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August 2011 – Computers vs. Traders – "Quote Stuffing"
Are Computers Unfairly Winning? - Analysis and Recommendations

August 8-10 Examples - It appears that computers often locked out humans in massive up and down market swings. Subpoenas Go Out to High-Speed Trade Firms. Mutual Funds were very active but many did direct institutional trades avoiding the high speed computer pitfalls.

Wednesday 8/10/11 - Stocks dove again, bleeding losses in final hour. As CNN said, "No rationale for the (huge 520 point Dow) market drop." There is evidence of substantial computer generated trading. Before we deal with that, let's first look at a few fundamentals:

The bond market shows we have no current debt crisis The US government is borrowing at record low rates. The 2-year Treasury yield hit an all-time low for the second straight day (0.16%). The 10-year Treasury auction had $77.8 billion trying to buy only $24 billion offered - again large excess demand by buyers for U.S. debt, regardless of the downgrade by S&P (yield 2.14%, below the previous record of 2.42%). 30-year Treasury yield declined to 3.33%. The Treasury sold $32 billion in 3-year notes at a record low of 0.50 percent Tuesday.

Interest on U.S. debt service is only 6% of total U.S. expenditures based on previous higher borrowing costs. Longer term it is essential to make modifications to entitlements which is the real long term debt issue looming, as well as increase revenue.

EARNINGS: THE BEAT GOES ON, but this seems to be ignored in the selloff. Macy's reported its earnings rose 64% to $241 million. Macy's calls it the most successful quarter in more than 10 years. Profit, sales, operating income and cash flow all exceeded expectations for the quarter ended July 30 and it raised its full-year outlook. But ironically shares of Macy's fell 3.62%

Many other retailers, especially luxury, reported surging July same-store sales. Overall consumer spending had a slight decline – lower gas prices - but those with jobs and the wealthy were shopping.

The risk is a further decline in consumer confidence with the market crash and a Congress unable to provide any hope for a more rapid recovery.

Most S&P500[1] earnings have surpassed the prior record of December 2007 despite the concern growth would slow with the disruptions from Japan and higher oil prices in the 2nd quarter.

With 92% of S&P500 companies reported, 71% beat earnings estimates, 75% beat on revenues. Estimate of S&P500 earnings growth in Q2 has risen to 12% (20% excluding financials) from 10% (18% excluding financials). Estimated earnings growth rate for 3Q 2011 is 17.3%. Thomas Reuters 8/12/11

The VIX "fear" or volatility index
The VIX soared 23% to a level (43) not seen since last year's flash crash.

Sean Heron, Rutgers University Adjunct Professor and former Goldman Sachs derivatives trader, said whenever the VIX is above 30, history shows it's a great time to buy. He points out that historically over the next 12 months after the VIX has hit 30 or more, the S&P500 average return has been 16.3% and it's been positive 86% of the time. He gave lots of technical reasons and asserts that historically when selloffs are this strong, with 90% of stocks falling below their 200-day moving average; the subsequent 1-year return has averaged about 30%. CNBC 8/10/11

August 8 - Massive down day by computer
Many market commentators were describing the Dow's 635 point decline as simply "irrational" since after last week's decline most described the market as oversold with low valuations.

The decline seemed more due to high speed trading taking over with record breaking huge volume on the downside. Computer trading dominated over humans. WSJ headline said, "Hedge Funds Hit 'SELL'." Margin calls also had to be met as the market plunged, triggering computer sell orders.

The massive market moves according to Jon Najarian of CNBC "Fast Money" were set up by the July 5, 2011 increase in the capacity of the quote system used by the major exchanges (CQS) to 1 million quotes per SECOND.

On August 8th the high-frequency firms (mostly trading for hedge funds it seems) exceeded the limit so the quote system could not keep up. Trades were happening so fast at times the "tape" (where humans see quotes) couldn't keep up, so trades were "masked" or hidden.

Najarian used example of a sample stock, Corelogic that had huge swings up and down - all in 51 milliseconds. "That's not trading, that's just masking what is going on in the market so people are blind to it and then picking their pockets." There is a firm that uses computers to track the orders of the high-speed trading computers.

The practice is sometimes referred to as ***quote stuffing*** by placing 'buy' and 'sell' orders, either long or short - and then cancel them microseconds later in an attempt to slow down the prices seen by regular investors and other traders on their financial systems or websites.

The "specialist" is supposed to balance orders the old fashioned way where people yell orders at him (or her) on the floor of the NYSE. But he is totally "run over" as the computers take over.

"60 Minutes" did an extensive report showing the huge "rack space" under the floor of the NYSE where firms have supercomputers run by mathematicians and scientists that program algorithms. Electrons get to their computers faster than another firm even a mile away from the NYSE.
http://www.cbsnews.com/video/watch/?id=6945451n

CNN World News Today – London 8/11/11 reported computer trading was creating huge swings in European markets.

On 7/20/11 Europe's top securities regulator (Esma) proposed tough new rules to limit the impact of high frequency trading in one of the first signs that regulators are taking decisive action to clamp down on the controversial activity. Andrew Haldane, executive director for financial stability for HM Treasury, said that the rapid growth of high-frequency trading had sparked price "abnormalities."

Asian markets have seen similar wide swings in very short time periods as high-speed trading is also common on the Asian Exchanges.

"Subpoenas Go Out to High-Speed Trade Firms"

The SEC and CFTC have issued subpoenas relating to "quote stuffing" and computer trading that resulted in the May 2010 "Flash Crash" where the Dow lost 700-points in minutes. Only a small percentage of trading firms are manipulating the market by these gimmicks. The majority is upset with the practices and wants regulations to prevent them. Maybe 100 of the 10,000+ trading firms are abusers per CNBC.

The fast-trading firms will oppose any regulations or actions to disrupt their "free enterprise" techniques since they make huge profits ($millions and $billions per 60 Minutes) as do the hedge funds that pay them.

The SEC has discussed minimum "time in force" rules to prevent buy orders from being cancelled very soon after issued. This would also prevent "pinging" where computers try and find the upper price other traders are willing to pay but cancelling the order before it can be executed. "What can be done to slow high-frequency trading?" Financial Times. Sept. 09, 2010.

The "flash crash" was not directly related to "quote stuffing" but shows how computer trading itself can result in large market swings.

Computers are programmed to buy or sell based on complex price movement prediction models. They trade in microseconds on very small changes in price and imbalances between various exchanges. As trends or "momentum" goes up or down this can result in a rapid spiraling up or down in prices.

In the flash crash, computers tried to sell in an originally minor market decline, "stop loss" orders on mostly ETFs (which are especially risky). A stop loss is intended to limit a loss by selling at the next offered buy (bid) price after a certain stop price. The computers however found no orders from buyers.

Every few milliseconds they kept dropping the selling "ask" price to find a buyer's computer set to buy at that price. If no buyer, they dropped the price repeatedly every few milliseconds, until a buyer was found. But there were no buyers for some stocks or ETFs and the price went all the way down to $0.01. At that point either some computer thought it was a good deal, or it was sold off as worthless. The seller who was trying to limit his loss got wiped out.

For complex reasons ETF's have far more risk for "bad execution" than a stock (or mutual fund).

Computer trading accounts for as much as 70 percent of the market volume. Not all of this is nefarious, however. Even the practice of sending out multiple quotes in milliseconds and canceling them shortly thereafter is not necessarily cheating. Often these orders have to be canceled by a firm because they were filled on another exchange first.

Many market participants are upset with those that misuse the system to intentionally "quote stuff."

August 9 - Massive Rally by Computers
Mutual Funds avoid the pitfalls

The Dow's 430-point gain on 8/9/11 was a day that included an 850 point Dow swing in 1 hour and 42 minutes reports CNBC. The market surged going into the close with humans basically blind as the computers took over with micro second trades on rising prices faster than a human could read or react.

CNBC from the trading floor of Luquidnet reported into the close there were 3 trades of 1 million shares or more. A bugle sound goes off in the room whenever there is a 1 million or more share trade.

Liquidnet enables institutions, especially mutual funds access to the largest natural pool of institutional liquidity in the industry. It allows them to execute large orders directly and anonymously - a legitimate need for money managers.

Morningstar says, "Liquidnet serves more than 630 institutional asset management firms that hold approximately 70 percent of the equity assets under management in the U.S."

A CNBC article on 8/9/11 says that mutual funds use Liquidnet to do direct block trades avoiding the risk of the high frequency trades:

"Liquidnet matches buy and sell orders between funds, in the process helping to insulate fund managers who need to execute large trades from the volatility caused by high-frequency traders, who move in and out of stocks to exploit price movement, sometimes in a matter of seconds. The firm has seen its daily trading volume double from the volume during the first half of the year. In the last two weeks, the volume has been just as strong on up days as during market declines, for both U.S. and international fund trading."

"Mutual-fund portfolio managers have dramatically stepped up their trading activity in August, in some cases pressured by customer fund withdrawals, as the stock market's volatility has worried investors. 'There are those institutions that see major buying opportunities today,' said Liquidnet CEO Seth Merrin. 'And there are those institutions that are being forced to sell or want to reallocate their funds somehow.'" http://www.cnbc.com/id/44079003

My Recommendations

High-speed trading seems to help when momentum from real human traders is up as much as when down. The result however is often hyper movements both ways and spiral movements – up and down.

It is understandable that people are panicked and scared given the large market declines. However, my view has not changed. I continue to believe that the economy will be challenged for many years by financial deleveraging and the ultimate withdrawal of fiscal and monetary stimulus.

Despite the gloomy macro outlook, in my opinion, the market is selling indiscriminately with a focus on fear rather than fundamentals, and equity valuations are attractive in comparison to other investment alternatives for those seeking long-term growth potential in their investments.

Unpredictable market psychology determines market movements as much as anything. However, over sufficiently long periods of time, the economic performance of the corporation and the price paid for its stock will determine the investment return, not market psychology.

I believe that security selection through the independent evaluation of managers looking for long-term outperformance (Alpha) vs. Risk (Beta) continues to be the best way to make recovery potential equity recommendations.

For income or less equity risk/recovery potential, I continue to recommend alternatives without bond or equity market risk. Obviously bonds are at very high interest rate risk as eventually rates should rise which will decrease bond values unless held to maturity. If you can't stand the pain or feel worldwide economies are about to collapse then you might consider moving to, or staying in cash.

What others are saying:

Bestselling author **Dave Ramsey** said 8/4/1011 on CNN, "This fear based thing, based on short-term traders, is not based on you and I, regular folks doing regular investing." Host John King asks why he believes fearful investors should "stay on the rollercoaster" and not bail out. Ramsey points out prior crisis such as TARP were much more real than what we face today. Even then in the 2008 decline it was better to have stayed in the market for the recovery. "Listen, Home Depot and McDonald's and Alcoa are not worth less today than they were yesterday - that is absurd. Translation – you are at Kmart with the blue lights on – these things are on sale today," he said.

CNN's **Ali Velshi** said that in 2008 if you got out of the market you would not have known when to get back in – you may still be out or gotten back in after the large initial gains were already made. "If you were invested in March 2009, you would have had one of the best years in history in the stock market. If you're smart enough to get out, you better be smart enough to know when to get back in, otherwise you just lock in your losses. "

Economist **Ben Stein p**ointed out that the stock market is not the same as the economy. Even if we would go back into recession he says, "the stock market is a barometer of corporate profits…and corporate profits so far are still extremely strong, the corporate sector is loaded with cash…it looks like it will be a long grinding climb out of the pit and the fact that the T-Party has taken away any possibility of government stimulus is a bad thing, but this doesn't look anything like a financial panic."

Mohamed El-Erian, chief executive of PIMCO said 8/4/11, "Unlike Greece and other peripheral European economies, America does not have an immediate debt and deficit problem. Yes the budget deficit is high, but there is ample funding available to the US Treasury at extremely low interest rates."

[1]Investors cannot directly invest in indices. Past performance does not guarantee future results. The material contained herein is for informational purposes only and should not be construed as investment advice, since recommendations will vary based on a client's goals and objectives. Information is believed to be from reliable sources; however, no representation is made as to its accuracy. All economic and performance information is historical and not indicative of future results. Hutchison Investment Advisors, Inc. is an Arizona registered investment advisor. Part 2A of Form ADV (Disclosure Statement) has been given advisory clients, is available upon request and is at www.davecfp.com