

Markets Shimmer Shimmer

Markets are like mirrors made of mercury: they reflect reality, distort reality, influence reality and thereby become part of reality.

For decades, we theorists have insisted that the reflective accuracy of markets is high (i.e. price \approx value) and that there are only weak feedback loops between markets and non-fundamentals like sentiment, liquidity, counter-party risk, etc. The weak factors seemed uncorrelated, so we imagined them collectively weaker yet. *Oops; double oops!*

One of our portfolio companies studies global equity markets in order to construct their successful global market neutral portfolio. Markets have oscillated between accuracy and distortion in a wonderful way, if your goal is to understand, at atomic granularity, how reality differs from theory.

The Efficient Market Hypothesis / Arbitrage Pricing Theory makes so much sense, yet has failed utterly for two years. Meanwhile, traders attuned to non-fundamentals have cleaned up. Were the traders right all along?

If we want better results, it might help to upgrade our navigational techniques. Tools differ in their accuracy, but accuracy does not always increase utility. As a young sailor I had a sighting compass (a compass in a telescope) for rough weather. It worked only on calm days, when I didn't need it. A tinfoil directional antenna on my AM radio was less accurate and looked silly, but it did the trick.

Research supports the trader's view that the weather matters. The energy state of the market, calm to chaotic, alters its dynamics:

- The energy state is fluid - it moves just like weather across a market landscape;

- The "local" energy state, as expected, determines the strength of interactions among variables (think of this as inverse latency, it *decreases* with more traffic);
- A change in energy state can cause a state-change in algorithms that define interaction among variables (i.e. a high positive correlation can "flip" to high negative correlation).

If the research is correct, then to navigate better we need to read the weather better. The bad news is that the tools to do so are not well developed – *break out the tinfoil?*

The good news is that we expect calmer weather, albeit with isolated thunderstorms, in the aftermath of the perfect storm.

Regulators worldwide are coordinating new market reforms. They want transparency and common infrastructure. By the end of 2010 most securities will be traded on exchange and settled without counterparty risk. This is overdue by decades at least.

Savvy and computer intensive traders have extracted unfair gains by keeping markets over-the-counter. In addition to favoring market insiders, this favors the well-funded. We have buy-side and sell-side oligopolies in bonds, derivatives, commodities and more. The cure is common settlement and deposit infrastructure, and daylight in the form of 24/7 exchange posting. It may take years for final implementation, but not decades.

Throughout 2009 an increasing proportion of stocks worldwide displayed "organized" price behavior. Still, carry the umbrella and watch for hail and lightning as the weather, shall we say, is changeable!