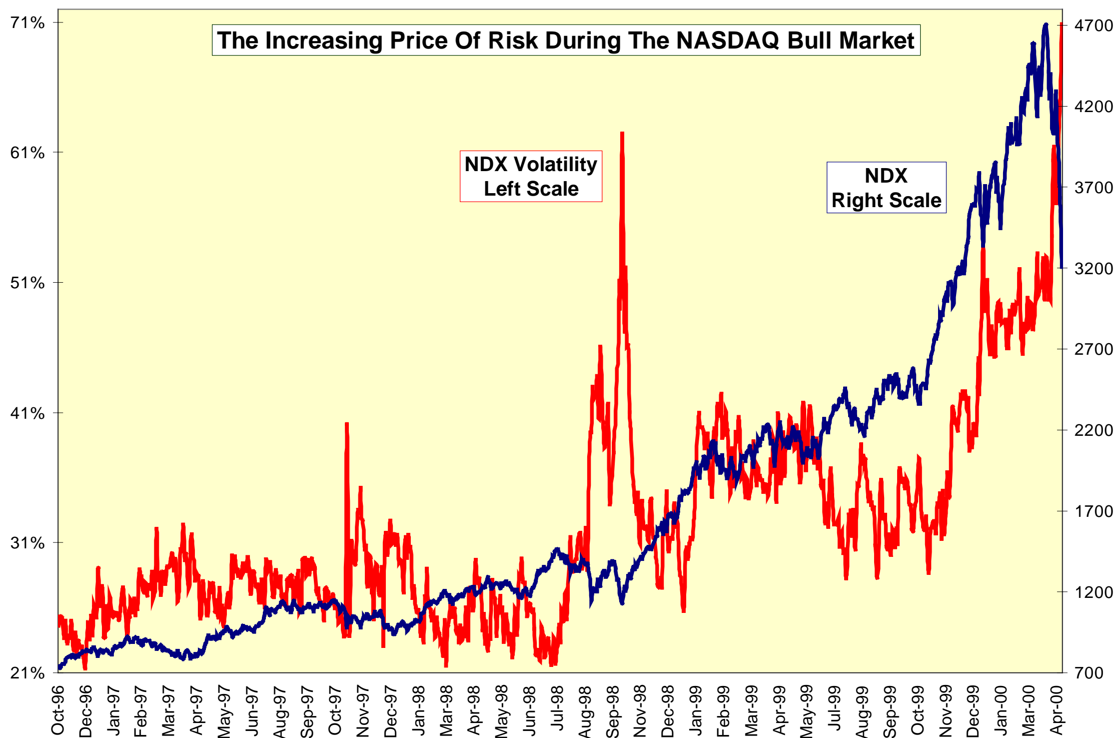
We Can Be Heroes, Just For One Day

You never know what you're made of before a defining moment of stress. Even though our combat is confined to the markets, an important parallel between trading and warfare holds: Heroes are ordinary people who do extraordinary things.

An odd characteristic of large-scale industrial warfare was the unintended development, planned by neither army and joined at a non-strategic site, of a cataclysmic bloodbath won by the heretofore-losing side. The list includes Gettysburg, Verdun, and Stalingrad. A common thread in all of these cases was over-extension by too-confident winners and a subsequent refusal to acknowledge their predicament until it was too late to do anything about it.

You only know you're overextended after the fact. The winning side over the past few years, no question about it, has been the bulls. We now know, too late, the March highs represented a bridge too far. The trick will be acknowledging our predicament and organizing a strategic retreat.

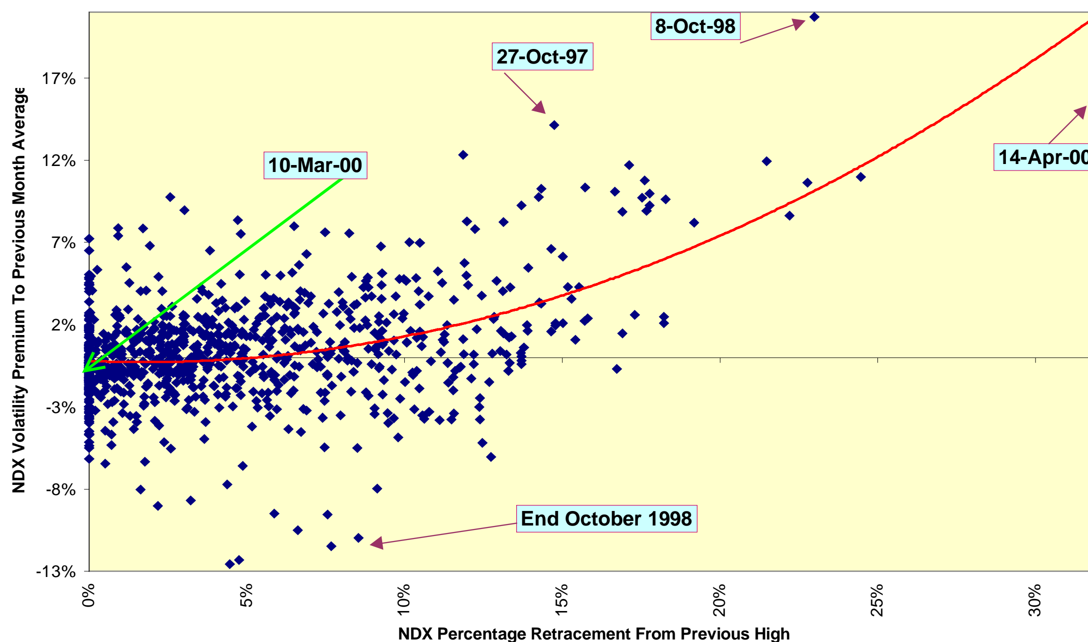
Hey, Watch It With That Thermometer!
Volatility is the market's price for uncertainty, a sort of thermometer for risk. It is normal for stock market volatility to increase as prices fall; few investors are naturally short stock, and demand for insurance jumps as stock prices fall. However, we noted (see "The Energizer NASDAQ," February 9, 2000) NASDAQ volatility was increasing during the incredible rally from October 1999 through March 2000.



This unusual combination was due, most likely, to dealer and marketmaker buying to maintain competitive position and to cover previous short positions. Moreover, the dollar value of each percentage move was increasing with the market's level, and this made the marketmaking game an expensive proposition. These observations led to the conclusion a market top would be reached when volatility rose during a rally: The last doubters would now be long.

We can look at the combination of price and volatility through the prism of anchoring. Anchoring is a fancy psychological term for getting used to a state of affairs and making judgments not based on any absolute standard, such as comparing P/E ratios to anything resembling reality, but to relative standards, such as where our personal equity was but a few fond weeks ago. Let's be honest with ourselves: The closing level on Friday, April 14, 2000 was not breached on an intraday basis until December 3, 1999, and that level seemed pretty high at the time. Had we not had the intervening 50% rally in three months, none of us would regard the present level as shockingly low. However, we anchored ourselves into a mental state of permanent rallies.

We can reorganize the data in the graph above to a scale based on gain retracement. Each price point on the NDX chart can be represented as a percentage loss from the all-time high; a new high will be on the left side of the scale as 0%. The largest gain retracement, by far, is the one on April 14, 2000 (this piece is being written over the weekend, and does not incorporate Monday's data). Each volatility point can be represented as a premium or discount to the previous month's average volatility. The largest volatility premia occurred on the market crash date of October 27, 1997, the 1998 spike low date of October 8, and the infamous April 14, 2000. The lowest volatility points occur at the end of October 1998; these coincide with the start of the huge rally in the NDX from 1129 on October 8, 1998 to 4705 on March 10, 2000.



The relative increase in volatility increases as a function of the square of gain retracement, as highlighted by the red trend curve. This isn't surprising at all; all but the most juvenile accepts some sort of retracement as part of the investing process, and we had become inured to the NDX's regular 10% corrections, three of which came this year prior to the present collapse. It's only when the truly unexpected occurs that we panic, mourn our losses, and push volatility skyward.

So, What'd The Thermometer Say?

The falling volatility/rising price combination did in fact define the recent NDX high (yes, your loyal correspondent would have mentioned it if had not). On March 9-10, 2000 the NDX's volatilities of 47.31% and 47.92% were 1.09 and 0.49 points, respectively, below the previous month's average.

The real question, of course, is when will it be prudent to be the hero, the guy willing to step up to the plate and catch the falling knife? The NDX data says "soon," at least for a trading bottom. Price may spike as low as 2630 on the NDX, but if it does and volatility starts to decline, stop selling and start buying. If this level fails, start retreating.

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As a follow-up to "The Energizer NASDAQ," readers were encouraged to e-mail the Chicago Board Options Exchange (www.cboe.com) and ask for a parallel index to their S&P 100 Volatility Index (VIX). This encouragement still stands.