Why Was The Market Up/Down Today?

SYNOPSIS

- Market pundits are obsessed with understanding the short-term movements in equity markets.
- According to those who follow the daily market moves closely, raising cash to pay taxes was the reason the market fell last Friday.
- The daily moves in equities are often a mystery, and the explanations conjured by those who claim to have a feel for the market should be taken with a grain of salt.

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Explaining the Unexplainable

I overheard a market commentator on television last Friday explain that the stock market was down that day because investors were selling stocks to raise cash so they could pay taxes in the upcoming week.

It's never fun to be the one who breaks the news that Santa Claus is not real, but I feel obligated to set the record straight when it comes to the accuracy of such commentary.

Market pundits are obsessed with understanding the short-term movements in equity markets. They want to explain why stock prices are rising and falling every moment of the day because those who can provide more color (another word for "insight" on Wall Street) are regarded as having a good "feel for the market."

However, market participants are not required to submit their reasoning when trading stocks. For those investors who have ever bought a stock online through a Schwab, Fidelity, or another website, no buy or sell order requires you to explain the reason why you are making the trade before you hit the submit button.

Large asset managers will even go out of their way to maintain anonymity by trading in "dark pools," which are special venues where nobody knows who is on the other side of a trade and activity is kept secret.

Instead, market commentary comes from a mix of sources that are frequently unreliable, such as large trading firms on Wall Street that execute big orders for their clients. These traders move millions of shares every day, which allows them to see the flows up close and personal.

The problem is that since most of the trading is electronic these days, their insight only explains the tiny fraction of trades that are not done electronically or via a dark pool. Most days, it's just too hard to explain why the market was up or down because that information does not exist in a consistent and/or reliable format.

Rather than admitting that they do not know why stocks have risen or fallen, a commentator's only option is to concoct an explanation that seems logical and well-informed but is nothing more than a guess. That way, they remain the market guru and none the wiser.

Exploitable Patterns

On the surface, the observation by this commentator makes a lot of sense. It was just a few days before Tax Day, so selling stocks to pay Uncle Sam is a very logical explanation. The problem is that equity markets rarely operate in such a manner.

The stock market is "anticipatory," which means that it runs on the expectation of future events. For example, if an investor believes that Apple will sell more iPhones over the coming years, she will buy the stock in anticipation of higher earnings down the road.

Let's take it a step further. Imagine a stock consecutively rose by 5% on the fourth day of every month and fell by 3% on the last day of the month. At some point, traders would notice this pattern. They would then buy the stock on day 2, sell it on day 28, and repeat every month.

The problem is that easy money does not last for long. Other traders would eventually catch on and copy the strategy, which would then cause the stock price to move on different days. Over time, the pattern would disappear.

The same applies to the commentator's explanation. If the market dipped consistently each year leading into Tax Day, then traders would quickly recognize this pattern and act on it. They would sell stocks days before they expected the masses to sell and then buy back when taxes are paid. Over time, the pattern would also disappear.

My goal here is not to criticize the commentator. He may very well be right. I am only offering this counterpoint to show that nobody, despite how smart and well connected they may seem, has the faintest idea as to what drives a $20 trillion stock market on any given day. At best, it is nothing more than an educated guess that can be easily debated.

Lastly, if pundits really knew the stock market well enough to understand what drives the daily movements, there is simply no way these individuals would go on television and divulge their secrets. Instead, they would be trading on this knowledge and spending their downtime buying islands rather than trying to boost their ratings on television.

The good news for investors is that since day-to-day movements in stock prices mean nothing to a long-term investment strategy, market commentary can be ignored with no great peril. Since their information is either wrong or baseless, excluding it from an investment thesis changes nothing.

The bottom line is that the next time someone tries to explain why the stock market was up or down on any given day, no matter how logical it may sound, take it with a grain of salt.

Sincerely,

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