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Crisis and Chaos in Financial Markets

Summary

Most investors understand that, historically, stock prices rise. This has been the case ever since securities started trading after the signing of the Buttonwood Agreement in 1792. It is undeniable that, over time, stocks appreciate. At the same time, however, there are times when stocks do not perform well. So-called bear markets surface periodically in which stock prices fall and shareholders lose money. In addition, sometimes the stock market's decline can be violent, such as the crash of 1987—an extreme example. That sharp market decline stands out in the history books as a period of extreme volatility and lost wealth for stock market investors.

The volatility trader has a different perspective on the market than the traditional stock market investor. The volatility trader understands that times of falling stock prices and rising volatility are inevitable. However, periods of high volatility offer an equal number of trading opportunities as when stock prices are rising. Therefore, volatility is not a negative. There are ways to profit regardless of market direction, and volatility is not a nemesis. Instead, volatility can offer some of the best financial rewards to the savvy trader.

Recent events highlight the value in trading volatility rather than blindly buying stocks and hoping they increase in value. In the fall of 1998, financial markets around the globe were rattled in a widespread panic. A short time later, after a surge in technology stocks and the creation of a speculative bubble in Internet stocks, the floor caved in and stocks suffered sharp declines for more than 18 months. By the middle of the year 2001, many companies saw their share prices trade at fractions of their year 2000 peaks. Then, in September 2001, the U.S. stock market suffered another blow when terrorists attacked the heart of the world's financial center—

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downtown Manhattan. All of these events, in less than five years, served to highlight some of the risks investors face. Some were economic, some political, and others military. Nevertheless, they all made the traditional approach to investing a gut-wrenching experience.

While trading volatility makes a great deal of sense given the complex nature of the stock market today and the myriad of uncertainties investors face, it is not a passive approach to the market. The volatility trader is actively involved in the day-to-day activity of the market. This does not necessarily mean trading every day and losing sleep at night due to the uncertainty of financial markets. However, it does require a certain time commitment that is not needed when simply buying stocks in anticipation that the market will be higher 10 years from now than it is today.

The savvy volatility trader understands the following key principles:

- Falling stock prices occur roughly one-third of the time.
- Profits can be made regardless of whether stocks are rising or falling.
- Volatility is a fact of life when investing.
- There are times when volatility in the stock market is high and makes the headlines in the financial press.
- There are times when volatility is low.
- Whether volatility is high or low, however, there are ways to generate profits using the strategies outlined in *The Volatility Course*.

Questions and Exercises

1. The U.S. stock market suffered its greatest point decline in history on ____________.

   A. October 29, 1929
   B. October 19, 1987
   C. April 4, 2000
   D. September 17, 2001

2. True or False: The bear market that preceded the Great Depression of the 1930s began on September 29, 1929, and lasted until June 1938.

3. What is an index, and why are indexes helpful when it comes to studying the stock market?

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4. True or False: Rising interest rates hurt stock market investors.

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5. The primary goal of the Federal Reserve is to ____________.
   A. Stabilize prices
   B. Promote economic growth
   C. Strive for full employment
   D. All of the above
6. Prior to the market slide from September 2000 until September 2001, the market was vulnerable and eventually collapsed because of ____________.
   A. Overpriced Internet stocks
   B. Excess speculative activity on the part of individual investors
   C. Rising interest rates
   D. Global economic decline
   E. All of the above
7. As a general rule, a bull market is identified by a ____________ rise from a low in the Dow Jones Industrial Average or other measure of the market.
   A. 10%
   B. 15%
   C. 20%
   D. 25%
8. As a general rule, a bear market is identified by a ____________ decline from a high in the Dow Jones Industrial Average or other measure of the market.
   A. 10%
   B. 15%
   C. 20%
   D. 25%
9. Can volatility in one financial market spread to other markets, or does it remain isolated? Why?

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10. True or False: Ultimately, the stock market falls more than it rises.
11. The world's largest auction-style stock exchange dates back to the Buttonwood Agreement of 1792. Today it is known as the ____________.
    A. New York Stock Exchange
    B. American Stock Exchange
    C. Philadelphia Stock Exchange
12. True or False: Volatility equals risk.

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13. True or False: It is usually profitable to bet against the financial system over the long term.
14. Briefly describe why rising and falling markets are named "bull" and "bear."

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Media Assignment

There are a number of different media tools available to the option strategist today—financial newspapers, magazines, the Internet, and television. The most valuable, by far, is the Internet. Today, while the cost of a personal computer has fallen dramatically, its speed, memory, and efficiency have enjoyed explosive growth. In addition, the proliferation of financial-related Internet sites coupled with the new high-speed Internet access capabilities (cable, DSL, broadband, etc.) have made tasks that once took hours possible in only minutes. There is no question that Internet access and subscriptions to a few key services greatly facilitate the process of identifying and implementing efficient option strategies.

While the Internet is the most important tool available to the option strategist today, this chapter focuses on events that cause volatility in the stock market, and following these events does not necessarily require the use of a computer. The chapter is concerned largely with the financial press in *all* its forms—television, radio, print, Web-based, and so on. Therefore, the first media assignment requires access to financial-related news services. These include, but are not limited to, financial television programs such as the *Nightly Business Report* on PBS, and *Moneyline* on CNN, and newspapers like the *Wall Street Journal*, the *Financial Times*, and *Investor's Business Daily*, along with Web-based financial news from Bloomberg.com, Yahoo! Finance, and Optionetics.com.

When evaluating the financial press, the reader is trying to answer the question, "What is moving the markets?" As described in Chapter 1 of *The Volatility Course*, there are a number of different factors that can trigger periods of volatility. Some stem from the stock market itself—such as earnings, concerns over corporate accounting, or stock mergers. Others are economic in nature and include changes in interest rates, energy prices, or economic growth. Finally, some events fall outside of finance altogether, but still rattle the nerves of investors. The terrorist attacks of September 11, 2001, are the most recent example, but there are others. Wars, politics, and other noneconomic events can all shake investor nerves.

The goal of the first media assignment, then, is to uncover what factors are driving the markets higher or lower on a day-to-day basis. To accomplish this assignment, start a trading journal. Each day, try to write a short account of the day's significant events and their apparent effects on the financial and business community. Keep in mind when doing so, however, that investors do not always react correctly. In addition, when markets begin to swing wildly the media often adds to the situation by dramatizing it since the financial press receives a lot more interest from market watchers when the situation appears chaotic and out of control. During those times, the option

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strategist must be careful not to get caught up in the excitement of short-term events, and to focus on the bigger picture instead. While it is important to understand what is moving the markets, the strategist must be able to stay emotionally detached from the situation in order to keep thought processes clear. If not, investment decisions are likely to be made out of fear or greed, rather than based on rational decision making.

Vocabulary List

Please define the following terms:

- Bear market
- Black Tuesday
- Bloody Monday
- Bull market
- Buy and hold
- Chicago Board Options Exchange (CBOE)
- Commodities
- Contagion
- Correction
- Dow Jones Industrial Average
- Exchange-traded fund (ETF)
- Federal Reserve
- Fed funds rate
- Futures markets
- Global financial crisis
- Index fund
- Liquidity
- Long Term Capital Management
- Margin
- Margin call
- Mutual fund
- Nifty Fifty
- Options
- Prime rate
- Pullback
- S&P 500