

## Volatility benefits some traders

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— (Editor's note: This is the second of two columns about stock-market volatility.)

We recently outlined some reasons for the dramatically increased market volatility of late. While volatility is painful for most of us, there are groups that thrive on volatility.

Day traders make a living capitalizing on, and often even driving, intra-day volatility. Day traders will buy when they see upward momentum in a favorite stock during the day, and sell or even sell short, when the stock begins to weaken. Their bread and butter is volatility, and they liquidate each evening because they cannot endure volatility when they are unable to trade.

Day traders are not the only ones that will sell a stock short. Short selling is the practice of selling stocks borrowed from another, with the intention of buying the stock back later at a lower price to cover the stock you borrowed and sold. Brokerage houses will allow investors to do this, in effect fronting them the stock temporarily, in theory. The market has observed of late, though, that there can be more short selling of a stock than the number of shares brokers hold in inventory. This means that a significant amount of stock is actually sold without the seller having any rights to sell.

Such "naked short selling" is much like writing a check when you don't have any money in the bank and no overdraft protection. But while such check kiting is illegal, the practice of naked short selling has been tolerated. Such tolerance on the part of the Securities and Exchange Commission has created an industry in selling shares that don't exist. By distorting upward the supply of stocks for sale, this practice dramatically accelerates downward movements in the stock market.

The tolerance of naked short selling, and the SEC's removal last year of the "uptick rule" that permitted short selling only once a stock begins to turn upward again, has contributed to the market volatility, especially on the downward side. These destabilizing forces have been employed most by hedge funds because such funds escape the regulation imposed on institutions and mutual funds.

A hedge fund is essentially a private partnership of investors that hire a manager to do whatever can be done to make a return. These managers often receive a commission of 20 percent of the profits of the fund, and have every incentive to manipulate markets or act on information not available to the average investor. So long as they succeed, the partners in the fund ask no questions.

The term "hedging" is generally reserved for the practice of covering one's bets. For instance, airlines hedge on aviation fuel price increases by buying fuel on the futures market in advance, thereby locking in their price and making their costs more predictable. This practice is not the bread and butter of hedge funds. Rather, these funds employ whatever practice they can, and exercise whatever market clout they can muster, to provide a lucrative return to the investors and a strong commission to the manager.

These hedge funds also thrive on volatility, and have considerable market power to enhance volatility. In fact,

it has been reported that one or two hedge funds can represent the majority of all trades in a given stock in a given day, leading the market up through their buying, and also profiting by selling short as they bring the market back down again.

Short sellers can inadvertently artificially raise the market, too. Recently, Volkswagen stock rose 90 percent in a day. The stock's fundamentals had been strong since Porsche recently enhanced their ownership share of VW. However, short sellers were betting the stock would decline with the downturn in the market. When the stock did not decline, they had to rush in to cover their naked-short-selling bets, thereby pushing VW stock up so much that it, for a moment, became the world's most highly capitalized company. In reality, the stock did not deserve to go as low as short sellers hoped it would, nor as high as short sellers inadvertently pushed it.

Of course, many of these practices would not be effective, nor the symptoms so extreme, if every market move could be fully scrutinized. We know that sunlight is a great sanitizer. Perhaps it is also a great stabilizer. The regulators have their hands full to try to recreate for financial instruments the level of transparency that each of us have for most all we purchase.

If whole industries have developed to data mine and analyze every purchase the average person makes, surely we can make the case for similar analysis and scrutiny for stock transactions.

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