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On The Flash Crash

More than four months after the May "Flash Crash", when the Dow Jones Industrial Average fell about 1,000 points and then almost immediately recovered, the actual causes have yet to be determined.

About $1 trillion in market value disappeared in the freefall. Exchange Traded Funds, or ETFs, were affected more than any other type of security, accounting for 70% of the securities dropping 60% or more in price.

Among equities, eight companies in the Standard & Poor's 500 Index saw their prices collapse to a penny a share while others saw theirs zoom up to $100,000 or more. But anyone who bought Accenture or sold Apple during the crash later had those trades busted.

There are a number of theories as to what really happened. Possible direct human causes, such as the "fat finger theory" in which a trader accidentally enters 1,000,000 instead of 1,000 shares, were discredited as soon as market data were analyzed.

Currently, regulators are examining a number of trading strategies used by large, institutional firms. One widely used practice, "quote stuffing", involves large numbers of rapid-fire buy and sell orders which are placed and cancelled almost simultaneously. Another is "sub-penny pricing" in which stocks are bought and sold in increments as small as one-tenth of a cent. These transactions typically take place outside regular market exchanges, in "dark pools", and can distort actual demand for a stock and thus its price.

In many ways, the Flash Crash is an example of how the stock markets have changed over the years. Some think the average investor doesn't stand a chance against the algorithms underlying these high-frequency, computer-driven trading strategies.

Of course, much of the institutional trading that goes on these days is really just sophisticated speculation. Advances in information technology have led to the development of complex and opaque strategies used to outsmart other complex and opaque strategies, all taking place within milliseconds. And there is always the competitive pressure to develop new angles, edges and innovations.

But patient investors in high-quality companies have been and will continue to be rewarded. By focusing on companies with strong fundamental characteristics and growing demand for their products and services, investors become part owners of <u>actual</u> revenue streams and <u>real</u> progress in earnings and dividends. As long as the management teams are fulfilling their responsibilities to stakeholders, share prices will rise over time to reflect this superior performance.

As a result of the Flash Crash, new trading rules and regulations are likely. It may turn out that technology simply overwhelmed itself. Interestingly, the tenets of long-term, common-sense investing based on strong fundamental characteristics have not changed since they were first developed more than seventy years ago.

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