

WHY TODAYS MARKET IS NOT LIKE THE MARKET YOU KNEW

By Daryl Guppy

We have a number of returning readers. These are readers who have traded prior to 2010 and then sat on the sidelines of the market for many years waiting for the volatility to disappear. We also have readers who are new to the market and discovering that markets do not behave in the manner suggested by the textbooks written prior to 2008.

Welcome to modern markets, and to this quick primer on the differences. Typical of this experience and the questions is this comment from one reader. He was in a trade and he noticed all the little orders flowing through and suddenly the stock went from \$0.40 down to \$0.33 in just a few minutes.

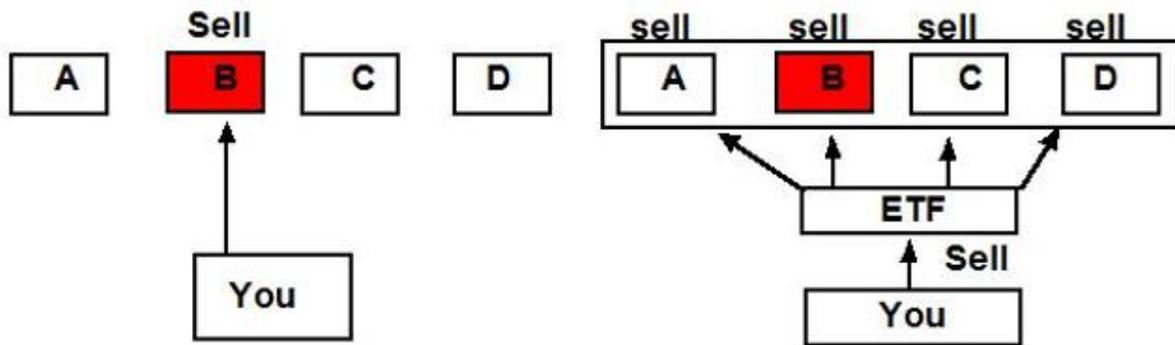
There are two dramatic new features in today's market and they influence the behaviour of every stock. They are High Frequency Trading (HFT) and Exchange Traded Funds (ETF). These are the terrible twins of the market and they have invalidated, or made less effective, many trading techniques. Together they have redistributed liquidity in the market and concentrated it in a small number of stocks.

KEY DIFFERENCES

We start with Exchange Traded Funds.



Investors love these funds and they have been piling into them for years. Now ETF trading accounts for 70% of trading on the New York Stock Exchange. This trading literally holds up the market. We believe they account for similar levels of trading on the Australian Exchange. This means there is less liquidity in stocks that are not part of the ETF universe as traders are focused on ETFs and the ETF manager must trade the underlying stocks. .

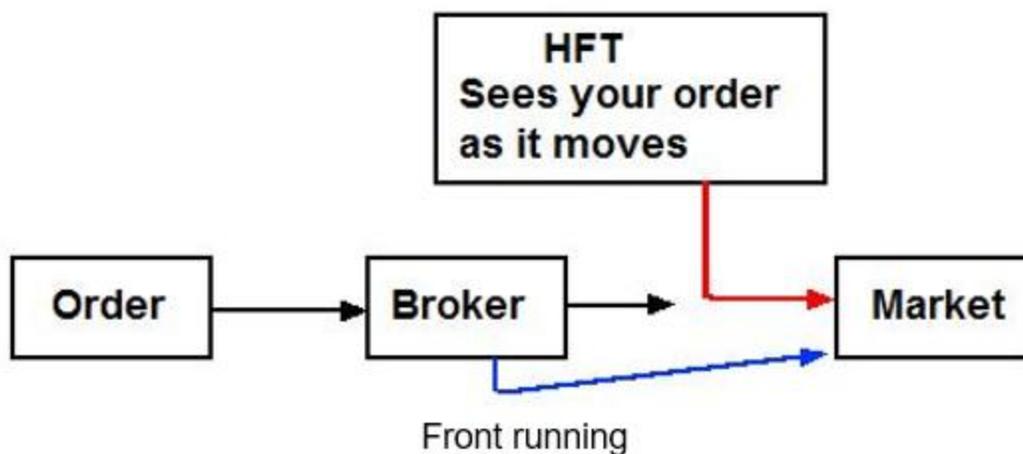


Here's one of the impacts on liquidity. When you own a portfolio of stocks, A B C and D and one goes bad then you sell that one stock. Not so with an ETF. The ETF holds a basket of stocks that make up the index. Let's say they are also A B C and D. . When they buy, or sell, then they must maintain the ratio mix. So when they sell they sell a little bit of every stock in their ETF portfolio. This includes the good performers and the bad performers.

The result is that the good stock that you also hold suddenly drops as a result of ETF selling. This kills rational stop loss methods and it kills the idea of value investing.

Enter the second terrible twin, high frequency trading. Strip away the fancy works and this style of trading is nothing less that front running on a massive scale. If your broker front runs your orders – puts his personal buyer order ahead of yours – then he goes to jail. If a High Frequency Trader does this then it's apparently OK. It's now around 30% of total Australian trading activity.

This is how it works.



The important impact of the HFT activity is the way it needs liquidity – provided by the increase in ETF trading – and the way it creates the illusion of trading activity with frequent orders pinging the market. Few of these orders are executed, but you can see them rapidly flicking in and out of the market. These are the little orders noticed by our reader.

It is a legitimate method to test the market with orders but this constant pinging is distorting market activity, particularly when the practice is extended to stocks with lower levels of liquidity. The result, a rapid fall from \$0.40 to \$0.33.

IMPACTS

Some of the impacts of this concentration of liquidity are these:

- Trend stability is compromised. Trends end rapidly
- It's difficult to set a stop loss as sudden and temporary price drops generate more false exit signals
- Classic trading methods work, but the execution of these methods is impaired. Trades may reach price projection targets but they do it more slowly and stay at target levels for a shorter time and on less volume.
- Volume droughts create exaggerated moves with large price gaps where no trading takes place at the intervening price levels. This disables stop loss execution and makes some trades more of a gamble.
- Stock risk has increased, but index risk remains the same.

SOLUTIONS

We apply several solutions. They do not suit all traders. Our solutions include:

- Short term trades in FX markets with AxiTrader. These markets have durable and reliable trends. We developed the ANTS method as a specific solution for the HFT and ETF market problems
- Index futures trading to get the advantage of leverage
- Trade ETFs and ETF dividend behaviour
- Trade ETFs with leverage by executing the trade via a CFD.
- Trade short term moves in highly liquid stocks. Often the potential gain is small, so execution is via CFD to leverage the returns
- Reduce position size in direct equity trades in mid cap and smaller stocks and use aggressive protect profit stops.
- When trading chart patterns set the exit targets at least one tick below the projected price target. This helps ensure trade exit execution.
- Develop algorithmic trading methods which lead to automated execution. This is a major new developmental area and we will be covering more of this in coming newsletters. We are working with TradeWorks to help develop and refine their algorithm trading product. It's exciting and very very promising. We will keep readers informed.

In the newsletter we continue to apply and modify classic trading methods. We test these so you do not have to lose money testing them yourself. In the newsletter we commit to explore new market instruments and show how these can be used to enhance returns within a low-risk trading environment.