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Thought of the Day'
"A Rigged Market?"
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Having worked on Wall Street for 47 years, what constantly amazes is how little I know about the market and how it works. Nevertheless, I feel reasonably comfortable in answering the question as to whether the market is rigged in the negative, despite allegations to the contrary by Michael Lewis in his fascinating book Flash Boys. With about 200 broker-dealers, thirteen exchanges and approximately 45 "dark pools" (off exchange trading venues), I suspect that innate competition helps subdue the natural greedy instincts of those who flock to Wall Street. Like most endeavors, the more intense the competition the more equitable the pricing. Competition, not regulation or price fixing, is the means by which capitalism best discovers fair prices. Smart people have certainly taken advantage of complexity, but that is a consequence of technology.

Perhaps it is a question of definition, but a rigged market to me suggests a cabal of likeminded people colluding to enrich themselves at the expense of the public. Instinctively, I am not a fan of High Frequency Traders, and Mr. Lewis has well articulated how they have taken advantage of the system, with little or no social or economic purpose other than personal gain. But I suspect Brad Katsuyama, as quoted in Flash Boys, is right when he says: "I think most of them have just rationalized that the market is creating the inefficiencies and they (HFTs) are just capitalizing on them." It has been a combination of technological advances and the unintended consequences of government deregulation and regulation that allowed HFTs to work their magic.

While Cliff Asness and Michael Mendelson are quoted, in an op-ed in the April 1st edition of the Wall Street Journal, as saying that high-frequency trading has been around for 20 years, such trading clearly got a boost when the SEC passed a rule in 2005 (U.S. Regulation NMS), which made it easier to trade stocks on multiple exchanges, but also mandated better transparency and consistent access to market bids and offers, regardless of where the individual stock is traded. Its intent was to open large exchanges such as the NYSE and NASDAQ to greater competition, including "dark pools." The consequence was an increase in high frequency trading, but with less clarity, as "dark pools" definitionally have no transparency. At the same time, the proliferation of HFTs meant that bids and offers displayed were often ephemeral, disappearing once a legitimate bid or offer was made. The front-running of orders, according to Mr. Lewis, was their motive, not providing liquidity, despite being paid to do so by some exchanges.

Evolution, as Darwin noted, does not require the strongest or most intelligent of a species to survive, but the one most adaptable. With technology ubiquitous and increasingly powerful, markets and the way they trade has changed significantly. In the dark ages, when I entered the business, the New York Stock Exchange was a privately owned (by seat holders), quasi-public, socially responsible, open-outcry institution, with brokers (seat holders) controlling orders and specialists (also seat holders) charged with maintaining orderly markets. Retail investors, as well as professional money managers had confidence in the system. It worked. The NYSE was the most efficient market in the world during the first two decades after World War II. Firms like Merrill Lynch (where I started in the business) helped spread stock ownership to millions of Americans.

As institutional investors grew in size, block trading emerged, with private brokerage firms using their own capital to make bids and offers on blocks of stock – blocks that were too big for individual specialists to absorb. Competition kept pricing competitive. However, the natural governor inherent in partnerships gave way to looser standards, as brokerage firms went public. Risks were downloaded onto public shareholders, permitting traders to price more aggressively. By 1997 ECNs (electronic communication networks) were becoming competitive as providers of liquidity. Decimalization arrived in 2000. In 2006 the New York Stock Exchange, which had been owned by seat holders since its founding in 1792, became a publically owned business. In April 2007, the NYSE merged with Euronext N.V. to form the first global equities exchange, and in December 2012 the company merged with IntercontinentalExchange (ICE).

What had been an icon of American capitalism, a quasi-public, socially responsible institution was now owned by a group established in 2000 to trade energy contracts. Volume on the NYSE has risen from under 10 million shares a day when I entered the business to around 750 million shares a day today. Forty-seven years ago the Exchange accounted for 100% of trading in NYSE listed shares; today they account for about 20%.

A multiplicity of exchanges, including "dark pools," along with no specialists to maintain orderly order flow and no block traders to provide liquidity, created a vacuum into which HFTs swarmed. The $64,000 dollar question, which no one can honestly answer, is: Have HFTs increased or decreased liquidity? Mr. Asness answers in the affirmative, though he cautions his answer, "…but it's hard to prove either way." What is unassailable is that liquidity is not, and cannot, be free. The middle man is often characterized as parasitic, but his presence is necessary for markets to function. If a market maker buys at the offer and sells at the bid all day long, he or she will lose money. High Frequency Traders, who are the bad guys in Mr. Lewis' book, are looking to make a penny, or even a fraction thereof, on all shares traded. They do so by combining speed with market intelligence derived from studying order flows. It doesn't sound like much, but one penny on a day in which 3.5 billion shares trade (about the average for the year) is $35 million.

But it is not the alleged "rigging" of the market that concerns me; it is the suspicion that no one is in charge in case of a calamitous event. Markets, like our credit system, rely on confidence. There will always be panics and market crashes. They are inevitable and cannot be avoided. But when they occur, they must be addressed quickly and confidence must be restored as soon as possible. Can we count on government bureaucrats to do so? In the panic of 1907, it was J.P. Morgan who intervened. In the aftermath of the October 1929 crash, it was William Durant (co-founder of General Motors) and members of the Rockefeller family who tried to stem the tide. (The market, in that instance, continued to slide through the end of November before recovering. The later collapse into the middle of June 1933 was more a function of bad fiscal, economic and monetary decisions by government, combined with a failure to restore confidence.) In 1987, the heads of equity trading at Salomon Brothers and Goldman Sachs made a point of buying stocks on Tuesday morning, October 20th when it appeared that the collapse of the day before would persist. In the fall of 2008, the $5 billion investment made by Warren Buffett into Goldman Sachs helped restore confidence.

It is my fear that markets, increasingly under the control of machines and robot-like investment managers, have become more susceptible to panic selling. I doubt that HFTs would step into the gap, as did Morgan, Durant, Shopkorn, Mnuchin, and Buffett in years prior. In the two decades following World War II, 90% of all stocks were owned individually by households. By 1960, half of all households had some stock ownership. They had become capitalists and took pride in their investments. To own a “piece of America” was not only a slogan; it reflected an aspiration. By definition, investing in stocks for the long term requires confidence in the future – a critical ingredient to building economic growth. Today, individual households own less than 25% of all shares, and investors are disparaged as one-percenters. It is true that more than half of households own shares through mutual funds and various retirement plans, but those represent multiple degrees of separation. The number of publically traded stocks has shrunk by 30% since 2000, in part because of costs of complying with government regulations. In the meantime, the Obama Administration, with its focus on inequality, has had a tendency to downplay the importance of equity investments and savings, preferring the political expediency of dividing the people into capitalists and non-capitalists.

One could argue that the market may be rigged, but the more important message is that such voices detract from the far more critical fact that the impersonal nature of investing today, the utilization of markets as casinos by algorithmically programmed computers, the speed with which orders reach exchanges and with holding periods measured in milliseconds, and the demonization of capitalism by politicians are destroying confidence, damaging economic growth and denigrating the concept of savings.