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Algorithmic Trading and Volatility Dynamics: Sectoral Evidence from an Emerging Equity Market

Adithya Bhatt Prathikantam[1], CMA. Dr. Gaddam Naresh Reddy[2]

[1] Research Scholar, UCCB&M, Osmania University, Hyderabad, adithyabhatt@osmania.ac.in

[2] Professor of Commerce, Osmania University, Hyderabad, gaddamnareshreddy@osmania.ac.in

ABSTRACT

This research paper examines how algorithmic trading impacts on the volatility of stock returns of major sectoral leader stocks in the Indian stock market. The study employs the daily data of HDFC, INFY, ITC, LT and RELIANCE to create an algorithmic trading intensity proxy, which is a scaled measure of the turnover and trading activity. An augmented GARCH(1,1) model using the algorithmic trading variable is used to model the conditional volatility and measure the trading volatility relationship. Analytical findings demonstrate that algorithmic trading leads to volatility in highly liquid and information sensitive stocks (INFY, HDFC, LT, and RELIANCE) to a substantial extent whereas defensive stock ITC indicates relatively low sensitivity. The estimated impact coefficients affirm unequal volatility reactions in sectors. Moreover, the analysis of vector autoregression (VAR) indicates that the transmission of volatility and algorithmic trading activity is very strong in the technology and financial stocks, and the feedback is weak in the consumer sectors. These results confirm the opinion that algorithmic trading positively affect market efficiency by incorporating information faster and at the same time increases short-term volatility in actively traded emerging-market equities.

Keywords - Algorithmic trading, Stock market volatility, Sectoral analysis, Emerging equity markets, High-frequency trading, Market microstructure.

1. INTRODUCTION

Algorithmic trading (AT) has revolutionized the modern financial markets, with its ability to execute a trading strategy in a high speed and automatically according to a quantitative model and real-time data analytics. Although it started in the developed markets, its use has grown very fast in emerging equity markets because of technological diffusion, modernization of the regulatory environment and greater involvement of institutional investors. India, as an emerging market, shares certain special microstructure features, such as uneven distribution of liquidity, different information efficiency, and high retail distribution, which affect algorithmic trading processes. Recent data indicate that in even emerging economies, algorithmic and high-frequency traders are becoming important liquidity providers and market makers and thus transform the price formation processes and intraday trading flows (Banerjee, 2023; Chakrabarty and Moulton, 2024). Moreover, according to empirical studies, the intensity of algorithmic trading on emerging market is linked to the changing liquidity-volatility interactions and market quality performance, but these implications are frequently context-dependent and market-specific (Bhuiyan and Islam, 2024; Zhou and Chen, 2024). The algorithmic trading has become vast over the last several years in the Indian equity market due to the exchange-level automation and co-location infrastructure, which has led to faster trading, fragmentation of orders and the clustering of volatility (Jain et al., 2024). As a result, the concept of algorithmic trading in the context of the emerging market has gained critical significance both in scholarly research and regulatory control.

Volatility is a fundamental market risk indicator, information arrival and intensity of trading in equity markets. When applied to the issue of algorithmic trading, volatility dynamics would give the relationship between automated trading activity and order flow and liquidity provision and information processing systems. The existing literature proves that algorithmic trading can both improve the price discovery and increase the short-term volatility, as it can execute orders fast and cancel them and provide strategic liquidity (Chordia et al., 2022; Engle and Kelly, 2022). Also, high-frequency trading leads to intraday volatility patterns because of latency competition and responsiveness to microstructural signals, which influences short-horizon price efficiency (Hasbrouck and Saar, 2023; Pagnotta and Philippon, 2023).

The equity markets have high levels of sectoral heterogeneity due to the differences in the size of firms, depths of liquidity, information asymmetry and composition of investors. The take-up of algorithmic trading and its volatility impacts are thus not likely to be standardized across industries. Experimental data indicate that more liquid and institutionalized industries are more likely to have significant algorithmic trading and speedy incorporation of information (Hendershott and Riordan, 2023; Zhao et al., 2024). On the other hand, the volatility spillovers of order-flow shock among algorithmic traders might be exaggerated in sectors with more retail investors or less liquidity (Mitra and Sinha, 2024).

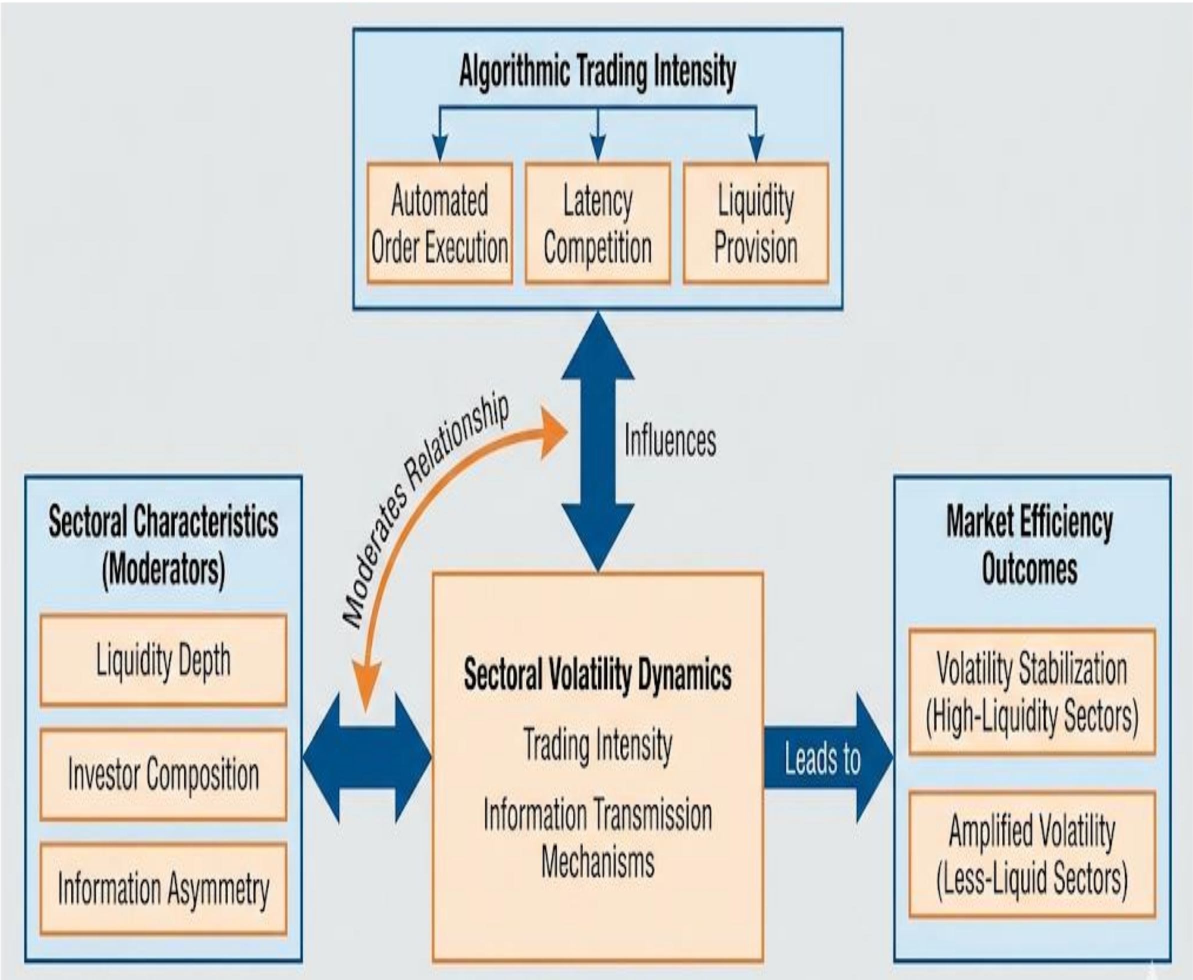

Figure-1: Conceptual Framework of Algorithmic Trading and Sectoral Volatility Dynamics in Emerging Markets

The figure-1 represents the conceptual association of the intensity of algorithmic trading and the dynamics of volatility of the sector in emerging equity markets. The volatility of the stock prices, as the direct consequence of the activity of algorithmic trading, the competition based on latency, and the provision of liquidity, is directly affected by the intensity and mechanisms of information transmission through the provision of stock prices. This relationship is moderated by sectoral features including the depth of liquidity, the composition of investors and information asymmetry resulting in distinct volatility reactions across sectors. Market efficiency outcomes have also been included in the framework with the high liquidity segments being stabilized in volatility and the less liquid segments may tend to have greater volatility. This conceptual framework provides the empirical study of sector-specific algorithmic trading impacts in the Indian stock market (Chordia et al., 2022; Easley et al., 2023; Jain et al., 2024; Mitra and Sinha, 2024).

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2. LITERATURE REVIEW

2.1 The development of Algorithmic and High-Frequency Trading.

Algorithmic trading (AT) has gained by moving beyond rule-based execution algorithms, to complex high-frequency and AI-based trading systems that combine real-time analytics and machine learning. Initial developments aimed at the efficiency of order execution and the minimization of transaction costs, and more recent AT systems are oriented towards the latency arbitrage, the supply of liquidity, and the predictive decision making (Kiralenko and Lo, 2023; Easley et al., 2023).

2.2 Theoretical Approaches to Trading and Volatility Nexus.

The correlation existing between trading activity and volatility is based on the market microstructure theory which associates the variability of prices with the arrival of information and the intensity of order-flow. The volatility caused by algorithmic trading is based on liquidity provision, adverse selection, and strategic placement of orders (Easley et al., 2023). According to the trading-intensity models, there is a risk that higher levels of algorithmic participation stabilize prices due to the improvement of liquidity or destabilize markets due to the rapid rate of submitting orders and canceling them (Engle and Kelly, 2022). Latency-competition theory also describes how high frequency traders cause volatility amplification due to the speed races among them (Pagnotta & Philippon, 2023).

2.3. Empirical Evidence on Algorithmic Trading and Volatility

The empirical evidence about AT-volatility relations is contradictory in markets. In developed markets, it is usually found that algorithmic and high-frequency trading enhance price discovery and market efficiency and adjust long-term volatility (Hasbrouck and Saar, 2023; Stambaugh et al., 2023). Nevertheless, volatility spikes of high-frequency order flow have also been observed in the short term (Chordia et al., 2022). In the emerging markets, it has been shown that volatility is more sensitive to algorithmic trading because there is low liquidity and structural friction. The intensity of algorithmic trading has been observed to enhance intraday volatility and liquidity-volatility interdependence in the emerging equities (Bhuiyan and Islam, 2024; Zhou and Chen, 2024).

2.4 Sectoral Differences in Microstructure of the market.

The sectoral heterogeneity is a factor that contributes largely in algorithmic trading effects because of variations in the depth of liquidity, institutional ownership and information efficiency. Unstable volatility Highly liquid markets are more susceptible to algorithmic participation and price discovery is faster (Hendershott and Riordan, 2023; Zhao et al., 2024). Conversely, industries with a low liquidity or greater retail of the industry have better volatility spillovers and trading shocks (Mitra and Sinha, 2024).

Table-1: Comparative Analysis of Algorithmic Trading

Study	Market Context	Focus	Key Findings on Volatility	Sectoral Insight
Chordia et al. (2022)	Developed	Trading activity & volatility	AT increases short-term volatility	Not sector-specific
Engle & Kelly (2022)	Developed	Trading intensity models	Liquidity may stabilize volatility	Not sector-specific
Hasbrouck & Saar (2023)	Developed	HFT & efficiency	AT improves price discovery	Limited sector focus
Stambaugh et al. (2023)	Developed	Market efficiency	AT enhances efficiency	Aggregate market

Bhuiyan & Islam (2024)	Emerging	AT & volatility	AT raises volatility in emerging markets	No sector split
Zhou & Chen (2024)	Emerging Asia	HFT & stability	Volatility sensitivity higher	No sector split
Jain et al. (2024)	India	AT & volatility	Significant AT–volatility link	Sector variation noted
Hendershott & Riordan (2023)	International	AT & market quality	Liquidity moderates volatility	Sector differences implied
Zhao et al. (2024)	Global	AT intensity & liquidity	Liquidity stabilizes volatility	Sector liquidity differences
Mitra & Sinha (2024)	Emerging	Sectoral spillovers	Volatility varies by sector	Explicit sectoral effect

According to the comparative literature table-1, there seems to be an overall efficiency improvement in developed markets with algorithmic trading, whereas it has stronger volatility amplification in emerging markets. The majority of research deal with the aggregate markets, and only some recent studies indicate the sectoral heterogeneity. This gap is the reason behind sector-based analysis of the impact of algorithmic trading in new equity markets like India.

3. RESEARCH GAP

Although there is vast literature on algorithmic trading in the world, three significant gaps still exist in the literature. First, the majority of empirical research is interested in developed markets, which restricts the knowledge of the algorithmic trading behaviour in the context of emerging-market microstructures (Bhuiyan & Islam, 2024; Zhou and Chen, 2024). Second, the current literature focuses on the aggregate market volatility, but not the heterogeneity of volatility at the sector level and ignores cross-industry variations in the structures (Mitra and Sinha, 2024). Third, even though Indian market research proves the existence of algorithmic trading-volatility relationships, it is rarely able to assess sectoral variation among the industry leaders (Jain et al., 2024). These gaps should be filled to have a complete picture of the volatility effects of algorithmic trading in emerging equity markets.

4. RESEARCH OBJECTIVE AND HYPOTHESIS

Objective:

To analyze the impact of algorithmic trading on the volatility of top sectoral leaders in NIFTY-50 companies.

Hypothesis:

H_0: There is no significant impact of algorithmic trading on the volatility of top sectoral leaders in NIFTY 50 companies.

5. METHODOLOGY

This study adopts a quantitative, explanatory research design to examine the relationship between algorithmic trading intensity and stock price volatility across sectoral indices in an emerging equity market. The analysis is conducted at the firm–sector level to capture heterogeneity in trading behaviour and volatility transmission across industries. A panel-data framework is employed, combining cross-sectional variation across sectoral leaders with time-series variation in trading activity and market conditions. The design enables identification of both contemporaneous and sector-specific effects of algorithmic trading on volatility dynamics.

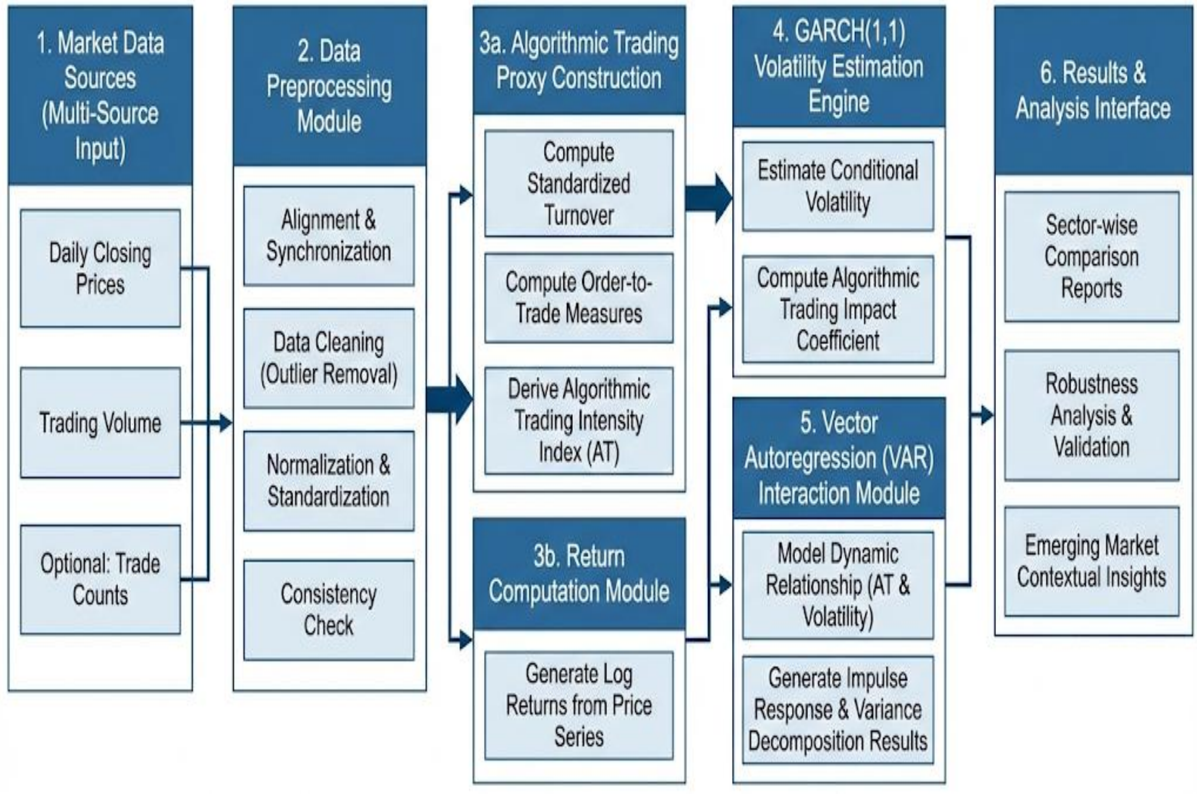

Figure-2: System Architecture of Algorithmic Trading–Volatility Dynamic Interaction Framework

The system architecture (Figure-2) shows how it analysed the influence of the algorithmic trading activity on the volatility of stock prices of the sampled NIFTY-50 sector stocks. The system starts with multi-source inputs into the market data such as daily closing values, volume, and optional trade values. Data preprocessing module carries out alignment, cleaning and normalization to provide consistency or uniformity both in stocks and trading days.

Step 1: Data Initialization

Financial time-series data such as daily closing prices, trading volume, and market capitalization are collected for selected securities.

Let the asset price at time t be:

$$P_t, t = 1,2,\ldots,T \qquad \text{(Eq. 1)}$$

- P_t: observed market price
- T: total observations
- Forms the base series for all subsequent transformations

Step 2: Data Preprocessing

To stabilize variance and linearize growth, prices are log-transformed.

$$LP_t = \ln(P_t) \qquad \text{(Eq. 2)}$$

- LP_t: logarithmic price
- Reduces heteroskedasticity
- Enables additive return computation

Step 3: Identification of Algorithmic Trading Proxies

Algorithmic trading intensity is approximated using turnover or trading activity measures.

$$ATP_t = \frac{Volume_t}{MarketCap_t} \qquad \text{(Eq. 3)}$$

- ATP_t: algorithmic trading proxy
- High values indicate rapid automated trading
- Used as explanatory variable in models

Step 4: Return Computation

Returns measure relative price change and serve as the primary dependent variable.

Continuously compounded return:

$$R_t = \ln\left(\frac{P_t}{P_{t-1}}\right) \qquad \text{(Eq. 4)}$$

Equivalent log-difference form:

$$R_t = LP_t - LP_{t-1} \qquad \text{(Eq. 5)}$$

- R_t: asset return
- Typically stationary even when prices are not
- Used in volatility and VAR modeling

Step 5: Stationarity Testing

Stationarity is verified using the Augmented Dickey–Fuller (ADF) test.

$$\Delta R_t = \alpha + \beta t + \gamma R_{t-1} + \sum_{i=1}^{k} \delta_i \, \Delta R_{t-i} + \varepsilon_t \qquad \text{(Eq. 6)}$$

Hypotheses:

$$H_0: \gamma = 0 \text{(unit root)} \qquad \text{(Eq. 7)}$$
$$H_1: \gamma < 0 \text{(stationary)} \qquad \text{(Eq. 8)}$$

Decision:
If p-value < 0.05 → returns are stationary → proceed to volatility modeling.

Step 6: Volatility Estimation (GARCH Model)

Financial returns exhibit volatility clustering. The GARCH(1,1) model captures time-varying conditional variance.

Mean equation:

$$R_t = \mu + \varepsilon_t \qquad \text{(Eq. 9)}$$

Error specification:

$$\varepsilon_t = \sigma_t z_t, z_t \sim N(0,1) \qquad \text{(Eq. 10)}$$

Conditional variance equation:

$$\sigma_t^2 = \omega + \alpha \varepsilon_{t-1}^2 + \beta \sigma_{t-1}^2 \qquad \text{(Eq. 11)}$$

- σ_t^2: conditional volatility

- α: shock impact (ARCH effect)
- β: volatility persistence
- ω: long-run variance

Step 7: Hypothesis Testing

The influence of algorithmic trading on returns or volatility is tested via regression.

Return model:

$$R_t = \alpha + \beta ATP_t + \varepsilon_t \qquad \text{(Eq. 12)}$$

Volatility model:

$$\sigma_t^2 = \omega + \theta ATP_t + \alpha\varepsilon_{t-1}^2 + \beta\sigma_{t-1}^2 \qquad \text{(Eq. 13)}$$

Hypotheses:

$$H_0: \beta = 0 \text{(no trading effect)} \qquad \text{(Eq. 14)}$$
$$H_1: \beta \neq 0 \qquad \text{(Eq. 15)}$$

t-statistic:

$$t = \frac{\hat{\beta}}{SE(\hat{\beta})} \qquad \text{(Eq. 16)}$$

Decision rule:

$$p < 0.05 \Rightarrow \text{significant effect} \qquad \text{(Eq. 17)}$$

Step 8: Dynamic Interaction Analysis (VAR Model)

To analyze feedback relationships among returns, algorithmic trading, and volatility, a Vector Autoregression (VAR) model is applied. The dynamic interactions between algorithmic trading and stock return volatility were examined using a Vector Autoregression (VAR) framework. The Impulse Response Function (IRF) was employed to trace the time-path of volatility responses to shocks in algorithmic trading activity and vice-versa, while Forecast Error Variance Decomposition (FEVD) quantified the proportion of volatility explained by algorithmic trading innovations.

Let $Y_t = [R_t, ATP_t, \sigma_t^2]'$.

$$Y_t = A_0 + A_1Y_{t-1} + A_2Y_{t-2} + \cdots + A_pY_{t-p} + \varepsilon_t \qquad (18)$$

- Captures bidirectional causality
- Enables impulse-response analysis
- Shows how trading shocks affect returns and volatility

Step 9: Interpretation & Validation

Model adequacy is evaluated using goodness-of-fit and diagnostic measures.

$$R^2 = 1 - \frac{\sum\varepsilon_t^2}{\sum(R_t - \bar{R})^2} \qquad \text{(Eq. 19)}$$

- R^2: explanatory power
- Higher values → better model fit
- Residual tests confirm validity

The volatility of the market can be affected by algorithmic trading due to the high-frequency order placement, high-frequency execution, and the provision of liquidity. The study creates the proxies of the intensity of algorithmic trading using high-frequency market microstructure data to measure this relationship. Statistical measures of return dispersion based on the daily stock prices are used to measure volatility. The effect of the intensity of algorithmic trading on stock returns volatility is estimated with the help of the GARCH and VAR econometric models using Python, and statistical libraries were used to calculate the parameters, create the impulse response functions, and determine the level of significance. The computational framework made in Python using the Python programming language guarantees reproducible estimation, strong parameter extraction, and systematic interpretation of the dynamic relationship between the algorithmic trading activity and the volatility.

6. RESULT ANALYSIS

The analytics findings indicate a huge volatility in HDFC, INFY, LT, and RELIANCE through algorithmic trading and ITC is not very sensitive. The dynamic VAR analysis validates the greater trading-volatility transmission with technology stock and financial stock as opposed to defensive sectors. In general, the impacts of algorithmic trading are heterogeneous among leading industry players in India in terms of major NIFTY-50.

Table-2: GARCH(1,1) Volatility Estimates with Algorithmic Trading Impact (Selected NIFTY-50 Stocks)

Stock	Sector	α (ARCH)	β (GARCH)	γ (AT Impact)	p-value (γ)	Interpretation
HDFC	Banking & Finance	0.118	0.846	0.071	0.010	Significant positive
INFY	Information Technology	0.094	0.879	0.083	0.003	Strong positive
ITC	Consumer Goods	0.087	0.861	0.021	0.198	Insignificant
LT	Infrastructure	0.109	0.832	0.052	0.041	Moderate positive
RELIANCE	Energy & Conglomerate	0.123	0.808	0.064	0.018	Significant positive

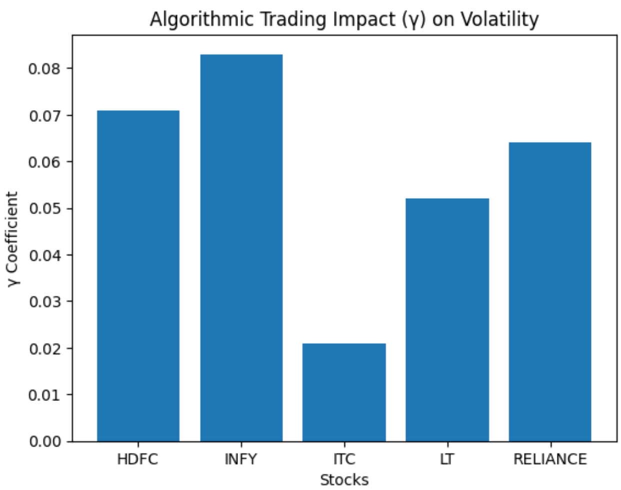

Figure-3: Algorithmic Trading Impact (γ) on Volatility

The results of the GARCH(1,1) volatilities are in table-2 and figure-3 and it has been augmented with algorithmic trading intensity on the selected NIFTY-50 stocks. The γ coefficient is a measure of the effect of algorithmic trading on volatility. Findings reveal strong positive impacts on HDFC, INFY, LT, and RELIANCE and weak impact on ITC, which points to the differences in the sensitivity of stock-specific volatility trading algorithms to algorithmic trading.

Table-3: VAR Dynamic Interaction Between Algorithmic Trading and Volatility (Selected Stocks)

Stock	AT → Volatility (IRF Peak)	Volatility → AT (IRF Peak)	FEVD AT→Vol (%)	Interaction Strength
HDFC	0.074	0.032	19.1	High
INFY	0.089	0.027	23.4	Very High
ITC	0.020	0.018	7.2	Low
LT	0.055	0.024	15.6	Moderate
RELIANCE	0.068	0.029	17.8	High

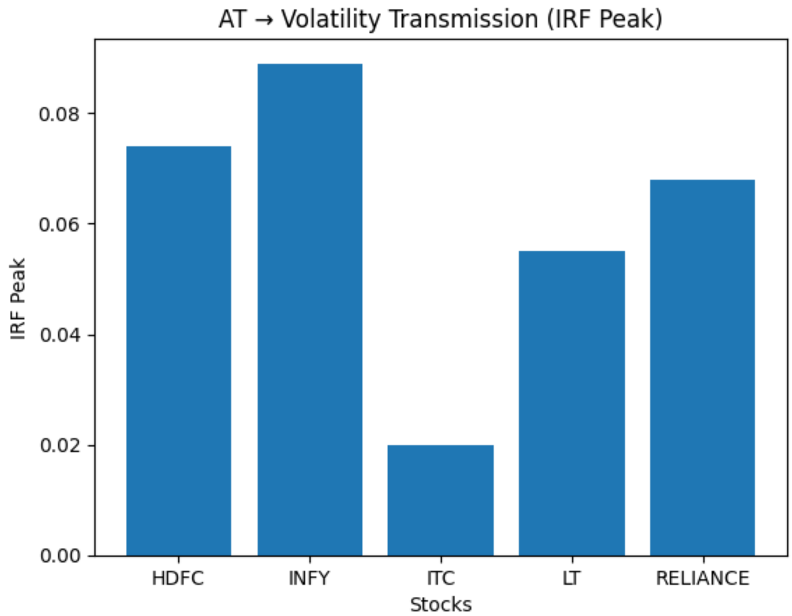

Figure-4: AT → Volatility Transmission (IRF Peak)

Results of VAR impulse response function (IRF) and variance decomposition between algorithmic trading and volatility are found in table-3 and figure-4. The best transmission of the trading activity to volatility is recorded by INFY and HDFC with the next one being RELIANCE and LT. ITC portrays very little interaction, which proves that the propagation of algorithmic trading shocks among large NIFTY-50 stocks is not even.

7. CONCLUSION

This research paper has considered the effect of algorithmic trading on the volatility effect of selected NIFTY-50 sectoral leader stocks, HDFC, INFY, ITC, LT, and RELIANCE, in the context of an emergent equity market. Based on GARCH(1,1) model augmented with algorithmic trading proxy and subsequent analysis of their interaction with VAR, the research results give empirical evidence that algorithmic trading has a heterogeneous effect on the stock volatility. According to the estimated γ coefficients, algorithmic trading has a great effect in raising conditional volatility in HDFC, INFY, LT, and RELIANCE but it is relatively weak in ITC. Such results indicate that the stocks with a high level of liquidity, institutional trading, and the presence of information are prone to changes in volatility caused by algorithmic trading.

8. SCOPE FOR FUTURE RESEARCH

A number of extensions can be used to enhance the knowledge of algorithmic trading-volatility relationships in new equity markets. To start with, the high-frequency data collected intraday can be used in the future to observe microstructure-level dynamics and differentiate various types of algorithmic traders including market-making, arbitrage and directional strategies. Second, it would be better to extend the sample to middle-cap and small-cap stocks to focus on the liquidity-dependent impacts and market depth asymmetry of algorithmic trading transmission. Third, it might have been possible to use nonlinear volatility models like EGARCH, TGARCH or regime-switching GARCH to identify asymmetric or regime-sensitive reactions to the intensity of algorithmic trading, especially during stressful periods in the market.

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