Crazy days on Wall Street leave some longing for a stockation. REUTERS/(CLOCKWISE) ALEX DOMANSKI, EDUARDO MUNOZ, FRANK POLICH, BRENDAN MCDERMID

THE MADNESS OF WALL STREET

Black holes, group think, panic and the age of the machines are all things investors most cope with in the new harrowing environment for stocks

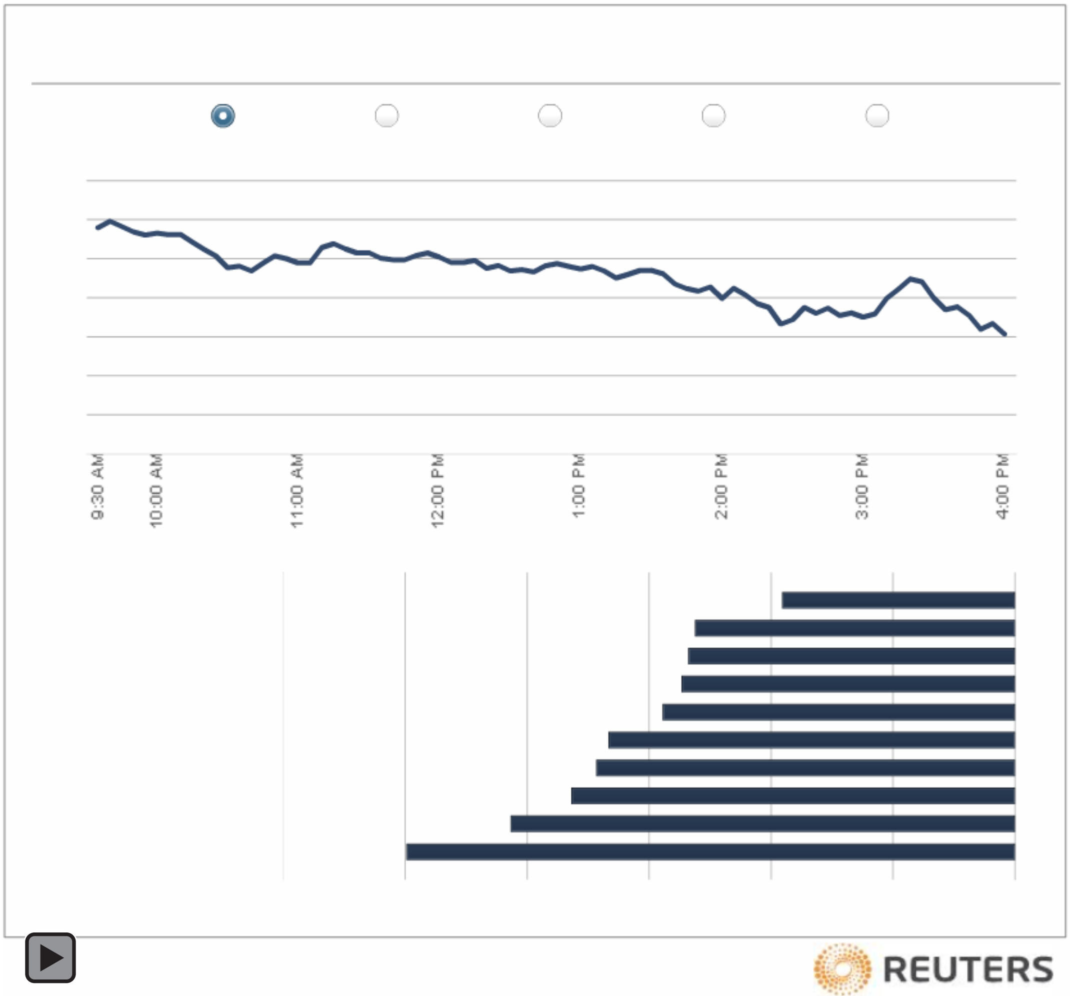
BY MATTHEW GOLDSTEIN, LAUREN TARA LACAPRA, JENNIFER ABLAN AND JOSEPH GIANNONE
NEW YORK, AUG 19

THE BEST THING TO be said of the recent stomach-churning turmoil on Wall Street is that it's taking place in August, a time of year when many people are lounging at the beach or camping in the woods and not paying attention to stocks.

But for everyone else not on a 'stockation,' watching the markets rise and fall like giant ocean swells has been an unnerving experience that some finance professionals worry could reshape investor behavior for months and years to come.

"Everyone felt this was idiotic," says Susan Kaplan, president of Kaplan Financial Services, referring to last week's volatility. "Most clients didn't want to deal with the markets anymore and went back to their summer vacations," said Kaplan, whose firm manages about $1.3 billion in customer money.

In the short term, doing nothing may well prove to be the best strategy for dealing



with the kind of dizzying gyrations that occurred the week of Aug. 8 in the U.S. stock market. At one point, the S&P500 was down 8 percent for the week before it erased all of those losses and then some in the ensuing days.

Thursday brought another August storm. The S&P500 plunged 4.46 percent and the benchmark 10-year Treasury note yield fell below 2 percent for the first time in 70 years. And the trouble is this turmoil may not be some temporary anomaly.

FREE FALLIN

EXPERTS SAY INVESTORS should expect even more volatility in stocks, as herd trading by hedge funds, knee-jerk trader reaction to news and lightning fast computer programs combine to make for a new and uncomfortable normal on Wall Street.

This new trading frontier even has its own signature milepost, something called "a liquidity black hole." It's a trading phenomenon in which there's so much intense selling pressure in big-cap stocks that it sucks all the oxygen out of the market and stocks plunge precipitously - as on Aug. 8 when every single stock in the S&P500 ended the day in the red.

"We have to be aware that we can be hit by one of these liquidity black holes with ever increasing frequency," says G. Andrew Karolyi, a finance professor at Cornell University Johnson Graduate School of Management. "If you are a long-term buy and hold investor you better be aware of these and not panic when you see it."

Yet some fear that's just what ordinary investors will do as this new hair-trigger trading dynamic becomes more common. There's a concern that frenzied trading could drive people further away from stocks at a time when, other than gold, there are few assets generating any kind of substantial return.

And that's something that could have long-term ramifications for the ability of investors to build retirement nest-eggs, especially given the historic poor ability of retail investors to time market swoons and surges. A portfolio with 20 percent in cash, 50 percent in a bond fund yielding 3.42 percent a year and 30 percent in stocks isn't going to enable a person in their 50s to retire any time soon.

Also if investors flee stocks it could make it harder for small, niche companies, such as ones in the biotech or clean energy sectors, to tap the public markets for capital. Or more of those companies might take their capital-raising business overseas to places like Hong Kong, which would be another blow to Wall Street.

"The market we are operating in is markedly different from five years ago," says Andrew Lo, a professor of finance at the MIT Sloan School of Management, who frequently writes on hedge fund trading strategies and markets. "We are seeing extraordinary emotional reactions from central banks,

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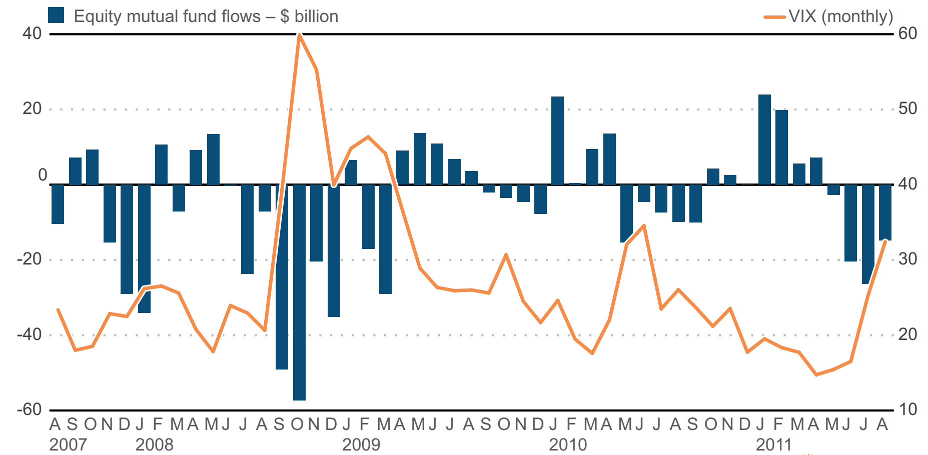
Running scared

After the implosion of the tech-stock debacle, mom-and-pop investors have shown a distaste for risk-taking. As volatility rises in U.S. stock markets, they have pulled net cash out of equity mutual funds.

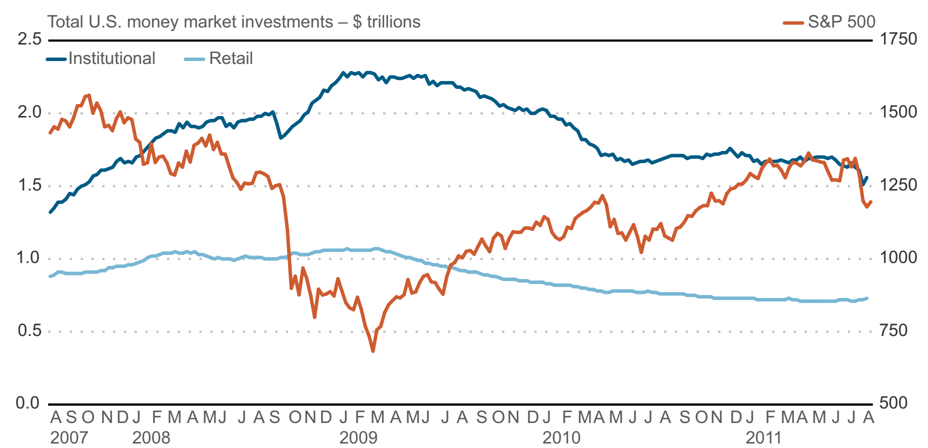


Source: Lipper, Thomson Reuters

Reuters graphic/Stephen Culp 16/08/11

Cash flow

As stocks plunged during the financial crisis, corporations moved dollars into money market accounts faster than retail investors, an indication that corporate treasurers may be more fearful of stock sell-offs.



Source: Money Fund Analyzer™, a service of iMoneyNet, Westborough, Mass. (www.imoneynet.com)

Reuters graphic/Stephen Culp 16/08/11

politicians, regulators and investors. That kind of reaction is not conducive for building long-term wealth. We have an environment that is highly unstable."

One might say Wall Street is a bipolar market that veers from despair to euphoria with each passing news headline.

19TH NERVOUS BREAKDOWN

OVER THE PAST several weeks, stocks prices have swung widely based on a range of factors: the perceived progress of European leaders in dealing with the eurozone debt crisis; the fears of a double-dip recession in the United States; the fallout from Standard & Poor's downgrade of U.S. debt; and whether the Federal Reserve will embrace a new round of easy money to jumpstart the economy.

L. Randall Wray, a professor of economics at the University of Missouri-Kansas City, says much daily trading in stocks is like a self-fulfilling prophecy. "What matters is what the markets think not what people in the markets believe," says Wray. "Traders are constantly trying to guess how daily events might affect other market participants."

This guessing game is largely being driven by super-fast computers with algorithmic programs designed to react to headlines and overall market trading patterns. The Tabb Group, a financial markets' research firm, estimates that during the frenetic week of Aug. 8, high-frequency trading firms and strategies accounted for 65 percent of the daily trading volume in the United States.

The power of the machines over trading is one reason why technical analysis, often pooh-poohed as Wall Street alchemy, is gaining more believers among traders. There's more interest than ever in computer programmers who can write algos to simply buy and sell stocks whenever the S&P hits a predetermined target, or some bizarrely-named trading pattern such as a "Death Cross" forms on screens.

Some of the surge in volatility is also attributed to a growing legion of money managers who frequently trade exchange-traded funds - which are baskets of stocks, indexes and other assets - as a way to hedge their positions.

"There's a different dynamic now because of the pervasiveness of high-frequency traders and hedge funds," says John Longo, chief investment strategist at MDE Group, which manages $1.3 billion in assets. Longo, also a finance professor at Rutgers Business School in New Jersey, adds: "The down-5-percent one day, up-5-percent the next day volatility wouldn't have happened in the past."

STORMY WEATHER

THE TROUBLE FOR ORDINARY investors is that there are no good market forecasts for predicting what might spark a liquidity black hole. Fear about the United States and European countries slipping back into

"PEOPLE DISTRUST WALL STREET AT ONE OF THE HIGHEST RATES I CAN REMEMBER."

DEVO NATION: Traders still work the floor of the New York Stock Exchange but today more than 60 percent of all daily trading in U.S. stocks is carried out by high-frequency trading firms and strategies.. **REUTERS/BRENDAN MCDERMID**

recession is a legitimate concern that could have real impact on corporate profits and stocks. But when traders act on those fears at lightning speed it can result in seemingly irrational sell-offs.

Take the scary 6.66 percent drop in the S&P500 on Aug. 8. On that first trading day after the credit rating arm of S&P stripped the U.S. of its vaunted Triple AAA debt rating, all 500 stocks in the index closed the day in the red.

The selling was so ferocious that shares of McDonald's Corp, for instance, fell 3.5 percent to $82.11, even though the fast-food giant reported a 5.1 percent climb in same-store sales for July, higher than analysts had expected.

Such selling with no regard to corporate fundamentals makes the notion of stock picking seem quaint.

Keith Wirtz, chief investment officer at Fifth Third Asset Management, with $18 billion in assets, says the indiscriminate selling means "good stocks are going down at the same pace as bad stocks."

Karolyi says the waves of wholesale selling driven by liquidity black holes are not just the byproduct of the over-computerization of trading, it's the end result of too much "group think" by institutional traders.

He says Wall Street first saw this in August 2007, when dozens of quant hedge funds suffered big losses at the start of the financial crisis because the algos they employed were all buying and selling the same securities. This flawed thinking by some of Wall Street's brightest math geeks was an early warning sign of even worse group think to come with regards to the value of securities backed by subprime mortgages.

REUTERS INSIDER

James Angel argues high-frequency trading is not to blame: **http://link.reuters.com/wyd33s**

Karolyi says his research, which will be officially published later this year in The Journal of Financial Economics, has found the phenomenon of liquidity black holes is spreading beyond the U.S. to other stock markets. That is problematic because the effects of liquidity black holes can be profound.

Critics of high-frequency trading firms argue that the May 6, 2010 "flash crash," in which the Dow Jones Industrials plunged 1,000 points in less than 20 minutes, was caused in part by an absence of liquidity or traders making markets in stocks. While securities regulators have never identified a single cause for the flash crash, they have noted that the rapid collapse of stock prices was exacerbated by some high-frequency trading firms turning off their computers and not making trades.

Some are starting to worry about the impact on ordinary investors of the rise of the machines and all these unforeseen consequences. These Wall Street professionals wonder whether events like the flash crash and the frenzied trading of this month will push average investors further away from stocks and into low-yielding money market funds and bond funds.

"The last 10 years have been a nightmare in this business," says Dave D'Amico, president and chief market strategist at Braver Capital Management, which has $575 million in customer money. "People distrust Wall Street at one of the highest rates I can remember."

MR. MARKET: Walter W. Bettinger, CEO and President of The Charles Schwab Corporation, speaks at the Charles Schwab IMPACT 2010 conference in Boston, Massachusetts October 28, 2010. **REUTERS/ ADAM HUNGER**

VIDEO

Breakingviews on the age of volatility: **http://link.reuters.com/peq33s**

Evidence of that distrust is already apparent. Over the past two weeks, retail investors pulled $17.4 billion out of U.S. equity mutual funds, according to Lipper, a mutual fund information service. Investors have been backing away from stocks for some time, with many retail investors missing out on a sizable chunk of the 5,000 point surge in the Dow Jones Industrials since the markets bottomed in March 2009.

According to Strategic Insight, a mutual fund consulting firm, stock mutual funds in 2009 took in about $85 billion as the markets were beginning to rise. In comparison, a record $425 billion was invested in low-yielding bond mutual funds.

This trend of retail investors preferring bonds over stocks continues to this day, even as the yield on the 10-year U.S. Treasury hit

CRY ME A RIVER: A woman walks through the rain on Wall Street in New York, August 16, 2011. **REUTERS/BRENDAN MCDERMID**

1.98 percent on Thursday. In 2010, investors added $222 billion more to bond funds than they withdrew. Yet despite an average 17 percent return last year for the average U.S. stock fund, retail investors took more money out of those funds than they put in, according to Strategic Insight.

"Americans are scarred by the devastating market crash of 2008," said Tom Roseen, senior research analyst at Lipper. "The gut wrenching losses of this period are still fresh in everyone's mind."

CRUEL TO BE KIND

THE TUMULTUOUS TRADING of August will only reinforce those painful memories.

Retail investors have notoriously bad timing. For the 17th time in as many years, Boston-based research firm DALBAR found that the 20-year returns realized by mutual fund investors lagged the markets thanks to ill-timed buys and sells driven by psychology. "At no point in time have average investors remained invested for a sufficiently long enough period to derive the benefits of a long-term investment strategy," DALBAR wrote in its 2011 investor behavior analysis.

Nonetheless retail investors, via their stock mutual funds, own a sizable chunk of America's publicly-traded companies. Strategic Insight reports that U.S. mutual funds and exchange-trade funds hold $4 trillion in U.S. stocks, or 27.7 percent of the total U.S. market capitalization.

Wall Street investment firms, of course, have a big stake in dissuading investors from turning their back on stocks or mutual funds. That's especially true for a big retail brokerage firm like Charles Schwab, which has marketed itself as a place for individuals to control their financial destinies.

Walter Bettinger, Schwab's chief executive officer, concedes that the current market turmoil will prove difficult for the online brokerage's less experienced customers.

"If someone's idea of investing is sitting in front of their computer without a strategy, of seeking gains through trading against machines making millions of trades a second, that's a tough row to hoe," says Bettinger.

He says the largest online investment firm is trying to move more of its customers to a mix of do-it-yourself investing and guidance from a financial consultant. He expects that to be an easier sell if extreme volatility continues.

The danger for Schwab and all of Wall Street is retail investors become ever more cautious and simply sit in cash, Treasuries and low-yielding bond funds.

And the danger for retail investors is they end up forsaking stocks and start seeking higher-yields in speculative investments that promise returns too good to believe.

(Reported by Matthew Goldstein, Lauren Tara LaCapra, Joseph Giannone and Rodrigo Campos; editing by Claudia Parsons)

DEATH CROSS ROCKS WALL STREET

BY RODRIGO CAMPOS
NEW YORK, AUG 19

BEFORE THE STORMY TRADING of August, many stock investors probably thought "death cross" was the name of some heavy metal band.

But after a period in which the S&P 500 plunged more than 15 percent, daily trading volumes spiked by 70 percent and the United States lost its vaunted 'triple-A' rating, a death cross and other technical analysis terms are something investors have had to become increasingly familiar with.

For chartists and market technicians, the death cross is a strong bearish signal that indicates a major shift in trading momentum.

In the case of the S&P 500, a death cross occurs when the 50-day average for the index sinks below, or crosses over, its 200-day average.

There was a time on Wall Street when many regarded technical analysis as

RED SEA: A trader is silhouetted against his computer screen as he works on the floor of the New York Stock Exchange in New York August 12, 2011. **REUTERS/JESSICA RINALDI**

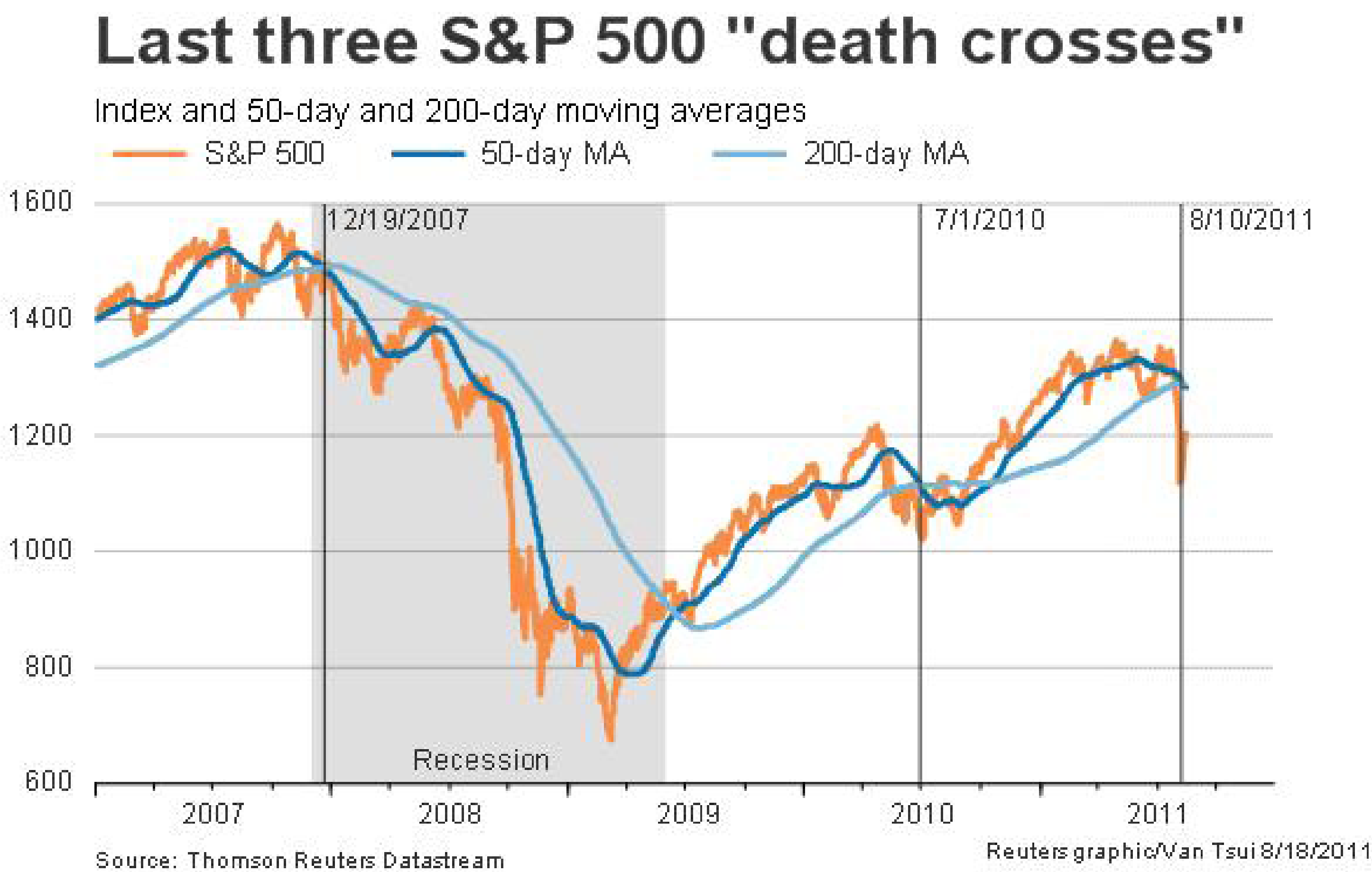
something akin to voodoo economics, especially among stock pickers who specialized in fundamental research. But with algorithimic trading all the rage, it appears that cold and dispassionate technical market analysis is coming of age.

The recent market plunge which took the S&P 500 to about 1,100 is a prime of example of why more traders are looking to technical analysis for guidance. That's because many computer-driven trading programs are pegged to buy and sell stocks when certain market levels are breached.

"Computers fire off automatically; you don't have the time lag you'd have in normal decision making," says Marc Pado, U.S. technical market strategist at Cantor Fitzgerald & Co. "Clearly this is not stock picking (but) indiscriminate buying and selling."

Pado says the selling all started when the S&P 500 broke through the 200-day moving average and a support level of 1,250 on the index. He says, "that started the capitulation to the downside that we saw in the market overall."

The beauty (or flaw) of technical analysis is that it tells traders when to buy or sell without regard to corporate earnings or



> *"THEY DON'T CARE ABOUT INTRINSIC VALUE, THEY CARE ABOUT SOME PATTERN. SO YOU HAVE DAYS LIKE LAST WEEK WHERE YOU GET WHIPSAWED 5 AND 6 PERCENT FROM DAY TO DAY."*

arguments over how to solve Europe's sovereign debt woes. So the silver lining of a precipitous drop in stocks is that it could be a signal for markets to go up.

"By selling off, the market is now discounting the bad news," said Carter Worth, chief market technician at Oppenheimer & Co in New York.

Another factor technical analysis focuses on is volatility and there has been a lot of that lately. In fact, one measure of volatility doubled in three days and on Aug. 8, when the S&P 500 fell 6.66 percent, the volatility index closed at its highest level since the market bottomed in March 2009.

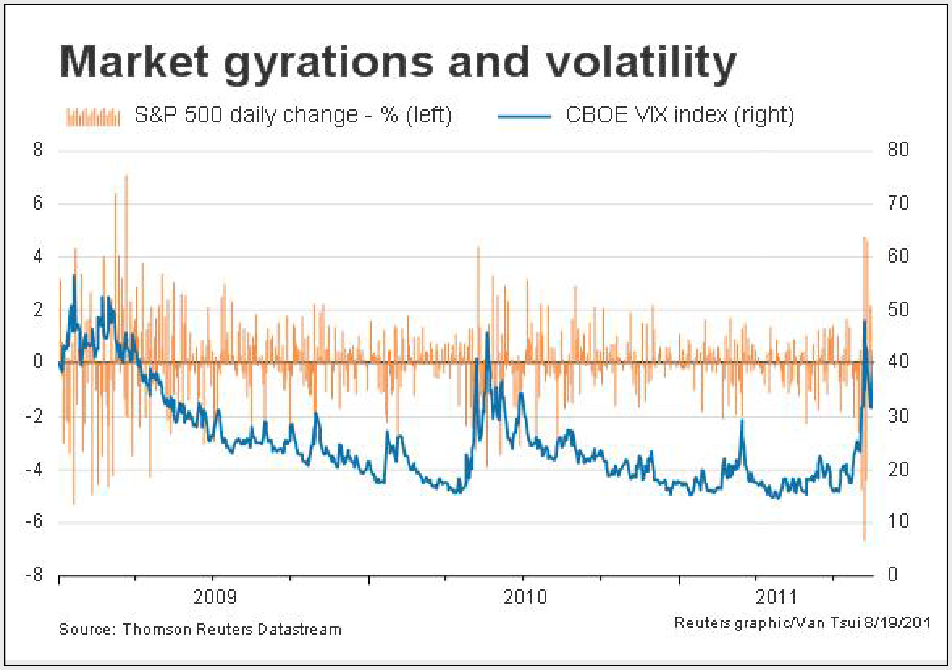
"It highlights how extreme, how one-sided it was," said Craig Peskin, co-head of technical analysis research at MF Global in New York, who noted that every stock in the S&P 500 declined on Aug. 8. "Everyone was treating everything equally."

Some likened what they were seeing in the market to last year's flash crash, when the Dow Jones Industrials plunged nearly 1,000 points in 20 minute. Except this time, it appears to be a flash crash in slow motion.

"We were moving over a three and a half day period like we were during the flash crash, just more orderly," Peskin said.

"It was totally irrational."

In fact, the week of Aug. 8 was so extreme it even left some technical analysts scratching their heads at the unusual up and down trading. On Aug. 9, stocks roared back, with the S&P 500 gaining 4.74 percent and almost wiping out the prior day's losses. Meanwhile, the Dow industrials would experience six days



trading in swings of more than 400 points.

"I don't have an exact answer on how to label that pattern from a technical perspective because the volatility was so extreme," said MF Global's Peskin.

Many market participants say this volatility is not going to go away. It is a new normal that makes technical analysis a key rule of the game - even if some dismiss it as market astrology and don't want to play.

There are also new opportunities, if traders have the stomach and the correct analysis tools -- and know how to use them.

"High-frequency traders are moving the markets based on price action, based on momentum - they don't really care what they're trading," said Bill Stone, chief strategist for PNC Wealth Management.

"They don't care about intrinsic value, they care about some pattern. So you have days like last week where you get whipsawed 5 and 6 percent from day to day," he said. "Those days can be scary, but they are also your opportunity because they are driving (lower) companies that have no reason to be falling so far."

(Reporting by Rodrigo Campos; additional reporting by Lauren Tara LaCapra; Editing by Jennifer Ablan, Matthew Goldstein and Claudia Parsons)

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