# Sentiment & Volatility

**John Gustafson – 18 August 2011**

As we continue to be whip-sawed back-and-forth by tremendous volatility and emotion, I wanted to further expand on a topic I addressed months ago, as well as in my note of a couple of weeks back – high frequency trading coupled with investor psychology.

Lately my tirades about front-running, high-frequency traders (HFT) are getting some serious company from serious people in multiple interviews – now we wait for the SEC and perhaps our old friend, Barney Frank to wake up... Just today, I saw an interview with two money managers who have been in the investment business for decades, who employ far-different styles when it comes to managing their assets, but who agree almost completely that high-frequency trading is basically legalized stealing and cannot believe the SEC (& NYSE) continue to allow and almost encourage the activity. (They were: Marvin Schwartz, MD & Sr. PM at Neuberger Berman – and Leon Cooperman, Chairman of the enormous hedge fund firm, Omega Advisors)

I've done a lot of thinking on this topic of late as I've watched the flickering ticks go by in multiple-percentage, daily swings (Is this the "new normal?") and it's almost as though you can watch the machines at work. The best analogy I can think of to illustrate my point is a snow-making machine at a ski resort – you can easily see it when it's turned on or turned off.

Throughout the day today we had an initial blast lower which ran completely out of control in early trading (HFT "making snow") – then the machines were seemingly throttled back, volume dropped, we caught a little bit of a bid, but most importantly it simply felt like a lazy summer day. Until… around 2:30 - 3:00, they started making snow again – almost magically the volume spiked, the emotions dropped and the market fell 100+ points in just a few minutes as the TV bleated it's negative message. Then, as if they wanted to escape political blame and finger-pointing, about 10 minutes before trading came to a halt for the day, the snow machine was once again turned off and the Dow gained back almost 100 points, lickety-split.

What does this all mean and how can it change? Schwartz & Cooperman both reminded me of a point I've outlined here several times – the elimination of the uptick rule in 2007 is what basically allowed HFT to flourish. I've discussed in painful detail previously what HFT is and basically how it works, but the "uptick rule" is even simpler: Prior to 2007, if you wanted to sell a stock that you don't own (sell short), you must sell into an uptick in the price. (i.e. If the last trade was $50 for the stock you want to short, you have to sell your shares at $50.01 or higher – and it used to be a 16th or 6 ¼ cents, before decimalization, but don't get me started on that change – and now you can merely pile in with all the other "long" owners as the shares drop in

value. Remember, HFT works on speed – and emotion... Slowing the flow and having to “work” an order almost completely removes the machine’s advantage – and at the very least would minimize the volume spikes.

Our old friends in Europe attempted to implement their own, clumsy volatility solution Tuesday by proposing a “transaction tax.” The thought would be that every single trade would have a small tax attached, which would serve to deter the high volume of trades necessary to scalp a profit in the HFT model. This seems odd to me, because although it does fit into the general, liberal European politician’s mind of revenue generation via taxation for redistribution – it seems to also be an odd admission that people will alter their behavior to avoid paying taxes. (Haven’t we been hearing just the opposite in our political discourse lately?) Hmmm…

The argument has also been made that the markets “need” the liquidity provided by the HFT crowd. Several of the studies I’ve read seem to indicate just the opposite. One report in particular - I believe from either “The Economist” or another similar publication last year – concluded that once things broke on high volume, the HFT machines would jump in and accelerate the volatility, (make snow) and then when it was really needed to change direction or other orders showed up, they would simply walk away. (snow machine off)

My fear is that the transaction tax probably will curb HFT as intended, but it also may curb the “good” liquidity from the rest of the market participants as well - by penalizing everyone and not simply the bad-actors you are trying to marginalize. Not a real confidence builder, for sure…

Many of the market reports today spoke of “a buyer’s strike” – meaning, there was just a lack of demand on that side of the trade, and people chose to sit and watch. Guess what that environment doesn’t provide very often? Correct! Upticks! Possibly more evidence that simply reinstating the uptick-rule would be a free and easy way to negate the incredible volatility at the worst possible moments of trading.

The other unnecessary restriction that our friends in the EU came up with this week was the banning of the short-selling of financial stocks because of the outlandish rumor-mongering going on. Again, the little Dutch boy has his finger in the dyke, but that isn’t a longer term solution. Short selling by thoughtful people isn’t bad – it does add liquidity (you may have heard the term “face-ripper” lately when it comes to upside volatility) and most short-sellers do more homework for their unpopular stances than long holders do, because of the inherent upside bias of the markets over the longer term.

Also in my last note I made the point that I felt that HFT could most-likely enhance rocket rides higher, which would probably stop much of the complaining as most folks are either out of, or long the market, but we’ve not really been in that type of environment since the machines have come to prominence in 2007. However, after watching a few more of these directionally-enhanced days, I think I have changed my mind on that front.

Investor psychology has always been a theme of these notes, and regularly as it relates to politicians causing economic damage, but I think it also plays in favor of the HFT crowd in our current malaise. Their primary goal is to have extreme volatility and heavy volume in one direction or another, so their black boxes can jump in front of everyone else and ride the wave. There are periods of irrational volatility to the upside (1999 tow-truck drivers owning islands, or perhaps even now in gold and treasury bonds), but those seem much more difficult to maintain overall and they are generally very narrowly focused. (The rising market tide doesn't necessarily lift all ships)

When the public is nervous, it is generally not that focused – I think *every* Dow stock was down today, at least they were at one point very close to the close, before HFT stopped making snow. Also, when looking to buy, very rarely (unless you're "Mr. Index," John Bogle or a leveraged hedgie looking for "risk on") do people simply buy the market – most people get a little selective on an enormous up-day. However, when the blood is being let and the pain is getting worse, "Keep the cheese, and let me out of the trap!" is a BIG motivator. Then, once combustion begins to the downside, the HFT folks show up with their gas cans and more "cheese" is abandoned.

Also, understand that I'm generally quoting the Dow 30 in this piece and not the S&P 500, (which most pros tend to use) but the public and the media focus on the much larger Dow numbers. (Chicks dig the long ball!) The Dow will be the headline on tonight's news, and the coffee-klatch shows in the morning and it's what sets the emotional tone for our economy as far as the public is concerned.

This swings back around to emotions and what I do for a living – and another topic I've addressed in the past regarding what you see and who you hear on TV and in the papers...

At this point in history if someone stands out there and blows their Vuvuzela for the Bulls and you lose money – even for a couple of days, regardless of what happens over the longer term, credibility is lost, emotions run high and future advice is discounted. Conversely, someone who is always overtly cautious and never sticks a toe in the water, once the inevitable downside volatility arrives, can and will always fall back to the canard, "Whew! See, good thing we were still sitting here on the dock." And if that tremendous, negative volatility never arrives, because of the decade we just experienced with the two "hundred year floods" in stocks and homes, it can still be an emotionally justifiable position. Neither tact will dogmatically make you money – so beware those who refuse to grow and adapt and take time to understand. (The period we are in now – psychologically - is almost an exact mirror image of the late 1990's. Just sayin'…)

In no way am I proclaiming that discretion isn't the better part of valor at this moment in time – you haven't heard me burning up the phone lines and/or e-mail crowing about my latest additions to the portfolios – but I am trying to remind folks that people who are always bearish and cautious and never take a position can't make you any more money than those who never

take off their rose-colored glasses. (Though, after the past decade, most of those perma-Bulls are dead, retired or simply doing something else for a living at this point.)

Finally, also please keep in mind that the TV presenters are not always there to help explain things and grasp what is going on - they are there to get ratings, sell advertising and put people / pictures / sounds they think the public wants to see and hear in front of the cameras. Just as with political coverage…

If the markets are rocketing upward and everyone feels good, you're going to mostly see folks who are positive and looking for opportunity. (Generally too late) If things feel terrible and everyone is scared, the guests trend toward those who are piling on and outline strategies to stem your losses once the horse is out of the barn. (Also probably too late) Their justification? That person is "right" today.

Simply a reminder – everyone has a bias... This, as always, reminds me of an old quote, "There are three sides to every story – yours, mine and the truth."

I thank you for your trust, business and advocacy - and I welcome any questions or further discussion.