

Day Trading, and Its Dangers

By BURTON G. MALKIEL

Last week's murderous rampage by a securities day trader in Atlanta has focused national attention on the frenzied world of day trading. While the motives behind the Atlanta shootings are complex, it appears that trading losses may have contributed to the shooter's ire.

What is day trading, this hot new phenomenon on Wall Street that has led many people to give up their regular jobs? What are the risks and rewards involved?

Books on electronic day trading top the lists of best-selling investment guides. They claim that ordinary people can find day trading a lucrative, exciting and accessible profession on today's wide-open electronic frontier. Harvey Houtkin, chief executive of All-Tech Investment Group, one of the day-trading firms where the shootings took place, is the self-proclaimed father of electronic stock trading. Mr. Houtkin claims that the resources of day-trading firms place individuals on a level playing field with the pros, creating financial democracy at its best.

Short-Term Profits

Day trading involves the pursuit of short-term profit through quick in and out trades, sometimes over a period of just a few minutes. For day traders the *long term* means later in the afternoon. These traders usually liquidate their positions at the end of each day. Day traders typically make use of a wide variety of online resources, such as Internet chat rooms and message boards.

Day trading in the stock market is akin to playing a computer video game each day while gambling lots of money at each click of the mouse. According to a trade association, thousands of investors play the game, and they represent a significant fraction of all trades executed during the day. Day traders can execute trades in the comfort of their homes or in the trading casinos made available by the large day-trading firms.

The techniques used by day traders vary, but most are based on some kind of momentum strategy. "The trend is your friend," as one Wall Street aphorism puts it. And it is not accidental that the largest day-trading firm (and another scene of the Atlanta shootings) is called Momentum Securities. Momentum strategies are not altogether foolish. The market is not a perfect random walk, and there is some evidence of short-term momentum in the pattern of stock price movements. But it is not at all clear that such patterns as may exist

represent true profit-making opportunities. No patterns are dependable all the time, and reversals in price trends occur with frightening speed. Moreover, whatever patterns exist are extremely small relative to the transaction costs that must be incurred to exploit them.

While it is true that the Internet has sharply reduced commission costs, online investors must realize that the biggest cost to trading is hidden in the spread between the bid and asked prices. Online day traders, even those trading directly with other investors through an electronic communication network, often give up a chance to trade within the bid-asked spread, as might be possible if they were using traditional brokers. Moreover, orders executed through many discount investment brokers are rerouted to other trading firms with the result that execution prices might reflect stock price movement subsequent to the time when the order was received. Thus the all-in transaction costs of online trading (including the high costs of margin borrowings) can substantially exceed the small stated commission cost. And if the trader in a high-tax state is successful, he will fork over nearly half of his gains to the tax man, since short-term gains are taxed at regular income tax rates.

Day traders have shown a special affinity for Internet stocks. Just as tulip trading became truly insane in 17th-century Holland when ordinary people started trading bulbs in Dutch taverns, so have the valuations of Net stocks as cyber-armies of day traders have eagerly snapped up the scores of new issues immediately after their offering. The entire float of even the largest Net companies such as Amazon.com changes hands twice a week. The spreading philosophy of the day traders that "fundamentals don't matter" may well have contributed to valuations of Internet stocks that can only be described in terms of a financial bubble.

To be sure, the communications revolution of the end of the 20th century is at least as significant as the Industrial Revolution of the late 19th century. The Internet will revolutionize the way commerce is conducted and will profoundly affect our daily lives. But the valuations of Net stocks can only be considered absurd. When the market capitalization of Priceline, a dot-com auction company whose site sells empty airline seats, exceeds the combined market capitalization of the major carriers Delta, U.S. Airways and United, one can only shake one's head in disbelief.

For all the boundless potential of cyberspace, eventually Internet companies will have to be valued in terms of their earnings. Internet commerce will succeed only if margins are razor-thin. And don't count on the power of the "first mover." Neither the first computer company nor the first Internet service provider prevailed. The same low barriers that enabled Amazon to challenge traditional booksellers will make the present leaders of the Net vulnerable to low-cost upstarts. While the Internet will deliver billions of dollars of savings to consumers, investors in Net stocks are likely to have the same unhappy results as did the biotech stocks that fetched similar astronomical prices a decade ago.

Predictably, there have been calls for further regulation of day trading and even suggestions that it be curtailed. The Wild West atmosphere of online day trading is addictive and will certainly ruin many who fall prey to it. Even worse, as one regulator put it, "When Aunt Minnie can access stock trading on her TV screen, we need marshals." Some critics also claim that armies of cyber-investors engender systemic risks for our securities markets and even for the economy as a whole.

There is no doubt that the legions of day traders are engaged in legalized gambling, and that most are likely to fail in this dan-

gerous pursuit. And there is no doubt that it is incumbent on securities firms to do a better job in acquainting their customers with the risks of jumping in and out of stocks each day. The lunacy of people spending hours researching the pros and cons of the appliances they buy, yet risking tens of thousands on a chat-room tip, cannot be stressed enough.

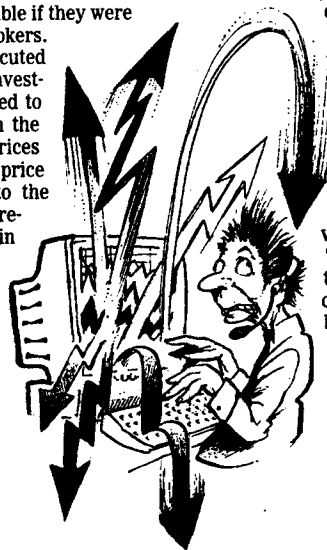
But surely a country that spends millions of dollars encouraging the poorest of its citizens to play state lotteries can hardly object to allowing its richer citizens the pleasures of gambling. As long as they are not misled by false and deceptive advertising, people who fall for such get-rich-quick schemes deserve the drubbings they are likely to get. And at least day-trading gamblers face better odds than those playing lotteries or casinos. Moreover, the amount of day trading is small relative to the clout of institutional investors, and it is not credible to argue that this activity poses systemic risks for our markets or our economy.

More Efficient Markets

In addition, day traders can actually benefit our markets in important ways. For example, one favorite strategy of day traders who are linked to market makers' trading screens is to scrutinize existing quotes and pounce on the bid or offer of a professional who is slow to react to price changes. While the market maker is likely to call such traders "bandits," they keep the pros on their toes and help make markets more efficient. Moreover, the day traders who access electronic networks directly will often narrow the spread between the best bid and offer prices in the market, giving all investors a better deal and squeezing the profits of the intermediaries.

And what of the Internet bubble, which I am sure will lead to the downfall of many day traders and investors alike? Even here there is a silver lining. The voracious appetite for Net stocks has funneled billions of investment capital into the industry and has encouraged legions of entrepreneurs to enter the field. It is not accidental that the U.S. leads the world in the development of communications technology for the new millennium. Such are the benefits of risk-taking and free capital markets, and this is the genius of capitalism.

Mr. Malkiel, a professor of economics at Princeton, is the author of "A Random Walk Down Wall Street," the updated seventh edition of which has recently been published by W.W. Norton.



He may lose his shirt—but that doesn't pose a larger risk for the markets or economy. In fact day traders can make markets more efficient.