

**Can Historical Comparisons Of Stock Market Volatility Still Be Valid?**

**Portfolios heavy  
with  
under-  
performing  
stocks almost  
never  
outperform the  
market.**

**Ignat's Law**

**Speculation in the  
stock market is always  
corrected in the good,  
old-fashioned way."**

**Wall Street Aphorism**

**And in my opinion  
that applies to  
computer driven  
speculation as well!**

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In my RMB report for last week, I referred to a rule of thumb that I developed that suggests that frequent daily volatility readings in the stock market of 4% or more can be used as a danger signal. A subscriber indicated that given all the changes that have taken place in the stock market, implications of that rule may have changed. He specifically referred to computer driven trading.

High frequency trading is indeed a new force in the stock market. It accounts for over 50% of the daily trading volume on major U.S. stock exchanges. The power of computer driven trading was revealed in the flash crash of 2010 although regulators have not been able to pinpoint the causes of that extremely rapid drop and almost full retracement in the stock market on May 6, 2010.

The 4% danger rule is based on the belief that the stock market becomes vulnerable to sudden and sharp price drops when the stock market becomes overly dominated by short-term speculators. Short-term speculators and traders usually fund their activities with large amounts of borrowings and this leverage can create an episode of forced selling.

I recall a comment quoted in the Wall Street Journal from a high frequency trader that indicated "My firm trades 18 million shares a day and our average holding period is 18 seconds." That is about as far away from investing as I can imagine. With such small gains generated and realized in seconds, the only way the

high-frequency trader can earn a reasonable economic return is through the use of leverage and this creates the stock market's instability.

Computer driven trading is usually based on a computer algorithm that defines the rules by which that computer will issue trades. The electronic trading platform must be so fast that there can be little human oversight of its trading. The computer driven trading can be switched off, but by then the damage may already have been done. I have seen reports that these computer algorithms can make trades for millions of shares of stock in a few seconds time.

As the market evolves, computer driven traders have learned that they must constantly update their algorithms to account for changes in stock market behavior. There seems to be no way to anticipate how the market behavior will evolve. It seems that the use of computer driven program trading, in and of itself, has the power to change market behavior in unexpected ways. These algorithms cannot anticipate what one professor calls "Black Swan" events. And these represent a change in the market that has never been seen before.

I believe that these changes in market behavior are just the way the world works. Extremely high stock market volatility suggests that the computer driven trading is just old fashioned speculation dressed up in high-speed mathematical models. These computer driven trading platforms also carry the risk that they can "run amok."

The violence shown by the bear market of 2002-2003 and the crash of 2008 indicate that the stock market has changed a lot, and maybe not for the better.

It seems that many of the computer driven traders want to trade the same way at the same time and that can snowball like a nuclear chain reaction.

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