IT’S NOT THE MARKET WE KNEW AND LOVED

By Daryl Guppy

We have suggested many times that markets changed significantly in 2008-2009 and that we have to adjust our trading methods and thinking. It’s a theme I will expand on at the IFTA conference in Sydney in October.

Notes from Convergex provide a background to major market changes. We add our own observations to these in bold.

- 1980s – 1999. Modern active money management develops around mutual fund managers and their primary sources of information: brokerage analysts. The bull market of the period both draws capital and gives managers a friendly backdrop to perform well. Brokerage analysts are the primary source of investment information, and the regulatory environment gives them preferential access to market-moving data points. Large asset managers also enjoy this benefit.

Trend trading methods work very well. Technical analysis and charting programs become readily available on desktop computers. This is a golden age where plain vanilla trading techniques deliver consistent returns. Market volatility is low, and trending activity is stable and prolonged. The market playing field is levelled and retail traders can successfully compete with professionals. Access to price data is expensive. There is an explosion of new technical techniques as retail traders harness the power of the desktop computers for analysis.

- 2000 – 2010. Hedge funds take over the lead as equity market price-setters. Their edge: the ability to invest only where they have actionable information, and to benefit from short as well as long positions. They draw on a wider base of information sources, such as subject matter experts in a given industry. After Continuous Disclosure Regulations which mandated that public companies had to widely distribute all important information, brokerage analysts have less impact on stock prices.

Market volatility increases and trading opportunities grow. The focus shifts to intra-day live data. Technical analysis and charting programs become more sophisticated and offer hundreds of indicators. However a gap opens between the retail trader and the professional, based largely on computing power that draws data from wider sources than just price data. The expansion of short side trading activity and the explosive growth of derivative trading products like CFDs offer new opportunities for traders. Investors have a more difficult task as trend volatility increases. Access to price data is often free, or very low cost. Technical analysis innovation slows.

- 2010 – present. Passive investing hits its stride as active management stumbles. According to the latest data from S&P Dow Jones Indices, over the last 10 years 85-90% of active U.S. equity managers have failed to outperform their respective benchmarks. The news is not much better for active hedge funds, as has been widely reported.

Investors are terrified of the market after 2008 and nurse their losses. Capital flees the market and equity trading declines. Nervous investors go for ETFs – passive investing – and this dramatically changes the structure and operation of the market. It concentrates liquidity, kills the small cap and mid cap trading opportunities, markedly increased trend instability and reduces trend longevity. Time in the market becomes the primary risk.

Traders desert equities and move to derivatives and FX markets as a means of increasing returns in shorter time frames. This requires an adjustment to the way we understand market. These are issues we have covered and explored in newsletters over the past few years.

The bigger story over and above ETFs is the way Algo and HFT trading further distort classic market activity. The playing field is tilted against the retail trader as sophisticated algos bully and game the market. Trade opportunities exist on the margins of the market.

The market is global, and retail traders have the ability to easily trade global markets using derivatives. Technical analysis provides an advantage for retail traders as the search for technical opportunities is no longer limited to home markets.

Despite low interest rates the market is seen as a dangerous place and the retail trader population dwindles. Charting and technical analysis provides solutions, but they must be matched with much more efficient trade execution strategies. It calls for a different skill set combination. Market data access is less independent as it's usually tied to specific charting and trade execution programs. The key change is the ability to execute trades direct from the chart screen. This opens the way to retail algo-based trading.

The liquid market becomes more correlated with most instruments moving in the same direction at the same time in reaction to the same global events.