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Waiting for the SEC Inquiry

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Well that was certainly fun on Monday! Stocks crashed 1100 points at the open, rallied 800 points and the fell almost 300 points to close down 588 points. Given yesterday's full Street$marts edition and the two blog posts I did here, I am sure most people were expecting a market update. After all, I did offer 3 Scenarios for Monday's Trading and the market did end up following scenario number one the most. I will get to the market in a subsequent post. Of note, almost every single interview I saw and comment I read called for "staying the course" or not selling. I guess those were the same folks who told investors that all was well over the previous few months as the major indices peaked. Hmmm...

It's not a topic I often mention, but from my seat, the system was clearly broken in the first half hour and the computers ran amock. It was beyond embarrassing and ridiculous, AGAIN. Just like we saw in May 2010, this was a second Flash Crash. NYSE and NASDAQ? Goldman Sachs, Citadel, Merrill Lynch and Virtu? You can hear crickets from the cats who ate the canary.

As someone who had forecast and was positioned for the correction, I was chomping at the bit to deploy some cash. Without any widespread firsthand knowledge, I believe that High Frequency Trading or HFT was responsible, not for the whole stock market decline, but for the quick acceleration and pricing dislocations or anomalies. Remember, HFT thrives when markets are volatile and liquid. Not so much in quiet and less volatile markets.

What I did see firsthand was enough small orders of less than 100 shares early in the day to make me believe that the computers were out of control as one of the footprints of HFT is odd lot trading or orders less than 100 shares. Let's add in the outrageous pricing in the opening few minutes that went away quickly enough that I couldn't even finish getting my orders in the que to execute. A little sour grapes perhaps? Absolutely, but there was also something very wrong with our markets.
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As the day began and I was glued to my screen, I noticed that XLV, a healthcare ETF was in free fall, showing an opening loss of 6% which almost immediately became 20%. These are not high flying micro cap technology stocks that don't trade volume. These are the most liquid stocks in the healthcare field. Johnson & Johnson and Pfizer account for almost 18% of the ETF. Memories of May 2010 and the Flash Crash immediately came to mind. I quickly checked IBB, a biotech ETF, and saw similar but not as dramatic weakness. That was clue number two as biotech is almost always more volatile with much higher beta than XLV and should have been down more.

You can see what I am talking about in the chart above. XLV opened down 6% and quickly collapsed to down 26% at the bottom of the green candle right after the tall red one. Minutes later, XLV was trading at $69 or 20% higher. That's not only abnormal, but shows a system not functioning like it was supposed to. And during this brief period as you can see above, volume was enormous, another hallmark of HFT.

I started looking at random large cap individual stocks both in and outside the healthcare sector and saw some truly astounding pricing dislocations in my opinion. Again, these stocks should not have fallen 20% in a matter of a few minutes. None had company specific bad news. GE, JP Morgan, CVS, McKesson and Verizon to name a few. And if you really want to be outraged, go look at CWB, the ETF that invests in less liquid convertible bonds, down 21% in two minutes.

I have not done a lot more research since then because I don't think it's worth the effort at this point, but I know from speaking with colleagues and peers that it was widespread in the ETF space. Just look at VHT, also in the healthcare space, below.

I am not big crier of injustice and "demander" of government intervention to fix our problems, so you won't find me flooding the SEC with calls and emails or creating a grassroots campaign to do so. I won't be surprised, however, if the SEC does open a formal inquiry into Monday's opening of trading as another Flash Crash did occur. Confidence was the casualty of Monday's embarrassment.

While my clients may have lost an opportunity, there were thousands of investors who were likely stopped out of their positions when they should not have been, costing them untold amounts of money.

Investment Quotes/Adages To Live By

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"Luck is the residue of effort."
"The most bullish thing a market can do is go up in the face of bad news."
"The most bearish thing a market can do is go down in the face of good news."
"The market can stay irrational longer than you can stay solvent."
-John Maynard Keynes

"Government is best which governs least" - Thomas Jefferson

Inflation is the one form of taxation that can be imposed without legislation.
-Milton Friedman

"You cannot legislate the poor into freedom by legislating the wealthy out of freedom. What one person receives without working for, another person must work for without receiving. The government cannot give to anybody anything that the government does not first take from somebody else. When half of the people get the idea that they do not have to work because the other half is going to take care of them, and when the other half gets the idea that it does no good to work because somebody else is going to get what they work for,that my dear friend, is about the end of any nation. You cannot multiply wealth by dividing it." - Dr. Adrian Rogers, 1984
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"Bear markets seem to be divided into three phases: the first being the abandonment of hopes upon which the final uprush of the preceding bull market was predicted; the second, the reflection of decreased earnings power and reduction of dividends, and the third representing distressed liquidation of securities which must be sold to meet living expenses. Each of these phases seems to be divided by a secondary reaction which is often erroneously assumed to be the beginning of a bull market."
- Robert Rhea

"Free enterprise is a rough and competitive game. Nobody too big to fail. Nobody too small to succeed. It is a hell of a lot better than government control." - Ronald Reagan via Dan Kennedy
"A government big enough to give you everything you want is big enough to take everything you have." - Gerald Ford via Dan Kennedy

"The problem with socialism is that, sooner or later, you run out of other people's money."
- Margaret Thatcher

"Diversification alone is no longer sufficient to temper risk... You need something more to manage risk well."
- Mohamed El-Erian

To Your Financial Success,

Paul Schatz
President
Heritage Capital LLC

1 Bradley Road Suite 202
Woodbridge CT 06525

203.389.3553 Phone
203.389.3550 Fax

www.InvestForTomorrow.com

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