \frac{\epsilon^{1-\gamma}}{1 - \gamma} \quad (8)$$

If the condition (8) is not satisfied, price manipulation is possible by accumulating stock slowly, maximally splitting the trade, then liquidating it rapidly.
Power-law impact: $f(v) \propto v^\delta$

If $f(v) \sim v^\delta$ (as per Almgren et al. [1]), the no-price-manipulation condition (8) reduces to

$$\epsilon^{1-\gamma-\delta} \geq 1 - \gamma$$

and we obtain

**Small $v$ no-price-manipulation condition**

$$\gamma + \delta \geq 1$$
From equation (6), the cost of an interval VWAP execution with duration $T$ is proportional to

$$C = \nu f(\nu) \ T^{2-\gamma}$$

Noting that $\nu = n/T$, and putting $f(\nu) \propto (\nu/V)^\delta$, the cost per share is proportional to

$$\left(\frac{n}{V}\right)^\delta \ T^{1-\gamma-\delta}$$

If $\gamma + \delta = 1$, the cost per share is independent of $T$ and in particular, if $\gamma = \delta = 1/2$, the impact cost per share is proportional to $\sqrt{n/V}$, which is the well-known square-root formula for market impact as described by, for example, Grinold and Kahn [10].
The square-root formula, $\gamma$ and $\delta$

- The square-root market impact formula has been widely used in practice for many years.
- If correct, this formula implies that the cost of liquidating a stock is independent of the time taken.
  - Fixing market volume and volatility, impact depends only on size.
- We can check this prediction empirically.
  - See for example Engle, Ferstenberg and Russell [7].
- Also, according to Almgren, $\delta \approx 0.6$ and according to Bouchaud $\gamma \approx 0.4$.

**Empirical observation**

$$\delta + \gamma \approx 1!$$
Bouchaud, Mézard and Potters [6] derive the following approximation to the average density \( \rho(\hat{\Delta}) \) of orders as a function of a rescaled distance \( \hat{\Delta} \) from the price level at which the order is placed to the current price:

\[
\rho(\hat{\Delta}) = e^{-\hat{\Delta}} \int_{0}^{\hat{\Delta}} du \frac{\sinh(u)}{u^{1+\mu}} + \sinh(\hat{\Delta}) \int_{\hat{\Delta}}^{\infty} du \frac{e^{-u}}{u^{1+\mu}} \tag{9}
\]

where \( \mu \) is the exponent in the empirical power-law distribution of new limit orders.
Approximate order density

The red line is a plot of the order density $\rho(\hat{\Delta})$ with $\mu = 0.6$ (as estimated by Bouchaud, Mézard and Potters).
Virtual price impact

Switching $x-$ and $y-$axes in a plot of the cumulative order density gives the virtual impact function plotted below. The red line corresponds to $\mu = 0.6$ as before.

Quantity: $\int_0^\Lambda \rho(u)du$
Impact for high trading rates

- You can’t trade more than the total depth of the book so price impact increases without limit as \( n \rightarrow n_{\text{max}} \).
- For a sufficiently large trading rate \( v \), it can be shown that
  \[
  f(v) \sim \frac{1}{(1 - v/v_{\text{max}})^{1/\mu}}
  \]
- Setting \( v = v_{\text{max}}(1 - \epsilon) \) and taking the limit \( \epsilon \rightarrow 0 \),
  \[
  f(v) \sim \frac{1}{\epsilon^{1/\mu}} \quad \text{as} \quad \epsilon \rightarrow 0.
  \]
- Imagine we accumulate stock at a rate close to \( v_{\text{max}} := 1 \) and liquidate at some (lower) rate \( v \).
  - This is the pump and dump strategy!
Impact for high trading rates continued

Substituting into condition (7) gives

\[
\frac{1}{\epsilon^{1/\mu}} \left\{ (1 - \epsilon) v^{1-\gamma} - (1 - \epsilon + v)^{2-\gamma} + (1 - \epsilon)^{2-\gamma} + v^{2-\gamma} \right\} + f(v) (1 - \epsilon)^{2-\gamma} \geq 0
\]

No-price-manipulation imposes that

\[
h(v, \gamma) := v^{1-\gamma} - (1 + v)^{2-\gamma} + 1 + v^{2-\gamma} \geq 0
\]
Graphical illustration

\[ h(v, \gamma) = 2 - \log(3)/\log(2) \]

\[ \gamma = 0.5 \]

\[ \gamma = 0.3 \]
Large size no price manipulation condition

From the picture, we see that $h(v, \gamma) \geq 0$ implies

$$\gamma > \gamma^* = 2 - \frac{\log 3}{\log 2}$$
Long memory of order flow

- It is empirically well-established that order-flow is a long memory process.
  - More precisely, the autocorrelation function of order signs decays as a power-law.
  - There is evidence that this autocorrelation results from order splitting.
- Imposing linear growth of return variance in trading time (Bouchaud et al. [5]) in an effective model such as (1) forces power-law decay of market impact with exponent $\gamma \leq 1/2$. 
Summary of prior work

- By imposing the principle of no-price-manipulation, we showed that if market impact decays as a power-law $1/(t - s)^\gamma$ and the instantaneous market impact function is of the form $f(v) \propto v^\delta$, we must have

$$\gamma + \delta \geq 1$$

- We excluded the combination of exponential decay with nonlinear market impact.
We observed that if the average cost of a (not-too-large) VWAP execution is roughly independent of duration, the exponent $\delta$ of the power law of market impact should satisfy:

$$\delta + \gamma \approx 1$$

By considering the tails of the limit-order book, we deduce that

$$\gamma \geq \gamma^* := 2 - \frac{\log 3}{\log 2} \approx 0.415$$

Long memory of order flow imposes $\gamma \leq 1/2$. 
Schematic presentation of constraints

\[ \gamma + \delta \geq 1 \]
\[ \gamma = 0.4, \delta = 0.6 \]
\[ \gamma = 0.5, \delta = 0.5 \]
\[ \gamma \leq \gamma^* \]
\[ \gamma \leq 1/2 \]
The model of Alfonsi, Fruth and Schied

Alfonsi, Fruth and Schied [2] consider the following (AS) model of the order book:

- There is a continuous (in general nonlinear) density of orders \( f(x) \) above some martingale ask price \( A_t \). The cumulative density of orders up to price level \( x \) is given by

\[
F(x) := \int_0^x f(y) \, dy
\]

- Executions eat into the order book (i.e. executions are with market orders).
- A purchase of \( \xi \) shares at time \( t \) causes the ask price to increase from \( A_t + D_t \) to \( A_t + D_{t+} \) with

\[
\xi = \int_{D_t}^{D_{t+}} f(x) \, dx = F(D_{t+}) - F(D_t)
\]
We can define a volume impact process

\[ E_t := F(D_t) \]

which represents how much of the book has been eaten up by executions up to time \( t \).

Depending on the model, either the spread \( D_t \) or the volume impact process \( E_t \) revert exponentially at some rate \( \rho \). This captures the resiliency of the order book: Limit orders arrive to replenish order density lost through executions.
When a trade of size $\xi$ is placed at time $t$,

\begin{align*}
E_t & \quad \mapsto \quad E_{t+} = E_t + \xi \\
D_t = F^{-1}(E_t) & \quad \mapsto \quad D_{t+} = F^{-1}(E_{t+}) = F^{-1}(E_t + \xi)
\end{align*}
Example: The model of Obizhaeva and Wang

In the Obizhaeva Wang (OW) model, we thus have

\[ f(x) = 1 \]
\[ F(x) = x \]
\[ E_t = D_t \]
\[ \Delta D_t := D_{t+} - D_t = \xi \]

Thus market impact \( \Delta D_t \) is linear in the quantity \( \xi \). Between executions, the spread \( D_t \) and the volume impact process \( E_t \) both decay exponentially at rate \( \rho \) so that at time \( t \) after an execution at the earlier time \( s \), we have

\[ D_t = D_{s+} e^{-\rho(t-s)} \]
Cost of execution and optimal trading strategy

Given a trading strategy \( \Pi \) with trading at the rate \( \dot{x}_t \), the cost of execution in the OW model is given by

\[
C(\Pi) = \int_0^T \dot{x}_t \, dt \int_0^t \dot{x}_s \, e^{-\rho(t-s)} \, ds
\]

When the trading policy \( \dot{x}_t = u_t \) is statically optimal, the Euler-Lagrange equation applies:

\[
\frac{\partial}{\partial t} \frac{\delta C}{\delta u_t} = 0
\]

Then, for some constant \( \lambda \), we have the generalized Fredholm integral equation

\[
\frac{\delta C}{\delta u_t} = \int_0^t u_s \, e^{-\rho(t-s)} \, ds + \int_t^T u_s \, e^{-\rho(s-t)} \, ds = \lambda
\]
Substituting

\[ u_t = \delta(t) + \rho + \delta(T - t) \]

where \( \delta(\cdot) \) is the Dirac delta function into (10) gives

\[
\frac{\delta C}{\delta u_t} = \int_0^t u_s e^{-\rho(t-s)} \, ds + \int_t^T u_s e^{-\rho(s-t)} \, ds
\]

\[
= e^{-\rho t} + \int_0^t \rho e^{-\rho(t-s)} \, ds + \int_t^T \rho e^{-\rho(s-t)} \, ds + e^{-\rho(T-t)}
\]

\[ = 2 \]

so \( u_t \) is the optimal strategy.

**The optimal strategy**

Trade blocks of stock at times \( t = 0 \) and \( t = T \) and trade continuously at rate \( \rho \) between these two times.
The optimal strategy involves only purchases of stock, no sales.

Thus there cannot be price manipulation in the OW model.

The OW price process is a special case of (1) with linear price impact and exponential decay of market impact.

- Consistent with our lemma, there is no price manipulation.

The OW model is also a special case of the AS model.
Optimal strategy in the AS model

The optimal strategy
Trade blocks of stock at times $t = 0$ and $t = T$ and trade continuously between these two times.

The optimal size $\xi_0$ of the initial block purchase satisfies

$$F^{-1}(X - \xi_0 \rho T) = F^{-1}(\xi_0) + F^{-1}(\xi_0) \xi_0$$

The optimal continuous trading rate is $\rho \xi_0$ and the optimal size of the final block is just

$$\xi_T = X - \left( \xi_0 + \int_{0}^{T^-} \rho \xi_0 \, dt \right) = X - \xi_0 (1 + \rho T)$$
No price manipulation

- Once again, the optimal strategy involves only purchases of stock, no sales.
- Thus there cannot be price manipulation in the AS model.

What’s going on?

“Under exponential decay of market impact, no-price-manipulation implies $f(v) \propto v$”
A potential conundrum

From Alfonsi and Schied [3]

“Our result on the non-existence of profitable price manipulation strategies strongly contrasts Gatheral’s conclusion that the widely-assumed exponential decay of market impact is compatible only with linear market impact.”

“The preceding corollary shows that, in our Model 1, exponential resilience of price impact is well compatible with nonlinear impact...

This fact is in stark contrast to Gatheral’s observation that, in a related but different continuous-time model, exponential decay of price impact gives rise to price manipulation as soon as price impact is nonlinear.”
Expected price in the two models

Recall that under the price process (1),

\[ \mathbb{E}[S_t] = \int_0^t f(\dot{x}_s) G(t - s) \, ds \]

In the AS model, the current spread \( D_t \) and the volume impact process \( E_t \) are related as

\[ D_t = F^{-1}(E_t) \]

so effectively, for continuous trading strategies,

\[ \mathbb{E}[S_t] = F^{-1} \left( \int_0^t \dot{x}_s \, e^{-\rho(t-s)} \, ds \right) \]
Cost of trading

The expected cost of trading in the two models is then given by

\[ C_{JG} = \int_0^T \dot{x}_t \, dt \int_0^t f(\dot{x}_s) \, G(t - s) \, ds \]

and

\[ C_{AS} = \int_0^T \dot{x}_t \, dt \, F^{-1} \left( \int_0^t \dot{x}_s \, e^{-\rho(t-s)} \, ds \right) \]

These two expressions are identical in the OW case with

\[ F(x) = x; \quad f(v) = v; \quad G(t - s) = e^{-\rho(t-s)} \]

For more general \( F(\cdot) \), the models are different.
VWAP equivalent models

Are there choices of $F(\cdot)$ for which we can match the expected cost of a VWAP in the two models?

For a VWAP execution, we have $\dot{x}_t = v$, a constant. Then

$$C_{JG} = v f(v) \int_0^T dt \int_0^t G(t-s) \, ds$$

and

$$C_{AS} = v \int_0^T dt F^{-1} \left( v \int_0^t e^{-\rho(t-s)} \, ds \right)$$

In [10], we show that $C_{JG} = C_{AS}$ for all $v$ if and only if $F^{-1}(x) = x^\delta$, $f(v) = v^\delta$ and

$$G(\tau) = \frac{\delta \rho e^{-\rho \tau}}{(1 - e^{-\rho \tau})^{1-\delta}}$$
Thus for small $\tau$,

$$G(\tau) \sim \frac{\delta \rho}{(\rho \tau)^\gamma}$$

with $\gamma = 1 - \delta$ and for large $\tau$,

$$G(\tau) \sim \delta \rho e^{-\rho \tau}$$

Resolution

With power-law market impact $\propto v^\delta$, and exponential resilience, decay of market impact is power-law with exponent $\gamma = 1 - \delta$.

Remark

The relationship $\delta + \gamma = 1$ between the exponents emerges naturally from a simple model of the order book!
Resolution

- There is no contradiction.
  - Exponential resilience of an order book with power-law shape induces power-law decay of market impact (at least for short times).

- Both AS-style models and processes like (1) are generalizations of Obizhaeva and Wang’s model.
  - The AS models are motivated by considerations of dynamics of the order book.
  - The class of AS models with exponential resilience has been shown to be free of price manipulation.

- Our results suggest that the empirically observed relationship $\delta + \gamma \approx 1$ may reflect properties of the order book rather than some self-organizing principle.
We now proceed to characterize decay kernels compatible with linear instantaneous market impact.

- The general case is left for future research.
Linear transient market impact

The price process assumed in [8] is

$$S_t = S_0 + \int_0^t h(v_s) G(t - s) \, ds + \text{noise}$$

In [9], this model is on the one hand extended to explicitly include discrete optimal strategies and on the other hand restricted to the case of linear market impact. When the admissible strategy $X$ is used, the price $S_t$ is given by

$$S_t = S^0_t + \int_{\{s < t\}} G(t - s) \, dX_s,$$  \hspace{1cm} (11)

and the expected cost of liquidation is given by

$$C(X) := \frac{1}{2} \int \int G(|t - s|) \, dX_s \, dX_t.$$  \hspace{1cm} (12)
Transaction-triggered price manipulation

Definition (Alfonsi, Schied, Slynko (2009))

A market impact model admits transaction-triggered price manipulation if the expected costs of a sell (buy) program can be decreased by intermediate buy (sell) trades.

As discussed in [4], transaction-triggered price manipulation can be regarded as an additional model irregularity that should be excluded. Transaction-triggered price manipulation can exist in models that do not admit standard price manipulation in the sense of Huberman and Stanzl definition.
First order condition

Theorem

Suppose that $G$ is positive definite. Then $X^*$ minimizes $C(\cdot)$ if and only if there is a constant $\lambda$ such that $X^*$ solves the generalized Fredholm integral equation

$$\int G(|t - s|) \, dX_s^* = \lambda \quad \text{for all } t \in T. \quad (13)$$

In this case, $C(X^*) = \frac{1}{2} \lambda x$. In particular, $\lambda$ must be nonzero as soon as $G$ is strictly positive definite and $x \neq 0$. 
Condition for no transaction-triggered price manipulation

**Theorem**

Suppose that the decay kernel $G(\cdot)$ is convex, satisfies $\int_0^1 G(t) \, dt < \infty$ and that the set of admissible strategies is nonempty. Then there exists a unique admissible optimal strategy $X^*$. Moreover, $X^*_t$ is a monotone function of $t$, and so there is no transaction-triggered price manipulation.

**Remark**

If $G$ is not convex in a neighborhood of zero, there is transaction-triggered price manipulation.
An instructive example

We solve a discretized version of the Fredholm equation (with 512 time points) for two similar decay kernels:

\[ G_1(\tau) = \frac{1}{(1 + t)^2}; \quad G_2(\tau) = \frac{1}{1 + t^2} \]
\( G_1(\cdot) \) is convex, but \( G_2(\cdot) \) is concave near \( \tau = 0 \) so there should be a unique optimal strategy with \( G_1(\cdot) \) as a choice of kernel but there should be transaction-triggered price manipulation with \( G_2(\cdot) \) as the choice of decay kernel.
In the left hand figure, we observe block trades at $t = 0$ and $t = 1$ with continuous (nonconstant) trading in $(0, 1)$. In the right hand figure, we see numerical evidence that the optimal strategy does not exist.

$$G_1(\tau) = \frac{1}{(1+t)^2}$$

$$G_2(\tau) = \frac{1}{1+t^2}$$
Now we give some examples of the optimal strategy with choices of kernel that preclude transaction-triggered price manipulation.
Example I: Linear market impact with exponential decay

\[ G(\tau) = e^{-\rho \tau} \] and the optimal strategy \( u(s) \) solves

\[
\int_0^T u(s) e^{-\rho |t-s|} \, ds = \text{const.}
\]

We already derived the solution which is

\[ u(s) = A \{ \delta(t) + \rho + \delta(T-t) \} \]

The normalizing factor \( A \) is given by

\[
\int_0^T u(t) \, dt = X = A \left( 2 + \rho T \right)
\]

The optimal strategy consists of block trades at \( t = 0 \) and \( t = T \) and continuous trading at the constant rate \( \rho \) between these two times.
Schematic of optimal strategy

The optimal strategy with $\rho = 0.1$ and $T = 1$
Example II: Linear market impact with power-law decay

\[ G(\tau) = \tau^{-\gamma} \] and the optimal strategy \( u(s) \) solves

\[ \int_0^T \frac{u(s)}{|t-s|^{\gamma}} \, ds = \text{const.} \]

The solution is

\[ u(s) = \frac{A}{[s(T-s)]^{(1-\gamma)/2}} \]

The normalizing factor \( A \) is given by

\[ \int_0^T u(t) \, dt = X = A \sqrt{\pi} \left( \frac{T}{2} \right)^{\gamma} \frac{\Gamma \left( \frac{1+\gamma}{2} \right)}{\Gamma \left( 1 + \frac{\gamma}{2} \right)} \]

The optimal strategy is absolutely continuous with no block trades. However, it is singular at \( t = 0 \) and \( t = T \).
Schematic of optimal strategy

The red line is a plot of the optimal strategy with $T = 1$ and $\gamma = 1/2$. 
Example III: Linear market impact with linear decay

\[ G(\tau) = (1 - \rho \tau)^+ \] and the optimal strategy \( u(s) \) solves

\[ \int_0^T u(s) (1 - \rho |t - s|)^+ \, ds = \text{const}. \]

Let \( N := \lfloor \rho T \rfloor \), the largest integer less than or equal to \( \rho T \). Then

\[ u(s) = A \sum_{i=0}^N \left( 1 - \frac{i}{N+1} \right) \left\{ \delta \left( s - \frac{i}{\rho} \right) + \delta \left( T - s - \frac{i}{\rho} \right) \right\} \]

The normalizing factor \( A \) is given by

\[ \int_0^T u(t) \, dt = X = A \sum_{i=0}^N 2 \left( 1 - \frac{i}{N+1} \right) = A (2 + N) \]

The optimal strategy consists only of block trades with no trading between blocks.
Schematic of optimal strategy

Positions and relative sizes of the block trades in the optimal strategy with $\rho = 1$ and $T = 5.2$ (so $N = \lfloor \rho T \rfloor = 5$).
Optimal trade execution is of great importance in practice.
The optimal trading strategy depends on the model.
- In Alfonsi-Schied style models with resiliency that depends only on the current spread, the minimal cost strategy is to trade a block at inception, a block at completion and at a constant rate in between.
- We exhibited other models for which the optimal strategy is more interesting.
Summary II

- In some models, price manipulation is possible and there is no optimal strategy.
- It turns out that we also need to exclude *transaction-triggered price manipulation*.
  - We presented example of models for which price manipulation is possible.
  - In the case of linear transient impact, we provided conditions under which transaction-triggered price manipulation is precluded.
- It remains for us to characterize optimal strategies in the empirically interesting case of nonlinear market impact.
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