

“Season of the Glitch”

When I look over my shoulder
What do you think I see?
Some other cat lookin’ over
His shoulder at me.

— **Donovan, “Season of the Witch” (1966)**

Josh Leonard: I see why you like this video camera so much.

Heather Donahue: You do?

Josh Leonard: It’s not quite reality. It’s like a totally filtered reality. It’s like you can pretend everything’s not quite the way it is.

– **“The Blair Witch Project” (1999)**



Over the past two months, more than 90 Wall Street Journal articles have used the word “glitch”. A few choice selections below:

Bank of New York Mellon Corp.’s chief executive warned clients that his firm wouldn’t be able to solve all pricing problems caused by a computer glitch before markets open Monday.

— **“BNY Mellon Races to Fix Pricing Glitches Before Markets Open Monday”, August 30, 2015**

A computer glitch is preventing hundreds of mutual and exchange-traded funds from providing investors with the values of their holdings, complicating trading in some of the most widely held investments.

— **“A New Computer Glitch is Rocking the Mutual Fund Industry”, August 26, 2015**

Bank says data loss was due to software glitch.

— **“Deutsche Bank Didn’t Archive Chats Used by Some Employees Tied to Libor Probe”, July 30, 2015**

NYSE explanation confirms software glitch as cause, following initial fears of a cyberattack.

— **“NYSE Says Wednesday Outage Caused by Software Update”, July 10, 2015**

Some TD Ameritrade Holding Corp. customers experienced delays in placing orders Friday morning due to a software glitch, the brokerage said.

— **“TD Ameritrade Experienced Order Routing, Messaging Problems”, July 10, 2015**

Thousands of investors with stop-loss orders on their ETFs saw those positions crushed in the first 30 minutes of trading last Monday, August 24th. Seeing a price blow right through your stop is perhaps the worst experience in all of investing because it seems like such a betrayal. “Hey, isn’t this what a smart investor is supposed to do? What do you mean there was no liquidity at my stop? What do you mean I got filled \$5 below my stop? Wait ... now the price is back above my stop! Is this for real?” Welcome to the Big Leagues of Investing Pain.

What happened last Monday morning, when Apple was down 11% and the VIX couldn’t be priced and the CNBC anchors looked like they were going to vomit, was not a glitch. Yes, a flawed SunGard pricing platform was part of the proximate cause, but the structural problem here – and the reason this sort of dislocation WILL happen again, soon and more severely – is that a vast crowd of market participants – let’s call them Investors – are making a classic mistake. It’s what a statistics professor would call a “category error”, and it’s a heartbreaker.

Moreover, there’s a slightly less vast crowd of market participants – let’s call them Market Makers and The Sell Side – who are only too happy to perpetuate and encourage this category error. Not for nothing, but Virtu and Volant and other HFT “liquidity providers” had their most profitable day last Monday since ... well, since the Flash Crash of 2010. So if you’re a Market Maker or you’re on The Sell Side or you’re one of their media apologists, you call last week’s price dislocations a “glitch” and misdirect everyone’s attention to total red herrings like supposed forced liquidations of risk parity strategies. Wash, rinse, repeat.

The category error made by most Investors today, from your retired father-in-law to the largest sovereign wealth fund, is to confuse an allocation for an investment. If you treat an allocation like an investment ... if you think about buying and selling an ETF in the same way that you think about buying and selling stock in a real-life company with real-life cash flows ... you’re making the same mistake that currency traders made earlier this year with the Swiss Franc (read [“Ghost in the Machine”](#) for more). You’re making a category error, and one day – maybe last Monday or maybe next Monday – that mistake will come back to haunt you.

The simple fact is that there’s precious little investing in markets today – understood as buying a fractional ownership position in the real-life cash flows of a real-life company – a casualty of policy-driven markets where real-life fundamentals mean next to nothing for market returns. Instead, it’s all portfolio positioning, all allocation, all the time. But most Investors still maintain the pleasant illusion

that what they're doing is some form of stock-picking, some form of their traditional understanding of what it *means* to be an Investor. It's the story they tell themselves and each other to get through the day, and the people who hold the media cameras and microphones are only too happy to perpetuate this particular form of filtered reality.

Now there's absolutely nothing wrong with allocating rather than investing. In fact, as my partners Lee Partridge and Rusty Guinn never tire of saying, smart allocation is going to be responsible for the vast majority of public market portfolio returns over time for almost all investors. But that's not the mythology that exists around markets. **You don't read Barron's profiles about Great Allocators.** No, you read about Great Investors, heroically making their stock-picking way in a sea of troubles. [It's 99% stochastics and probability distributions](#) – really, it is – but since when did that make a myth less influential? So we gladly pay outrageous fees to the Great Investors who walk among us, even if most of us will never enjoy the outsized returns that won their reputations. So we search and search for the next Great Investor, even if the number of Great Investors in the world is exactly what enough random rolls of the dice would produce with Ordinary Investors. So we all aspire to be Great Investors, even if almost all of what we do – like buying an ETF – is allocating rather than investing.

The key letter in an ETF is the F. It's a Fund, with exactly the same meaning of the word as applied to a mutual fund. It's an allocation to a basket of securities with some sort of common attribute or factor that you want *represented* in your overall portfolio, not a fractional piece of an asset that you want to directly *own*. Yes, unlike a mutual fund you CAN buy and sell an ETF just like a single name stock, but that doesn't mean you SHOULD. **Like so many things in our modern world, the exchange traded nature of the ETF is a benefit for the few (Market Makers and The Sell Side) that has been sold falsely as a benefit for the many (Investors).** It's not a benefit for Investors. On the contrary, it's a detriment. Investors who would never in a million years consider trading in and out of a mutual fund do it all the time with an exchange traded fund, and as a result their thoughtful ETF allocation becomes just another chip in the stock market casino. This isn't a feature. It's a bug.

What we saw last Monday morning was a specific manifestation of the behavioral fallacy of a category error, one that cost a lot of Investors a lot of money. **Investors routinely put stop-loss orders on their ETFs.** Why? Because ... you know, this is what Great Investors do. They let their winners run and they limit their losses. Everyone knows this. [It's part of our accepted mythology, the Common Knowledge of investing.](#) But here's the truth. **If you're an Investor with a capital I (as opposed to a**

Trader with a capital T), there's no good reason to put a stop-loss on an ETF or any other allocation instrument. I know. Crazy. And I'm sure I'll get 100 irate unsubscribe notices from true-believing Investors for this heresy. So be it.

Think of it this way ... what is the *meaning* of an allocation? Answer: it's a return stream with a certain set of qualities that for whatever reason – maybe diversification, maybe sheer greed, maybe something else – you believe that your portfolio should possess. Now ask yourself this: what does *price* have to do with this meaning of an allocation? Answer: very little, at least in and of itself. Are those return stream qualities that you prize in your portfolio significantly altered just because the per-share price of a *representation* of this return stream is now just below some arbitrary price line that you set? Of course not. More generally, those return stream qualities can only be understood ... *should* only be understood ... in the context of what *else* is in your portfolio. I'm not saying that the price of this desired return stream means nothing. I'm saying that it means nothing in and of itself. An allocation has *contingent meaning*, not absolute meaning, and it should be evaluated on its relative merits, including price. There's nothing contingent about a stop-loss order. It's entirely specific to that security ... I want it at this price and I don't want it at that price, and that's not the right way to think about an allocation.

One of my very first Epsilon Theory notes, "[The Tao of Portfolio Management](#)," was on this distinction between investing (what I called stock-picking in that note) and allocation (what I called top-down portfolio construction), and the ecological fallacy that drives category errors and a whole host of other market mistakes. It wasn't a particularly popular note then, and this note probably won't be, either. But I think it's one of the most important things I've got to say.

Why do I think it's important? Because this category error goes way beyond whether or not you put stop-loss orders on ETFs. **It enshrines myopic price considerations as the end-all and be-all for portfolio allocation decisions, and it accelerates the casino-fication of modern capital markets, both of which I think are absolute tragedies.** For Investors, anyway. It's a wash for Traders ... just gives them a bigger playground. And it's the gift that keeps on giving for Market Makers and The Sell Side.

Why do I think it's important? Because there are so many Investors making this category error and they are going to continue to be, at best, scared out of their minds and, at worst, totally run over by the Traders who are dominating these casino games. This isn't the time or the place to dive into

gamma trading or volatility skew hedges or liquidity replenishment points. But let me say this. **If you don't already understand what, say, a gamma hedge is, then you have ZERO chance of successfully trading your portfolio in reaction to the daily "news"**. You're going to be whipsawed mercilessly [by these Hollow Markets](#), especially now that the Fed and the PBOC are playing [a giant game of Chicken](#) and are [no longer working in unison to pump up global asset prices](#).

One of the best pieces of advice I ever got as an Investor was to take what the market gives you. Right now the market isn't giving us much, at least not the sort of stock-picking opportunities that most Investors want. Or think they want. That's okay. This, too, shall pass. [Eventually. Maybe](#). But what's not okay is to confuse what the market IS giving us, which is the opportunity to make long-term portfolio allocation decisions, for the sort of active trading opportunity that fits our market mythology. It's easy to confuse the two, particularly when there are powerful interests that profit from the confusion and the mythology. Market Makers and The Sell Side want to speed us up, both in the pace of our decision making and in the securities we use to implement those decisions, and if anything goes awry ... well, it must have been a glitch. In truth, it's time to slow down, both in our process and in the nature of the securities we buy and sell. And you might want to turn off the TV while you're at it.

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