Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Is the Market Due for Another "Black Monday?"

By Mitch Zacks
Portfolio Manager

This year marks the 30th anniversary of Black Monday, October 19, 1987, when the Dow Jones Industrial Average fell 508 points (-22.6%) in a single day of trading. Many readers probably remember where they were during the crash, and maybe even how it felt.

30 years later, the market feels eerily vulnerable to a similar type of crash. Here's what I mean by that statement: back in 1987, the source of the precipitous decline was largely attributed to "portfolio insurance," which was a *quantitative tool* designed to use futures contracts to protect against market losses. Long story short, it backfired. Instead of working as designed, it actually created a disastrous feedback loop where automated programs were responding to selling with even more selling.

Fast forward to today, and you see an ever-growing number of institutional traders and hedge funds using quantitative, rules-based systems known as algorithms to trade stocks, make bets on volatility, attempt to mitigate risk, and so on. In other words, quant strategies exist today for many of the same reasons as the programs that helped cause the 1987 crash.

Recent History Suggests that "Crashes" are Not Only Possible, But Likely

Recent history already has a few examples where algorithm-based trading likely caused short-term hemorrhages in the market. On May 6, 2010, the S&P 500 fell 7% in just 30 minutes, as the bid-ask offers on stocks went completely haywire, in some cases with bids as low as a penny and offers as high as $100,000.

On August 24, 2015, the Dow dropped over 1,000 points *during the first 5 minutes of trading*, likely as a result of algorithms reacting to heavy selling pressure that occurred in China and Europe before U.S. markets opened. In all likelihood, the selling activity overseas caused a chain reaction where U.S.-based traders were using options before market hours to hedge against downside, exacerbating the downside when the markets actually opened. And

that is indeed what occurred: 25% of the Russell 3000 index was down 10% or more intraday, and many large ETFs traded far below the value of their underlying assets.

It's true, we've seen instances where algorithms were arguably the culprits behind wildly volatile, irrational price movements in stocks, and we'll probably see plenty more. But, that does not mean investors would be wise to fear these volatile spells, or to try and trade around them due to fear of total market collapse. In fact, the appropriate response in each of the above cases would have been to do precisely the opposite—ignore it.

This table helps to explain why:

Event/Date	Short-Term Market Impact	Market Performance That Year
Black Monday, 1987 Crash	-22.6% (Dow)	+5.81%
Flash Crash, May 6, 2010	-7% (S&P 500)	+14.82%
August 24, 2015	-10% (Russell 3000)	+1.38%

Every year there was a 'scare,' stocks still managed to post gains for the full calendar year. *The reason, in my view, is simple: because over time, stocks move to their intrinsic, earnings-driven values*. If earnings and the economy continue to grow over the long-term, then it really does not matter if the occasional tremor rattles the market. I'd suggest that any sudden, 'quant-driven' movements should not impact the long-term trajectory of stocks. And that's what matters to long-term investors.

Bottom Line for Investors

For all the efforts and money being spent trying to game the market for miniscule price movements over seconds of time, we do not think it will change the value of owning equities over the long-term. We believe that stocks will generate a similar return over the next 30 years as they did over the last 30 years, and so what happens on a day-to-day basis is far less important to investors than the importance of capturing that long-term return. That remains the focus of how we manage assets here at Zacks Investment Management.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

See what Mitch can do for you by visiting our website at ZacksPCG.com

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