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Market Volatility . . . "Goes to 11"

You may have come across the concept of the "Wisdom of Crowds" and how effective it is in markets. For those who have not, "Wisdom of Crowds" is the idea that large, diverse, and incentivized groups combine to come up with better answers than individuals. For example, have a crowd guess the number of jellybeans in a jar and the winner gets a cash prize. The average of each person's guess in the crowd will be remarkably close to the actual number of jellybeans in the jar (and much closer than almost all of the individual guesses). This has been tested many times and in many forms. It almost always works.

Does the "Wisdom of Crowds" apply to financial markets like the stock market? The popular view is – "Of course it does." Academics assert that the stock market is an "Efficient Market" for valuing investments. However, that assumes that all the market participants are making decisions based on their view of the value of an investment. In reality, fewer and fewer market participants are valuing investments. Instead, most attempt to buy or sell ahead of the crowd. This moves the focus off value and onto anticipating what other traders will do. Referring back to the jellybean example, most participants are not trying to guess how many jellybeans are in the jar, they are trying to guess what the majority of guessers will guess.

Sixty to seventy five percent of trading volume is Algorithmic[1] ("algos"). Algos trade based on a predetermined set of rules. Humans write computer programs to execute trades if certain conditions are met. These rules are typically focused on the near-term move in a stock price. Buy-Sell balance is much more important to the near-term share price than the fundamental value of the investment. Trading ahead of the crowd can lead to quick profits. Program trading is largely about guessing what the crowd will do and then doing it first. That is why new information with little consequence to long-term value can create sizeable moves in stock prices.

A simple example, Company A announces earnings that beat expectations. Algos expect the market participants to buy the stock on this news due to past patterns, so the computer buys the stock at the open. The algo buy volume pushes the stock price up more than the fundamental value increase from the new data would warrant. Algo traders then sell out of the stock at the close or over the next few days making a quick profit. The next quarter rolls around and Company A beats again. Algos come again but in even greater numbers because the pattern is even more established. The crowding of algorithmic trading amplifies price swings. The value of a company eventually matters but in the immediate term, value has probably never been less relevant.

The purpose of the stock market is not to accurately value stocks. The purpose of the stock market is to provide liquidity. Liquidity investors can use to try and turn a profit. Algorithmic trading is here to stay. Basing decisions on expectations of investor behavior offers the potential to make money faster than investing based on a view of a company's fundamental long-term value.

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Warren Buffett's mentor Benjamin Graham famously said, "In the short run, the market is a voting machine but in the long run, it is a weighing machine." I would offer this update "In the immediate run, the market is a pattern recognition machine, in the short run it is voting machine but in the long run, it is a weighing machine."

Each stock is its own market. And each "stock market" is influenced by all the other "stock markets". Right now, some "stock markets" are bearish and pessimistic while others are bullish and optimistic. A few are extremely optimistic (cough – AI – cough). Just as positive algorithmic trades attract more positive trades, negative trades attract more negative trades. Opposites do not attract in algo trading. Selling attracts more selling, buying attracts more buying.

Algos have likely helped drive down the stocks in the bearish markets. This creates opportunity for us. Investing in the pessimistic and undervalued areas improves long-term expected returns, while simultaneously impeding short-term expected returns[2]. That's ok.

We are focused on investing in companies we believe will be worth substantially more in the future. The longer they grow their value the better. Algos affect the path, but the fundamental value of a company sets the destination. We appreciate algos giving us more buying opportunities along the way. Time is on our side.

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[1]https://www.quantifiedstrategies.com/what-percentage-of-trading-is-algorithmic/
[2]https://www.plancorp.com/blog/valuations-and-return-expectations

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