



A Follow-Up On The Flash Crash: Are the Markets Safe?

"Just 'cause you got the monkey off your back doesn't mean the circus has left town."
– George Carlin

Summary

- Following the flash crash of May 2010, policymakers have implemented various trading policies to limit the recurrence of similar market disturbances.
- These actions appear to have been effective, as most clearly evidenced by a lower level of individual stock dislocations.
- Importantly, however, these policies were not designed to eliminate market volatility.
- Market volatility has persisted, and even increased, justifiably due to growing concern over economic growth and sovereign finances.
- Investors should seek protection from these economic and market risks, but they should do so without blindly forfeiting long-term returns.

Reacting to a Flash Crash

During last year's flash crash, individual stocks temporarily experienced significant price dislocations. Some smaller stocks traded briefly at \$0.01 and other larger company stocks saw temporary swoons of more than 40 percent. Many investors were spooked by these extreme fluctuations and some found the experience as cause to question the integrity and fairness of the financial markets.

Fortunately, as we had anticipated in our September 2010 *Monthly Insights*, regulators took the matter seriously. In recognition of the instability introduced by high-speed trading, policymakers initiated a review process to examine ways to de-incentivize trading practices that proved to exacerbate extreme market dislocations rather than provide liquidity and stability. Regulators also sought to ensure uniform pricing data between divergent exchanges. In its essence, the resulting policies were designed to slow markets during extreme events so that investors would be able to operate on a more level playing field, thus encouraging greater participation.

Perhaps most important, however, was the implementation of the “single-stock circuit breaker” rule. This measure halts trading when a stock trades more than 10 percent away from the high or low of the previous five minutes.¹ The rule – which was first implemented for S&P 500 stocks in June 2010, expanded to all listed stocks in August 2010 and further expanded to Russell 1000 stocks in September 2010 – allows participants time to provide the needed liquidity, thereby averting more serious trading irregularities.

Have the New Policies Worked?

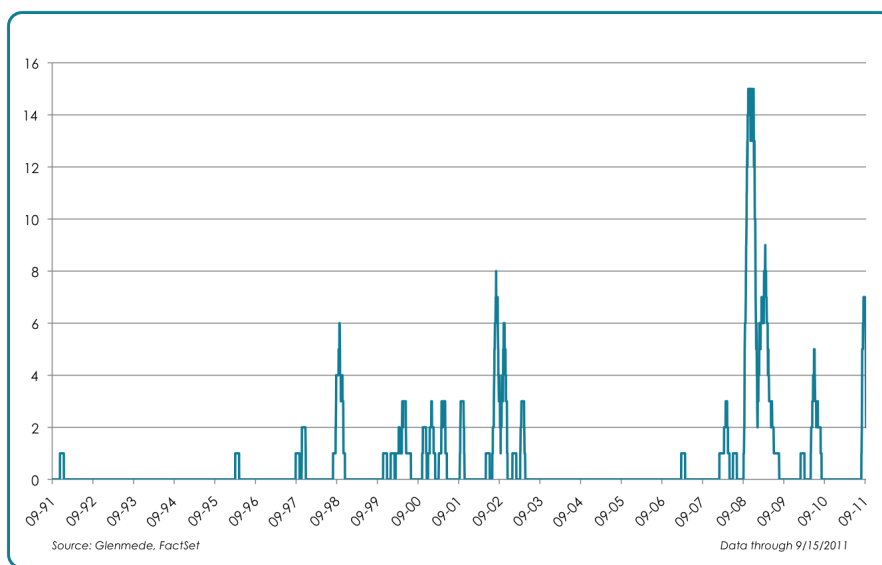
The first true test of these new measures came in August 2011. During this recent period of market volatility, high-frequency trading programs remained active throughout the day, as opposed to pulling back when the market fell, as had occurred during the 2010 flash crash. Buying and selling was more evenly distributed throughout the day, and pricing data seemed to flow easily between exchanges. Of note was the lack of large, distorted moves in individual stocks.

Simply put, the primary role of market regulators is to ensure markets function in an orderly and fair manner. From this perspective, regulators feel the implemented policies, at least initially, have accomplished their primary goal. While ongoing debate continues as to whether the single-stock circuit breakers can be refined to better promote stability and price discovery, we will not delve into the details of these debates at this time.

No Panacea for Market Volatility

Whereas policymakers may feel they succeeded in promoting a more robust and fairly operating market environment, many investors remain unconvinced it is safe to tread in these waters. Admittedly, based upon the frequency of +/-3 percent days recently experienced as outlined in the below graph, one could easily surmise it is not, in fact, safer today.

Number of Days With More Than +/-3 Percent Change From Previous Close During Previous 25 Trading Days



¹ The price band for non-Russell small cap stocks is wider: +/-30% for non-penny stocks; +/-50% for penny stocks.

The reality, however, is that both the policymakers' pride in their actions and investors' concerns are equally justifiable. Markets must function as a price discovery mechanism, providing clearing prices at which buyers and sellers agree to transact. Regulators, for their part, never intended to derail this process or prevent price changes brought about by changes in fundamental information. Ultimately, there is no regulation or exchange rule that can prevent all market fluctuations.

Investment Strategy: Protecting Without Forfeiting Long-Term Returns

This brings us to our current viewpoint and investment strategy recommendations. Fundamental data has changed rather dramatically for the worse over the past few months, so a spike in market volatility should not be surprising. We are in fairly precarious times during which consumers and governments are working to repair their bloated balance sheets; the intensity of this situation is now more pronounced due to slower economic growth and increased financial pressure on governments and European banks. As a result, it is quite imaginable that economic growth will be below normal for an extended period and more vulnerable to disruption and added market volatility.

Until political leaders in the U.S. and Europe embrace more proactive plans to restore fiscal order or the global economic picture stabilizes, we expect above average market volatility to continue. As a result, investors face a meaningful challenge — macro risks require a greater focus on portfolio protection, but traditional protection is quite expensive. As is now mandated by the Federal Reserve, cash and money market rates are expected to stay near zero for two years, and Treasury bond yields have been driven to 50-year lows. Fortunately, developing an asset allocation is more than choosing between stocks and bonds or cash. We believe that mid-range risk investments will provide better long-term risk-adjusted returns than either end of the spectrum — returns better than the most conservative fixed income and even quite close to traditionally higher equity returns, while offering a disproportionate amount of protection. Investors should underweight both the safest assets (cash and Treasuries) and the most economically sensitive equities, concentrating portfolios more in the middle of the risk spectrum.

By favoring mid-risk strategies, investors can manage their risk exposure while optimizing their portfolio performance for the sub-par economic growth and heightened volatility environment. Included in the middle of the risk spectrum are higher-quality (lower-risk) equities, BB-to-B-rated corporate bonds (higher risk than investment grade corporate credit, but lower risk than equities), global bonds, options-based strategies and absolute return strategies (our preferred name for the category including hedge funds). Of course, any of these suggestions are meant to be complementary to a complete allocation that still includes traditional equities as well as high-quality fixed income. By positioning a portfolio in this manner, investors will not relinquish as much prospective return, but can still achieve a meaningful risk reduction.

Monthly Insights is intended to be an unconstrained review of issues, topics and considerations of possible interest to Glenmede's clients and is not intended to be applicable to any one particular client. The views and opinions expressed are those as of the time of publication and are subject to change. Actual investment decisions for particular clients are made in light of applicable considerations and may be different from the views expressed here. Likewise, actual portfolio performance may differ from the results discussed. Clients are encouraged to discuss the applicability of any topic or view contained in any Glenmede publication, especially Insights, with their Glenmede representative.