In This Issue

The Stock Market Becomes "Tower of Terror"

High-Frequency Trading Boosts Trading Volume

Low Volume Could Mean Lower Stock Prices

Q&A...What is arbitrage?

In the News

Keep in Touch

Join Our Mailing List

Wenning Investments, LLC

Wenning Advice

Vol. 2 - Issue 2 **Spring 2010**

The Stock Market Becomes "Tower of Terror"

Roll coaster analogies are often used to describe the volatile movement of the stock market. A better amusement park metaphor for May 6 would be the "Tower of Terror," a ride that drops riders straight down from a great height.

With a drop in the Dow Jones Industrial Average just short of 1,000 points over a 20-minute period, "terror" was indeed an appropriate reaction among white-knuckled traders. It was the biggest and fastest drop in market history.

The good news is that the market showed amazing resilience, recovering all but 347 points by the end of the day and making up the rest within a week.

The plunge was initially blamed on a "fat finger," in which a trader allegedly typed a "b" instead of an "m" on a trade order, resulting in a "billion" instead of a "million." Fat chance of that happening, though, since no trading system would execute such a large trade without the trader going through proper channels.

It appears that several factors caused the plunge, but the most important of them is believed to have been high-frequency trading.

The Dow Jones Industrial Average on May 6 during the "flash crash."

High-Frequency Trading Boosts Trading Volume

In addition to the quick market recovery, another positive outcome of the May 6 "flash crash" is that it brought attention to the growth of high-frequency trading (HFT), which is conducted by proprietary trading desks at big banks and private hedge funds.

While most average investors had heard little if anything about HFT before the May 6 plunge, the Federal Reserve Bank of Chicago found that it accounted for 70% of equity trading volume in 2009. TABB Group, which researches financial markets, found that HFT accounts for 73% of all equity trading, up from 30% four years ago.

Investors, with help from market makers, create an efficient market in which prices adjust based on market demand. Demand reflects both risk and potential reward. A majority of trades today, though, are the result

of computer-driven trading that takes advantage of small inefficiencies in the market.

Shah Gilani, Contributing Editor for Money Morning wrote that, "HFT incorporates mathematically driven algorithms that prompt powerful computer systems to look for statistical patterns and pricing anomalies by scanning the various stock exchanges and alternative trading networks.

"When an opportunity arises to profit from what practitioners of these incredibly profitable strategies call 'statistical arbitrage,' traders employ massive leverage and execute their trades by using super-fast computers. Typically, these trades are executed in nano-seconds (billionths of a second) and the opportunities can be over just that quickly, or it may last for minutes or hours. Less frequently, some of these types of trades are held for a few days, or longer."

HFT is credited with improving market efficiency. For example, it may narrow quoted spreads, especially on stocks that trade at relatively high volumes. But, because of the volume involved in HFT, it can create wild market swings, such as the May 6 "flash crash."

Low Volume Could Mean Lower Stock Prices

HFT is not the only factor distorting trading volumes. The growth of exchange-traded funds (ETFs) and arbitrage (*see below*) are also pumping up the volume.

As we noted in Vol. 1, #8 of *Wenning Advice*, the growth of ETFs has been advantageous to investors, because they are professionally managed, like mutual funds, but are priced continuously and are traded on exchanges. They also provide an opportunity for investors to gain exposure to alternative investments, adding diversification to their portfolio.

As profitable as they are for investors, they can be even more profitable for authorized participants, which buy and sell ETF shares and simultaneously buy and sell all of the stocks in the ETF. This keeps the ETF's net asset value (NAV) in line with the value of the underlying stocks, which is a good thing, but it also creates an opportunity for risk-free profits.

By artificially boosting trading volume, HFTs, EFTs and arbitrage may be masking serious market problems. Why should you care?

First, consider that light trading is a sign of a weak market. When investors have confidence in the market, they buy more stocks, sending prices higher. It's a simple matter of supply and demand. Prices rise and fall along with demand.

Stock prices have been going up, of course, but prices are not being driven by a flourishing economy or high earnings. They have simply been recovering ground they lost in the last bear market. When the market moves higher, low trading volume is typically seen as an indicator that the trend is unlikely to continue.

In addition, though, trading volume is a measure of liquidity. Lack of liquidity lowers the value of an asset. Having $10,000 cash in hand, for example, is more valuable than having a $10,000 certificate of deposit that will mature in six months. So when trading volume falls and stocks become less liquid, prices fall.

Even with the growth of high-frequency trading, statistics show that recent trading volume is anemic. If equity trading volume were audible, you would need a hearing aid to hear it.

When market commentators talk about today's market, the phrase "light trading" is commonly used. Trading volume on the New York Stock Exchange is 25% lower this year than it was at this time last year. The 200-day moving average of 1.2 billion shares a day was previously as high as 1.6 billion shares a day, according to The Associated Press.

But the real problem is that trading by traditional investors is even lighter - much lighter - than the stats indicate. If HFT is covering market problems, such as low demand and a lack of liquidity, is it really making the market more efficient?

Q&A

What is arbitrage?

Arbitrage is the attempt to take advantage of price differences of identical or similar financial assets on different markets or in different forms. Price

differences are usually very small, but large profits are made by trading a huge volume of the asset.

For arbitrage to work, the purchase of assets in one market and the identical sale of assets in another market must take place simultaneously. Otherwise, the arbitrageur is exposed to the risk that prices will change in one of the markets before both transactions are completed.

In addition to this "execution risk," as it is called, arbitrage involves other risks. Devaluation of a currency when international arbitrage is taking place, for example, could cause the attempted arbitrage to backfire.

Overall, though, arbitrage is often virtually risk free and can be very profitable.

In the News

Topics we've commented on recently include ...
Actively managed exchange-traded funds (ETFs) in *The Baltimore Sun*.
Baby boomer retirement in the *MetroWest Daily News*.
Bond ETFs in *Daily Finance*.

Be sure to visit our newsroom for the latest updates and for previous issues of *Wenning Advice*.

Keep in Touch

Have an idea for a future issue of *Wenning Advice*? Are you interested in active investing or would you like to refer a friend who may be interested?

Contact Brenda P. Wenning, principal of Wenning Investments, LLC of Newton, Mass. She can be reached at Brenda@WenningInvestments.com or 617-965-0680.

Visit her Web site at www.WenningInvestments.com.

Visit Brenda's blog at www.WenningAdvice.com.

If you would like to be taken off our list, please reply here. If you have a friend who might benefit from "Wenning Advice," please reply here.

Forward email