MV Capital Management Thought Content Series: Markets in Transition

The 3:30 Club

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It's 3:30 p.m. Do you know where your assets are?

Every evening news commentator will dutifully report the daily close on Wall Street, usually giving the point and percentage gain or drop at the closing bell for the Dow 30 Industrials, the S&P 500 and the NASDAQ Composite.   These days those numbers are volatile enough – four out of the past five trading days have been 100+ point days up or down on the Dow, representing greater than a 1% change from the previous close. Time was, and not so long ago, when you might get four 1%+ days over the course of a whole year – now it's just another trading day.

For those of us who spend our days following the tape, though, the daily close is just a part of the whole story. We know that the trading day is really composed of two parts: what happens from the market open at 9:30 a.m. to 3:30 p.m.; and that special brand of crazy taking place in the final 30 minutes to the closing bell at 4:00 p.m. A great deal of the market's volatility is generated in those unpredictable end-of-day gyrations. As we write these words it is 2:15 p.m. and the Dow is down about 255 points. In another ninety minutes, based on our recent experience, we could easily be *up* by that amount. Or down by 400. Who knows? For that we have to thank the 3:30 Club. [Update: it is now 4:10 p.m. and the answer is: down 324 points].

The 3:30 Club is a motley assortment of hedge funds and other large-scale institutional investors who send torrential waves of electronic buy and sell orders into the system. The pace is frenetic – no time for restroom breaks. Of course, the 3:30 Club has no need for restroom breaks as its members are not actual human beings. They are highly complex mathematical algorithms residing in the dark recesses of massively robust computational platforms with nanosecond-speed processing capabilities. Yes – the "rise of the machines" is not some futuristic dystopia somehow featuring Arnold Schwarzenegger. It is here in real time, and we see its very tangible handiwork on a near-daily basis during that 30 minute window before the end of the trading day.

Of course, the 3:30 Club doesn't perform *all* its feats in that one time slot. The 2:30 p.m. "flash crash" a few weeks ago will attest to that. But more often than not its most notorious activities do coincide with the end of the trading day.

The 3:30 Club has been in fine form since the EU debt crisis moved to the top of the X-factor hit parade in early May. Not that there is any real correlation between the news drips about debt instability in Greece or Spain, or Germany's intention to ban short sales, or the future of the unified currency, and the daily price movements begotten by the 3:30 Club. After all, Greece's problems were already in the news last autumn, and the country's woes exacted their first real hit on international markets back in February of this year. Europe's woes provide a kind of background noise, like the constant humming of a refrigerator, always reminding us how tenuous our year-long economic recovery may be. That background noise raises the overall level of market volatility and makes it more likely that on any given day one thing or another thing is going to ignite fevered transaction orders one way or another.

Nobody has any reasonable idea what those things are (and if someone tries to tell you otherwise we would suggest not listening to any investment advice he or she may have to dispel). We don't know what happens at 3:30 Club meetings (and heaven knows they don't keep meeting minutes!). Their secrets are enshrouded in the tens of thousands of lines of computer code that lie in repose until some particular pulse of packet-switched data trumpets them into action, and the hordes of transaction orders march forth like some horrific droid army from a 2:30 a.m. Sci-Fi channel thriller.

Here's what we do know: what those algorithms react to has no resemblance to those TV pronouncements made by living, breathing humans. "The market rose today on higher than expected numbers for new housing starts." "Shares fell sharply as traders reacted negatively to the possible fate of the Euro." Nonsense. A statement more closely aligned with reality might go something like this: "The machines flooded the NYSE Superdot system with buy orders today because at 3:36 p.m. the price line of Asset X reached a correlation coefficient of Y with the 30-day trend line of Economic Indicator Z, and all the while Geopolitical Flashpoint N did not materialize even though the President of Insanistan detained a fleet of oil tankers in a portside town for one more day."

The 3:30 Club is a creature of the early 21st century and for all practical purposes it is here to stay. Most of the regulatory and institutional framework for our "modern" securities markets was constructed in the first half of the 20th century. For all their relevance to the challenges brought about by this brave new world of technological marvels, though, those laws, regulations and practices might as well have been written in the 12th century. To prosper, securities markets first and foremost need to reassure prospective investors both large and small that the system is fair, transparent and orderly. It's not that 200-point swings in the last five minutes of trading are in any way illegal or improper. It is that when such events become the norm, for reasons that the unaided human brain cannot fathom, regular people become skittish about committing their savings to investment opportunities, and ever more skeptical that anything remotely like a level playing field exists. That is obviously bad for the long-term health of the market.

In the past three years much has happened to shake the confidence of investors. Amid the eye-popping failures of large financial institutions, and even whole countries teetering on the brink of failure, the weirdness of the 3:30 Club has not been at the center of the policy debate. We applaud the efforts of national and global policymakers to bring the institutional architecture of securities markets into the 21st century. We just hope that the issues represented by the 3:30 Club figure prominently into their ongoing deliberations and actions. Meanwhile we stand by our long-repeated mantra: trying to predict the short-term is a foolish endeavor. That is truer now than ever, courtesy of the 3:30 Club.

With warm regards,

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