A NEWSLETTER FOR FRIENDS AND CLIENTS
OF MERCER ADVISORS

PERSPECTIVES
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Lack of Alignment Brings Chaos

What was that? The new catch phrase is "flash crash," a combination of electronics and emotion that drove the market down almost 1000 points and back up about 700 points Thursday in less time than some people take for lunch.

How weird did the day get? Sotheby's shares opened at $34.61 and closed at $33, but in between, shares hit $100,000. The market value of Sotheby's briefly exceeded that of many countries.

At the other end of the spectrum, Exelon Corp., a $30 billion utility, was briefly worth… zero. Some other companies that briefly hit zero in trading yesterday were consulting firm Accenture, Boston Beer (Samuel Adams), Impax Laboratories, and fellow utility Center Point Energy.

For all of these companies, these were intraday blips on which the share price closed near the price at which it opened. But the largest single-day drop ever and one of the largest percentage fluctuations ever is no ordinary blip.

Theories behind the volatility included delayed Greece panic and the "fat finger" theory that someone mistyped a trade order (e.g., billion instead of million). The truth lands between the more mundane and more mysterious.

Electronic NYSE monitors pause trading in a stock when buyers and sellers are too far apart. It's not a frequent occurrence, but it has happened many times before with success.

However, in the past, NYSE controlled by far the majority of the shares of its companies. Today, the NYSE controls only 25% of NYSE company shares; the rest are traded by private companies, much of it electronically.

Thursday at about 2:40 ET, NYSE monitors paused trading in five stocks, including 3M and Proctor & Gamble. Within a minute or two, humans restarted trading.

The private companies did not stop trading and registered this withdrawal as a loss of liquidity reminiscent of the credit crunch that dried up credit a couple of years ago. If bids dried up, computers automatically bid a penny for the stock, which is how a stock could briefly bottom out.

The market dropped 580 points in seven minutes. The declines in 3M and Proctor & Gamble alone accounted for a 400-point drop in the Dow, the head of the NYSE said. Within half an hour, the market had lost almost 1000 points and then rebounded several hundred points.

As prices dropped, automatic stop-loss trades kicked in, which caused more price declines and more stop-loss trading. At the 500-point drop mark, high-frequency trading firms like Tradebot shut down, further increasing the loss of liquidity. For a few minutes, international money flooded into US Treasuries, the Euro fell, and the price of gold broke $1200 an ounce. By the end of the day, the market closed down, but that's not surprising given the number of automatic sells that were triggered. This week is starting on a big rebound.

Friday was another day. NASDAQ and other exchanges that kept trading began undoing trades on hundreds of stocks with excessive price movement. That doesn't mean traders were made whole.

For example, suppose a stock began the day at $60. A trader bought the stock at $10 then sold on the rebound at $50. The buy is wiped out because the price is too extreme. But the sale is within acceptable price range and would stay. Thus, the trader is left holding the shares short at $50. His previous profit is wiped out. To make a profit now, he must buy again at a price far enough below $50 to cover trading costs—and this on a stock that started the day at $60.

No word on whether brokers will also refund trading fees.

Over two-thirds of all trades unwound involved volatile ETFs; this is just one more reason Mercer Advisors does not deal in ETFs. Volatility (and frequent trading) already eat away at long-term returns, and now we know there is a non-market risk in autotrading.

Mercer Advisors clients sustained no harm resulting from the brief dip.

So, that's what happened, but what does it mean? It does suggest an underlying problem with market mechanics, but in no way are we talking about the kind of market meltdown we had in 2008. There is no AIG or Bear Stearns or Lehman out there waiting to set off a long-term fall. But mechanical glitches create their own form of market uncertainty, and more than anything, the market hates uncertainty.

Add that to the shoes that are still hanging—unresolved financial problems in Greece, unresolved financial problems here, the hung Parliament in the UK, the attempted terrorist attack in Times Square—and it all makes the market a bit twitchy.

The current uncertainty can be improved. Friday's job report, more positive than

expected, is the fifth month of growth out of the last six months and the biggest single month in four years. Since unemployment is historically the last lagging economic indicator, this suggests that the whole economy is moving up and out of the worst of the recession.

But no matter what, there will always be uncertainty.

About five years ago, the economy seemed unnaturally stable. Markets were rising, interest rates were low, real estate prices were high, and credit was plentiful. We now know that the stability we remember was an illusion, at least in part. The seeds for the banking crisis had been sown and were already sending out runners into the economy. Risk was there; it was just hiding.

As much economic pain as we have had in the last two years, at least we can say we're on the back side of it. The worst of the underlying economic sludge has been exposed, and we are cleaning it up. It will be an uneven process, with some advances and some setbacks. There are still rocks to turn over, still problems to solve, but they are manageable problems.

This lack of alignment among trading firms is another rock to turn over. Senators Kaufman and Warner have already sent a letter to Banking Committee Chairman Senator Dodd requesting an investigation saying, "A temporary $1 trillion drop in market value is an unacceptable consequence of a software glitch."

It can be a bit heart-stopping while it happens, but in the end, discovering a problem is one step closer to solving the problem—one step closer to stabilizing the market for long-term investors like us.

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Wall Street Journal May 6, 2010
Allan Chernoff, "What Hit the Market?" CNNMoney, May 7, 2010