The Original Flash Crash (or Why Liquidity Fears Are Nothing New)

In his latest memo, Oaktree Capital's Howard Marks opined about ETFs and their liquidity profile:

If you withdraw from a mutual fund, you'll get the price at which the underlying stocks or bonds closed that day, the net asset value or NAV. But the price you get when you sell an ETF -- like any security on an exchange -- will only be what a buyer is willing to pay for it, and I suspect that in chaos, that price could be less than the NAV of the underlying securities. Mechanisms are in place that their designers say should prevent the ETF price from materially diverging from the underlying NAV. But we won't know if "should" is the same as "will" until the mechanisms are tested in a serious market break.

Worries about ETF liquidity are nothing new. Investors and pundits alike have been discussing the ramifications of this new-ish fund structure for years now.

Some assume ETFs and index funds have played an integral role in the rise of stocks since 2009. These people also assume that investors in these funds will get destroyed during the next downturn but the worry is that the carnage could be even worse in ETFs because they trade throughout the day (whereas mutual funds only offer one closing price to transact).

I get the idea that there could be trouble caused by a liquidy mismatch in long-term assets during a short-term panic. But these worries are nothing new. Investors have long been making short-term decisions with long-term capital at stake.

The flash crash in May of 2010 that saw stocks fall close to 10% within minutes along with the more recent one in August of 2015 are still fresh in the minds of many investors.

But most don't realize there was another flash crash that preceded these two -- by six decades or so.

On May 28, 1962, the Dow Jones Industrial Average fell more than 6%. At the time, it was the largest point drop in the Dow since the Great Depression. Stocks were already down double digits on the year heading into the flash crash but it completely caught investors off guard.

Things got so crazy that the tape which relayed prices to investors was on a delay, meaning the prices people were trading on were stale. By 2 PM, the delay was 52 minutes. It got even worse, as John Brooks explains in his book, Business Adventures: 12 Classic Tales From The World of Wall Street*:*

The tape delay, which by 2:26 amounted to fifty-five minutes, meant that for the most part the ticker

was reporting the prices of an hour before, which in many cases were anywhere from one to ten dollars a share higher than the current prices. It was almost impossible for a broker accepting a selling order to tell his customer what price he might expect to get. Some brokerage firms were trying to circumvent the tape delay by using makeshift reporting systems of their own; among these was Merrill Lynch, whose floor brokers, after completing a trade, would—if they remembered and had the time—simply shout the result into a floorside telephone connected to a "squawk box" in the firm's head office, at 70 Pine Street. Obviously, haphazard methods like this were subject to error.

We take for granted the fact that we have the ability to receive up-to-the-second pricing these days anytime we want on our phones or computers. Selling during a panic when you have no idea what the actual prices are is the equivalent of downhill skiing with a blindfold on (this is also why you use limit orders for these funds, not market orders). It could work out but I wouldn't recommend it.

There were many parallels between this 1962 experience and the worries about ETFs today. But in those days, it was mutual funds everyone was worried about. Replace 'mutual funds' with 'ETFs' in this passage from Brooks and it could have been written today:

The investment community's collective shudder at this possibility was intensified by the fact that the mutual funds' power to magnify a market decline had never been seriously tested; practically nonexistent in 1929, the funds had built up the staggering total of twenty-three billion dollars in assets by the spring of 1962, and never in the interim had the market declined with anything like its present force. Clearly, if twenty-three billion dollars in assets, or any substantial fraction of that figure, were to be tossed onto the market now, it could generate a crash that would make 1929 seem like a stumble. A thoughtful broker named Charles J. Rolo, who was a book reviewer for the Atlantic until he joined Wall Street's literary coterie in 1960, has recalled that the threat of a fund-induced downward spiral, combined with general ignorance as to whether or not one was already in progress, was "so terrifying that you didn't even mention the subject."

Surprisingly, mutual funds played the role of hero during the 1962 flash crash. On the day of the crash, mutual funds in aggregate bought 530,000 more shares than they sold. While some thought a repeat of the 1929 crash was on the table, the market stabilized the next day, rising 4.5% along with a gain of 1.5% the next day, good enough for a gain of 6.1% over those two days. When all of the investors who panicked rushed back in to buy in the ensuing recovery, mutual funds actually sold a net 375,000 shares of stock.

So mutual funds acted as a stabilizer for the overall market in both directions, something no one would have predicted.

I'm not suggesting ETFs will act as a similar stabilizer in the future or that they won't see dislocations in the difference between their price and NAV. This will probably happen at some point but it's not a foregone conclusion that ETFs will play a large role during the next panic (recall that ETFs make up just 6% of the U.S. equity market).

It doesn't really matter what type of fund or securities you use for market exposure -- if you turn into a panicked or forced seller there's a higher probability you'll receive poor trade execution. That's the trade-off between short-term liquidity and long-term holdings.

Panics are nothing new, you just have the ability to panic in a wider variety of fund structures these days.

Source:
Business Adventures: 12 Classic Tales From the World of Wall Street

Further Reading:
Saying There's a Bubble in ETFs Makes No Sense