How $39 Billion of Stock Trades in One Second - Transcript

Tom Mullooly: In episode 95 we're going to talk about how $39 billion worth of stock was traded in one second.

Welcome to the Mullooly Asset Show. I'm your host, Tom Mullooly, and this is episode number 95. Today we want to talk about an article that was in the Wall Street Journal recently. The headline was, "$39 billion of stock gets traded in just one second." What they're referring to is the rebalancing that took place a couple of days ago in the Russell indices. You know there's the Russell 1,000, the Russell 2,000, there's a lot of these different indices and they're large.

There's $9.2 trillion worth of stock tied to these various Russell indices and they're supposed to basically capture the total stock market depending on which way you're looking at it. Now by comparison, that's $9.2 trillion for all those Russell indices. Over here, the Dow Jones Industrial average, there's $29 billion, still a colossal amount of money, but nothing compared to some of these other indices.

So why are these indices important? Because a lot of mutual funds that are ... If you're a small cap manager, you're going to be measuring against the Russell 2,000 or the Russell 3,000 if you get involved in micro caps. If you're a mid-cap manager, you're going to be measuring against the Russell 1,000. So these indices really do play a part, not only to tell us the yard sticks, how the markets are doing, but also for fund managers and portfolio managers to measure, to use as the yard sticks.

So when they made this change in the Russell 2,000 for example, just a few days ago, 300 different companies were getting dropped from the indices. So it's become a full time business predicting which companies are going to get dropped, which companies are going to get added. You see, the Russell indices are all based on market cap. So the market capitalization of a company, it's very simple. It is the number of shares that the company has outstanding times the market price. So if you did a little homework you could see a company that has say, well the cut off now for the Russell 2,000 is $159 million, that's the market cap you need. So if you saw a company that wasn't in the Russell 2,000 and they had a market cap of $150 million or $155 million, pretty good bet that that company's going to get added to the index. Like I said, it's become a full time business trying to predict which companies are going to make the cut.

Why is that important? Because when it's announced, these companies, their stock moves because every ... We know that the index is going to be tracking it and every fund manager is going to buy it if they're mirroring the index. That's really important. You're bringing in a new steady line of buyers. More buyers, higher prices. That's just the way it works, that's supply and demand.

But here's the problem with these index funds, and a lot of people are getting involved in these index funds. The whole idea is they just buy the index and they hold onto it, but starting back in 1989, Standard and Poor started ... It was back in 1989 that Standard and Poors announced that they were going to make a change, and the change was going to happen the next day. And every company that was trying to mirror the index, every mutual fund manager, was scrambling the next day to try and buy the stocks that were now going into the index and selling all the ones that were coming out. So what happens now is the indexes, these indices, give the mutual fund managers, they give everybody in the business a little heads up. They give them a few days' notice, sometimes it's a week or two, but they give them advance notice. So what happens? The companies that are being added to the index, people start buying them because they're being added to the index. And what happens to the companies that are announced that they're leaving the index? They get sold.

So if you're a mutual fund manager or portfolio manager and you are tracking the index, you want to track it as close as you can, the problem is you don't make the change until the day it happens. So the news has already been out there for a week, sometimes two weeks, that your company or this company is going to be added to the index, and these other positions are going to be sold. What happens is you buy the new names higher, you sell the old names that are going out lower, so it's a hidden cost of index funds that you are buying high and selling low.

Rob Arnott who is the founder of Research Affiliates thinks fund managers ought to wait. They ought to take a little longer and move a little slower, give them time to rebalance. Basically by giving them time to rebalance it allows that buying and selling frenzy to get out of the way, let prices come back to normal. He suggests that maybe you should wait a year to go back in and replace the names that have been dropped with the names that have been added. What his work has shown is that those names that were cut from the index, the companies that get dropped from the index, actually outperform the underlying index to the tune of about 21% per year in the first year after the company's been dropped from the index. So the companies that are getting dropped because they're poor performers, they tend to do pretty well in the following year. The flip side, the opposite, is also true. The companies that get added to the index from the day they're officially added to the index, going forward they usually lag the index by one or two percent each year. It's pretty amazing. These companies get added. We saw it in the Dow Jones when Apple was added a few years ago. It had probably one of its worst years ever in recent history.

So this is the kind of stuff that can move markets quite a bit. We can see markets up or down a lot in a very quick period of time. We can see them move, gain ground and lose ground very quickly. And a lot of this happens in the last 30 minutes of trading or the last, say, 40, 45 minutes of trading. Now, East coast time, stock market closes at four o'clock, so you need to take a look at where you are at 3:15, 3:30 and see what's going on with the market and then see where the market closes at four o'clock. Why does this happen? There's a lot of portfolio managers, there's a lot of mutual fund redemptions, there's a lot of rebalancing. There's also things like option expiration which happen on the third Friday of every month. They all happen at the close.

So it's very important that all of these things happen right at the close of the market, so you'll see all these trades lining up and sometimes I've walked out of the office on days. I'll come home and someone will say, "Yeah. The market looked pretty good today." You know what? It might have looked like, you know, it might have looked terrible all throughout the day until the last 15, 20 minutes trading. Or, you could take a pretty normal day and it could wind up down a considerable amount right at the very close. And you say, "What happened at the end?" There's really no answer for that, other than portfolio managers are making the end of the day changes. It's one reason why we're careful about putting orders in near the close of market, and also we're pretty careful about using stop orders. We don't want to be taken out of a position by a computer. We would rather keep our eyes open and watch things as they happen.

Speaking of keeping your eyes open, we appreciate you watching this video, and we will see you in episode number 96. Thanks for watching.