



## **Why Are U.S. Equity Markets Experiencing Increased Volatility?**

### **Market Brief**

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## **WHY ARE US EQUITY MARKETS EXPERIENCING INCREASED VOLATILITY?**

The US equity markets have been experiencing increased volatility and negative returns so far in 2008. This is no secret, most investors are painfully aware of this fact. The increase in the market's volatility is less obvious but most people recognize the markets' increasingly large price swings. First we should discuss the definition of volatility. Volatility is a measure of the change in a share's price over a given time period. It is often expressed as a percentage and computed as the annualized standard deviation of percent change in daily price. That's the definition, but most people just know that the market seems to be making some unbelievably big price moves and individual stocks move even more dramatically. We see this increased equity market volatility and it begs the question WHY? Here are some thoughts and observations.

## **PENNY INCREMENTS – THE ELIMINATION OF THE SPREAD**

In trying to help the small, individual investor, the SEC (Securities Exchange Commission) did away with trading in 1/8th's and 1/16th's increments (the spread between the bid and ask price) in the year 2000. They allowed equities to be traded in penny increments. Their rationale was to level the playing field between the institutional investor and the individual investor. What it ultimately did was get rid of the over-the-counter (OTC) market makers, as well as NYSE floor traders. These broker/dealers used to supply liquidity and stability to the markets. These traders used to make the spread between the bid/ask price – for that profit potential they would supply liquidity, which would lead to increased price stability. The medium and small broker/dealers, supplying liquidity, have been disadvantaged by the smaller bid/ask spreads. As such, the small to mid size firms are getting squeezed, and their trading operation are less profitable. They lack the economies of scale that the large Wall Street wire houses and investment banks possess. If they can't make money trading, these small/mid size firms, who were liquidity providers, cannot afford to pursue these market making activities. The loss of these interested parties, supplying liquidity and stability, has increased volatility.

## **THE RISE OF THE ELECTRONIC TRADING AND THE ECN'S**

Not too long ago stocks traded exclusively on either one of two platforms. One platform is the floor of a stock exchange (usually the NYSE - New York Stock Exchange). The other platform is over-the-counter (OTC) on the NASDAQ (National Association of Securities Dealers Automated Quotation System). These two venues are still used but now there is another platform and it is called an ECN. ECN is the acronym for

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“electronic communications network.” These ECN’s are privately held electronic systems that bring buyers/sellers together for the electronic execution of equities. On the surface the advent of a new alternative trading platform sounds like a good thing, a “no brainer” – choice and competition are inherently good. Yet it’s not quite so simple; there are problems and drawbacks that have evolved from the increasing use of the ECN. The main negative consequence of the ECN is the reduced role and importance of the NYSE specialist (each NYSE stock has a specialist, who is the primary market maker for any given equity and whose job it is to maintain a fair and orderly market).

On listed trades, the orders used to go exclusively to the floor of the exchange for price discovery. Yes, the specialist had an advantage in seeing the order flow but he also had the responsibility to make a market - maintaining a fair and orderly market. This helped dampen down volatility, especially in a downward moving market. The specialist knew where other interested players, had an interest - supplying liquidity at certain levels and price points. Orders used to go to the floor, i.e. 25,000 shs available down an 1/8th, 50,000 shs down a 1/4, 100,000 shs down a 1/2. Liquidity used to go to a central location, at certain price levels – this is no longer the case.

The ECN liquidity is anonymous and liquidity suppliers can either disappear or conversely, force the issue and exaggerate the move. The end result of the ECN outgrowth was to force the NYSE to merge with the biggest ECN (Archipelago - ARCA). At the hands of the ECN, the NYSE specialist has lost his information advantage afforded by being the central point of trading and price discovery. The powerful emergence of the ECN – with anonymous liquidity that can either disappear or stampede into the market, in either direction—is increasing volatility.

### **SHORT TERM - IMPATIENT MONEY**

General market wisdom states that investors should invest with a long term outlook and time horizon. This is a truism but not every market participant is a long-term investor. Other participants include day traders, institutional trading desks, hedge funds, and other participants. Many of these participants collectively represent very large sums of money seeking returns with any number of time horizons, return expectations and agendas. By nature, these pools of money are active traders with a very short time horizon; trading, not investing is for most, their primary activity.

Day traders by nature want to be in and out of trades. They are quick to take both profits and losses. The hedge fund world is even worse. Most hedge funds have a 2% & 20% fee structure. That means that they charge a 2% management fee and that they receive 20% of the gains as an incentive fee. It used to be that there was a limited number of hedge funds that

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catered to an extremely wealthy or institutional clientele – it was an exclusive group of both money managers and investors. There are now over 8,000 hedge funds in existence. Many of them are employing the same strategies and marketing to smaller pools of money that Wall Street firms bundled together. With the electronic access to the markets, they are able to stampede money into and out of securities very quickly, even disruptively. These funds often use leverage and trade more frequently in an attempt to generate returns. They have large dollars and can push the markets and stocks/securities to extremes. This is a herd mentality that capitalizes on and promotes the fear and greed factors at work in the markets. The hedge funds are one of the biggest negative drivers in today's markets and are a huge source of the increased volatility we are seeing. Note the SEC release at the end of this brief.

### **INFORMATION FLOW – MEDIA HYPE**

Market participants have always evaluated and reacted to news. This is unchanged but what has changed is the method and frequency of delivery. Print media use to be the main method of delivery but not anymore. Our computers and TV now bombarded us with information. Financial news is now available 24/7 and people are plugged in with their computers, hand held devices and TVs.

Television media, in particular, is saturating people with information and misinformation. It has become a media circus with every piece of data being treated as if it was of paramount importance. CNBC is a perfect example of the hype. They build up the anticipation of the news – they announce the news – they have a panel of so called experts (quite a few who have an agenda), evaluate and discuss the news – then they endlessly debate back and forth. The media is playing on the fear/greed psychology, as well as conditioning people to think short term. They want people excited about their station and product but they are overdoing it – it has become NOISE. They feed the investor's fear and greed emotions, making all investment decision short term in nature, which is fueling the increase in volatility.

### **SIDEWAYS MARKETS AND OTHER FACTORS THAT INCREASE VOLATILITY**

During the decade of the 1990's investors got used to strong, upward moving markets. In general, investors, especially long-term investors, are happier when the markets are moving higher. But now with the markets moving sideways it puts added pressure on hedge fund managers who get paid from performance. The over sized fees hedge funds levy are much harder to justify in a flat, sideways moving market. Trying to get performance (justifying their fees), the hedge funds are forced to plow in and out of sectors and equities. The herd mentality is in effect again and the quick flow of money in and out of market

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sectors is magnifying the volatility.

**Other Factors:**

*--Price discovery for the stock market really happens in the S&P futures pit. Many large institutional investors hedge portfolio risk through a trade in the S&P futures. Because of the huge liquidity and leverage, the action in the futures pit dictates actions in the equity markets through the mechanism of program trading. The market's daily trading volume is huge and program trading is a big part of this daily volume. The futures are the tail that wags the dog (equity market).*

*--Regulators (SEC and the NASD) are asleep at the wheel – poor oversight at the top.*

*--Volatility is always worse on the downside and we have recently experienced large down moves in the equity markets.*

To our point, in mid-July the Securities and Exchange Commission (SEC) made an official warning to market participants who appear to be disseminating rumors and other falsehoods in an effort to foment investor panic and manipulate stock prices. The rumors are picked up by the news outlets and through the magic of media reporting, become news, quasi-fact and self fulfilling events. The full SEC release is below.

In conclusion, several factors are at work increasing volatility. This increased volatility can be unsettling, especially in the short term. By focusing on a long term investment plan investors can take advantage of increased volatility. By systematically rebalancing their asset allocation, investors can take advantage of the market's increased volatility, trimming asset classes that have appreciated and adding to recently underperforming asset classes. With a formal program, the negative effect of emotion on decision making is reduced.

*Marne L. DeSantis  
Principal*

**Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information**

Prevention Effort Augments SEC's Ongoing Enforcement Investigations

FOR IMMEDIATE RELEASE  
2008-140

Washington, D.C., July 13, 2008 — The Securities and Exchange Commission today announced that the SEC and other securities regulators will immediately conduct examinations aimed

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Founded in 1994, West Chester Capital is a registered investment advisor managing \$150 million of client assets. Located in West Chester, Pennsylvania, West Chester Capital is a wholly owned subsidiary of AmeriServ Financial, a publicly held bank and trust company, headquartered in Johnstown, Pennsylvania. AmeriServ is a \$1 billion bank with a trust company administering \$1.8 billion in client assets.

West Chester Capital manages fiduciary quality portfolios and investment programs for individuals and institutions within a framework of openness, integrity, objectivity and rigorous client advocacy.

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at the prevention of the intentional spread of false information intended to manipulate securities prices. The examinations will be conducted by the SEC's Office of Compliance Inspections and Examinations, as well as the Financial Industry Regulatory Authority and New York Stock Exchange Regulation, Inc.

The securities laws require that broker-dealers and investment advisers have supervisory and compliance controls to prevent violations of the securities laws, including market manipulation. Examiners will focus on these controls and whether they are reasonably designed to prevent the intentional creation or spreading of false information intended to affect securities prices, or other potentially manipulative conduct.

These examinations are in addition to the Commission's enforcement investigations into alleged intentional manipulation of securities prices through rumor-mongering and abusive short selling that are already underway.

"The examinations we are undertaking with FINRA and NYSE Regulation are aimed at ensuring that investors continue to get reliable, accurate information about public companies in the marketplace," said SEC Chairman Christopher Cox. "They will also provide an opportunity to double-check that broker-dealers and investment advisers have appropriate training for their employees and sturdy controls in place to prevent intentionally false information from harming investors."

FINRA, NYSE Regulation and the Options Regulatory Surveillance Authority recently reminded industry firms that intentionally spreading false rumors or engaging in collusive activity to affect the financial condition of an issuer are violative activities, and further reminded market participants to review their internal controls and procedures to prevent this type of conduct.

### **For More Information:**

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