# Taking Exception To The Basket Case

Let's assume, just for the sake of argument, the stock market commentariat is filled with self-pitying whiners who are unable to admit when they are wrong but who have no trouble compiling a list of scapegoats for when they are.

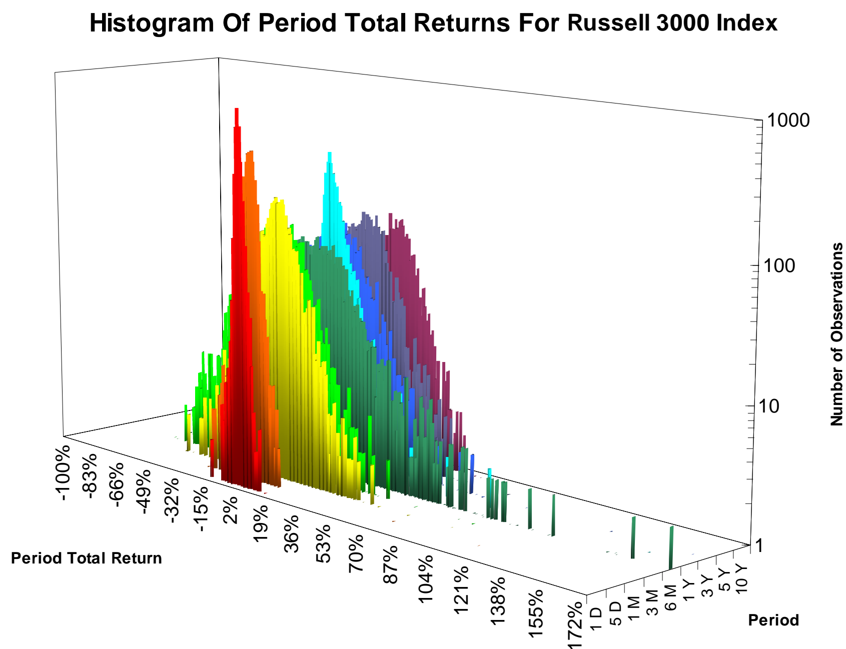
Work with me here.

One of their bugaboos for years has been how indexation and basket trading has destroyed the utility of their fundamental analysis by forcing stocks to rise and fall in unison. Over the short-term, this claim is entirely valid; if a stock is a part of a major index-linked exchange-traded fund such as the SPY or QQQQ, it will be starring as the baby thrown out with the bathwater.

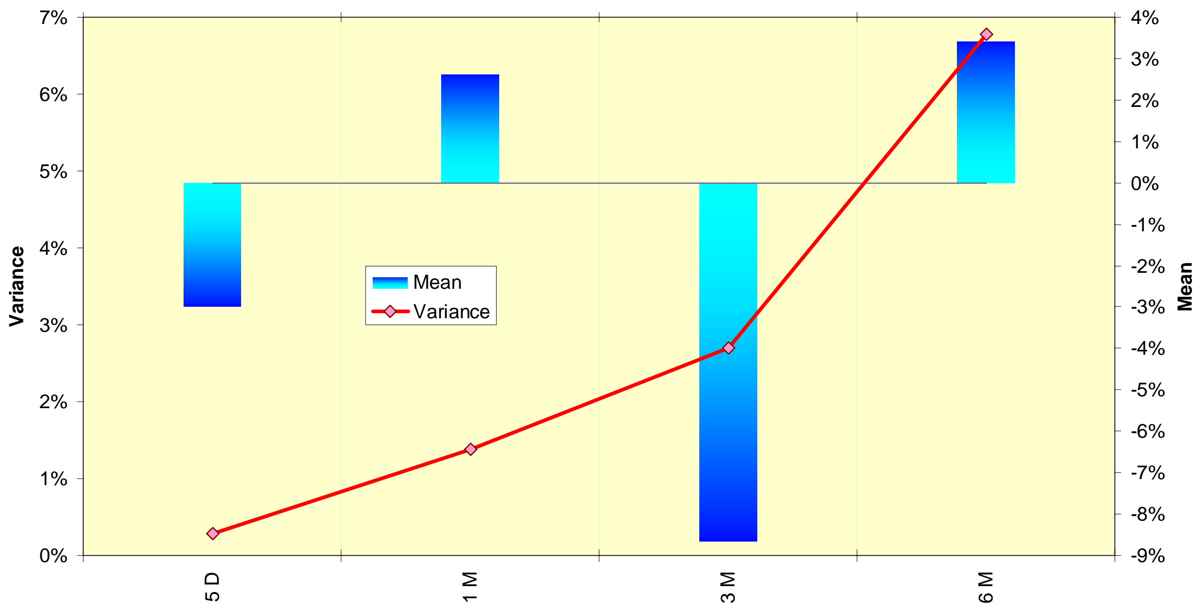
But over time, value will come to the fore. The short-term effects of indexation are noise; the long-term impact of fundamental analysis is signal. An analyst should not want to be judged on the twists and turns of the modern high-frequency trading market; this is a Loser's Game. Conversely, if a HFT quant jock (or, more properly, the software program involved) is thinking about anything longer than the next few microseconds, they have taken their eye off their chosen ball.

**Time Keeps On Ticking, Ticking**

If prices separate from their index effects over time, how quickly do they do so? If we examine the members of the Russell 3000 index, itself tradable under the ticker IWV, and look at their one- and five-day, one-, three- and six-month and one-, three-, five- and ten-year total returns, we find these distributions look very different from one another. This is to be expected.




Now let's rearrange the information above to the more usable timeframes of five days and one-, three- and six months. Anything longer than six months invites problems associated with secular market trends, the annual reconstitution of the Russell indices and the survivor bias associated with all indices.




The results are indisputable and, I might add, statistically significant. Regardless of whether the mean of period total returns rises or falls over any of these periods, the variance of those returns rises. Cream rises to the top; let's not talk about what sinks to the bottom.

We can be assured, therefore, if an analyst can add value, rewards will follow. So what if on any given microsecond IBM went down with the basket instead of rising as predicted?

As an aside, this is why all of the actions to bust trades outside of bounds imposed after May's flash crash are so off the mark. If some goof's computer was willing to sell Exelon or Accenture at a penny, the best way to stop them from doing so in the future is to make them eat that trade. While they are munching on the losses – perhaps washed down with a nice dry rosé on a late summer afternoon – they will have time to think about how to avoid their own stupidity in the future. Discipline of the market, free markets for free men, and all that. If we bail them out of their losses, where is their incentive to avoid them in the future?