As Volatility Continues, the Blame Game Heats Up

Regulation, the loss of specialists, electronic trading — they're all on the list when it comes to placing blame for recent market volatility.

Volatility is the norm these days as the markets experience dramatic ups and downs amid the global financial crisis. The government announces a bailout plan — the market tanks. The government announces tweaks to the bailout plan — the market jumps.

In fact five of the 10 biggest point declines on record for the Dow Jones Industrial Average occurred in September and October of this year. Five-, six-, even seven-hundred-point drops have become commonplace, and traders have been on a roller-coaster ride of gains and losses (see related table, page 22). It's a brave new trading world, and volatile markets reign.

Many observers have been quick to point the finger at widespread electronic trading — in particular, program trading — as the major culprit behind stocks' wild ride. Program trading as defined by the New York Stock Exchange is “a wide range of portfolio trading strategies involving the [electronic] purchase or sale of 15 or more stocks having a total market value of $1 million or more.”

Electronic trading can set off a “vicious sell-off that chases itself down and no one is there to stop it.”

—Joe Saluzzi, Co-founder and Co-head of the Trading Desk, Themis Trading

Not So Special?

Other experts have suggested that the industry was too quick to dismiss the specialist model on which the exchanges historically relied. The NYSE, for example, has just six specialist firms on the floor today, down from more than 40 in the early 1990s.

The specialist concept was originally put in place to increase liquidity and ultimately provide more-efficient trading. The specialists' role is to act as dealers and provide liquidity and depth when the markets are unbalanced. Specialists assigned to a certain security are obligated when demand goes up to sell their firm's inventory or short the stock, often at prices higher than the current bid/ask spread.

But as electronic trading has taken over and the NYSE has moved

MANAGING THE DESK

By Cristina McEachern
The growth in electronic trading obviously has had an immense impact on the markets, having completely rewritten the nature of trading. But its rapid rise has not come without consequences. "We had no choice but to go electronic, and fast, with Reg NMS, but no one anticipated the volatility we have today," says Joe Saluzzi, cofounder and cohead of the trading desk at Themis Trading, a Chatham, N.J.-based agency broker. The specialists aren't out there to control the flow, slow things down.

Fall's Volatile Market

The table below indicates the largest intraday point swings for the Dow Jones Industrial Average since 1987. Eight of the top 10 occurred in little more than two weeks, starting at the end of September, and the top nine all occurred during the current financial crisis.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Date</th>
<th>Close</th>
<th>Day High</th>
<th>Day Low</th>
<th>Point Swing</th>
<th>Net Change</th>
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<td>1</td>
<td>2008-10-10</td>
<td>8,451.19</td>
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Source: The Wall Street Journal Historical Index Data
"Now it's a free-for-all — the specialists are not in the middle," he continues. "Programs are running wild; algo guys are chasing the program guys. It becomes a vacuum and bids drop, everything disappears — the vicious sell-off that chases itself down and no one is there to stop it."

Olympian's Sarkisian recalls the time when specialists were everywhere and fractions were still the norm. "Back with the specialists and the fraction market, maybe people didn't like those spreads, but there was more fluidity and things were not gyrating all over," she asserts. "Specialists were there and the book was there, and there was less fragmentation of the market."

With the specialist model all but extinct, and without a price-discovery mechanism in one place, volatility has set in, Sarkisian adds. "The specialist model was not perfect, but they did have a responsibility to buy on the way down and sell on the way up. They had a responsibility to the marketplace," she points out.

'A Free-for-All'

"Now it's a free-for-all," Sarkisian continues. "But this is what institutions wanted — they felt they couldn't trade [efficiently] because a specialist was there buying in front of them, and they felt they were paying higher spreads."

Noting that as spreads narrow, trade sizes decrease and fewer block trades can be matched, which in turn boosts volatility, Sarkisian adds that firms need to look at the big picture and consider all costs. "The spreads may be lower, but how many shares can you get done?"

"Specialists add a lot of credence to the market — a certain amount of consistency and a reliability that we need in the marketplace."

—Michael Levas, Founder and Chief Investment Officer, Olympian Capital Management

Curb Appeal

Themis Trading's Saluzzi also has some ideas to help slow the volatility. "We can't get the specialist system back, but we can put back the 2 percent curbs to slow down the program [trades], the spark igniting the fire," he says, adding, "They come in and you can feel them coming in, then the algos start chasing them."

Two percent curbs, or trading collars, were put on brokerage firms that used program trades when the NYSE Composite Index moved up or down more than 2 percent. The rule was removed in October 2007 when the exchange determined that the rule was no longer effective in curbing market volatility.

Saluzzi also says the implementation of a full one-second holding period before a trader can cancel an order could help ease volatility. "There would be no more immediate cancels [from] the guys who are putting quotes all over and clogging the data pipes," he points out. "If we slow down the volume of the IOCs, we might be able to slow down the volatility."

Despite his ideas, Saluzzi suggests, market crashes are somewhat inevitable and each needs to be handled on its own terms. "Look at 1987," he offers. "We had specialists, we had the uptick rule and the market crashed worse than now."