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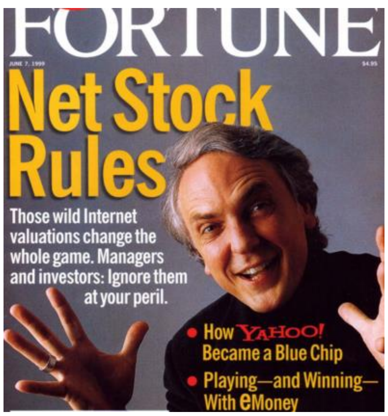


“How Yahoo! became a blue chip!”

“eMONEY!”

Current Views

↑EURUSD @ 1.1280
Stop at 1.1139
Take profit 1.1474

Wednesday, July 15, 2020

Forexplainer #17

A crazy trading story from the year 2000

Welcome to Forexplainer Number 17. As I explained on March 12, 2019 (AM/FX: Forexplainer 1): Each month, around the 15th, I will publish a longer-form piece called “Forexplainer”. Sometimes it is something educational I read elsewhere, and sometimes it is something I write myself. Today, a fun story from my day trading days.

The story feels super relevant given the current NASDAQ momentum bubble and the upcoming TSLA add to the S&P 500.

Enjoy!

This story appeared on LinkedIn, once upon a time, so if you already read it there—see you tomorrow.

Note: This piece is written from the point of view of my overconfident, 27-year-old self

July 26, 2000

It’s 3:05 p.m.

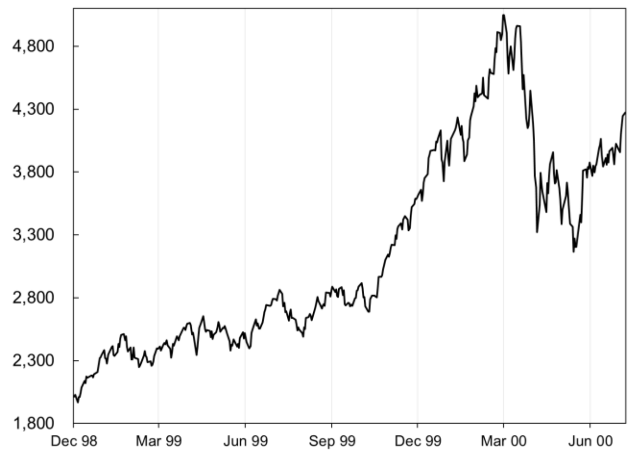
I am sitting at my workstation in a 50-person day trading operation in Toronto, Canada. I don’t have much risk on. Waiting for the 4 p.m. close.

A few months ago, in March 2000, the NASDAQ topped out just above 5,000 then crashed to 3,200. Everyone thought the tech bubble had gone permanently Tango Uniform. People thought: Finally, game over.

But not so fast. Now it’s summer and we’re trading back above 4,000, the Fed’s cutting rates and new all-time highs are within reach.

About a year ago, I deposited my entire net worth into a day trading account ($25,000). Now I’m running $350,000+. And it is worth noting this factors in a fair few purchases including a nice library of PlayStation 2 games, two years of rent in downtown Toronto, a sweet Sony 200-disc CD player and a black, 1996 BMW M3.

By July 2000, it looked like the NASDAQ was gearing up to make new highs again



Data from Bloomberg

Many days I bail out of here by 2 p.m. because there isn't much trading to do after lunch, but today I'm here for the close. It could be a big one. JDS Uniphase, a Canadian optical networking stock and internet darling, (NASDAQ: JDSU) will be added to the S&P 500 today. When a stock is added to an index, it creates a ton of demand for the stock because many funds simply track the indexes and so they need to buy the stock that's added in order to accurately mirror the index. The JDSU add was announced a few weeks ago and there has been some excitement about it. Today is the day.

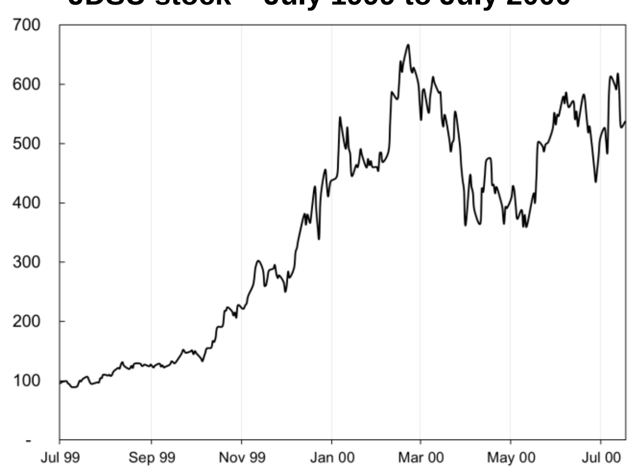
The indexers don't use any finesse when they add the stock. They just buy it at the end of the day. This leads to a situation where large S&P 500 adds create nearly impossible-to-fill demand for a stock in the closing moments of trading on the day the stock is added. Stocks close at 4:00:00 p.m.

I own 800 shares of JDSU, a decent but not super aggressive position size. Risking $4/share ($3,200 maximum loss or just under 1% of my capital).

It's 3:56 p.m.

To give you a sense of the hysteria around JDSU and Canadian tech darlings at that time.... From October 1999 to March 2000, JDSU Uniphase stock rallied 600%, splitting two-for-one three times in just six months.

JDSU stock – July 1999 to July 2000



Meanwhile, Nortel Networks, another Canadian technology favorite, represented 35% of the entire Toronto Stock Exchange market capitalization in July 2000. That's right. One Canadian company accounted for 35% of the Canadian stock market, dwarfing the Big Six banks and the hugely-profitable Western Canadian oil companies.

It's 3:57 p.m.

JDSU is trading around $132 and everyone in the entire day trading office (around 50 traders) owns some. I'm nervous because when everyone knows something in markets, it's usually wrong. The idea in trading is to know something before everyone else, and then get out once everyone knows it. But I don't want to miss the last push higher as every index fund in the world comes in to hoover JDSU.

It's 3:58 p.m.

The stock rallies to $136.50. I tap a few buttons and I'm out. No way am I holding on until exactly 4 p.m. It's way too dangerous. Sometimes with these index adds, too many people are positioned in advance and the buying from indexers isn't big enough to offset all the day traders trying to take profit so the price crashes right at 4 o'clock.

I am satisfied with the profits. I bought 500 shares at $129 about an hour ago and sold them at $136.50 for a profit of $3,750 minus brokerage. Brokerage is tiny so that's pretty much $3,750 in my pocket. Traders here keep 100% of P&L after bro. I settle into my seat to watch the last two minutes of fireworks. I feel like I should have a bucket of popcorn in my lap for this.

It's 3:58:40 p.m.

Tension builds in the room. There is always a ton of activity at the close, even when there is no index add, so with the JDSU thing happening, everyone is still here and everyone is locked and loaded for any last second opportunities. The greediest JDSU holders hope for one last push higher.

Our trading screen looks something like this (this is a sample showing Cisco Systems (NASDAQ: CSCO), not the JDSU window):

Level 2 screen for Cisco Systems circa late 1990s

This is called the NASDAQ Level 2 screen and it shows all the buyers on the left and sellers on the right. MMID means "Market Maker ID", BID is the price someone is willing to buy, SIZE is the number of shares (in 100s). Ask is the price someone is willing to sell. If the bid price matches an ask price, they match and the buyer transacts with the seller. When two prices match, a trade happens and both prices disappear. For reasons that I hope are obvious, the BID price is always lower than the ASK price.

The MMIDs indicate different banks and electronic communication networks (ECNs, or brokers) that place orders. For example, JPMS is JP Morgan, BOFA is Bank of America, LEHM is Lehman Brothers. ARCA, ISB, SIZE and BTRD are examples of ECN prices. ECNs are used by day traders and banks to show liquidity and execute in the market.

Our setup trades mostly with ISB, BTRD and ARCA. We trade using hot buttons assigned to the function keys. You set up your default number of shares (mine is set to 1,000) and the F keys on the left are F1: Sell on ISB, F2: Sell on BTRD, F3: Sell on ARCA. Then to buy you press F6 F7 and F8. You can operate these keys very quickly because there is no confirm dialog. You press F1 and you have instantly sold 1,000 shares of whatever stock window you are on at the best BID available on ISB.

It's 3:58:50 p.m.

I am relaxed, watching the prices spin higher and lower in the JDSU window. My PC can barely keep up with the number of quotes and trades being jammed down the pipe but somehow it manages and the information continues to flow smoothly and impossibly fast. Then I notice something weird. JDSU is $141 bid on ISB. And $140 ASK on ARCA. Impossible. And it's not just there for a microsecond. It's just sitting there.

"Guys, you see this?"

Everyone is in the zone, doing their own thing. Nobody has noticed the discrepancy.

I tap F1 and then F8 in succession, selling 1,000 shares at $141 and buying them back at $140 in less than a second. My P&L clicks $1,000 higher. I do it five more times in about 5 seconds. Still believing this is probably too good to be true, I check my P&L. This must be a mindfart right? Wrong. My P&L is $5,000 higher than it was before I made the keystrokes.

"Dude! ARBITRAAAGGGGGE!"

I yell out, to no one in particular (channeling the 1994 Beastie Boys song: Sabotage). Then I go nuts on the keyboard. F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 as fast as I possibly can. Like a kid playing the 1980s coin op video game "Track and Field".

I pause for breath and check my P&L. Up another $12,000 in about 12 seconds. The ISB and ARCA feeds both reset at 4:00:00 because the market makers drop out at the official close. I can only do this arbitrage 'til 4.

It's 3:59:35 p.m.

F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8 F1 F8

24 more times I press the F1 to F8 combo and my P&L jumps another $24,000 in less than 30 seconds.

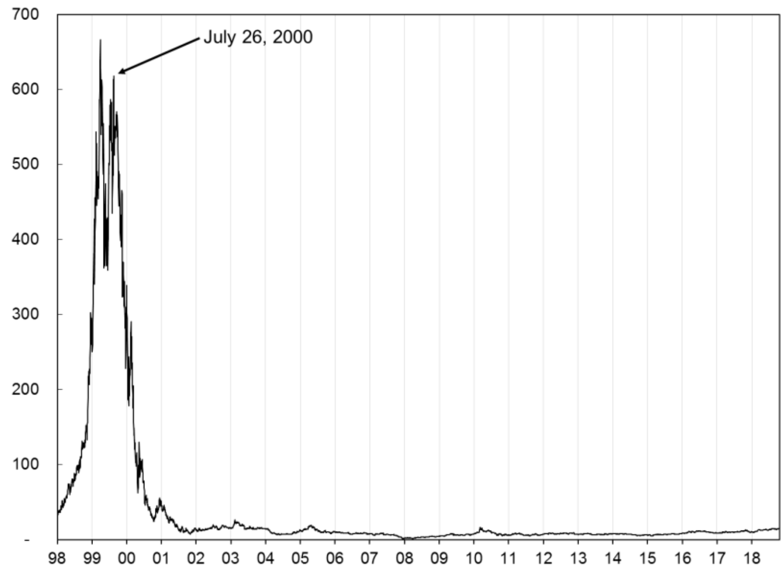
My final P&L that day is +$48,500, the best day anyone had ever realized in that office to that point. Everyone gathers around my desk. My heart is pounding, vision pulsating. My buddy points to my P&L.

"Nice!"

Post-script

Never before or after that day did I see a market inverted like that again. It was a one-time deal. JDSU stock never traded higher than the 4:00 p.m. print on that day: July 26, 2000. It went on to lose 99% of its value in the next few years. Here's the chart:

JDSU common stock: 1998 to 2019



Note that due to reverse splits, the prices on this chart don't match the prices in my story

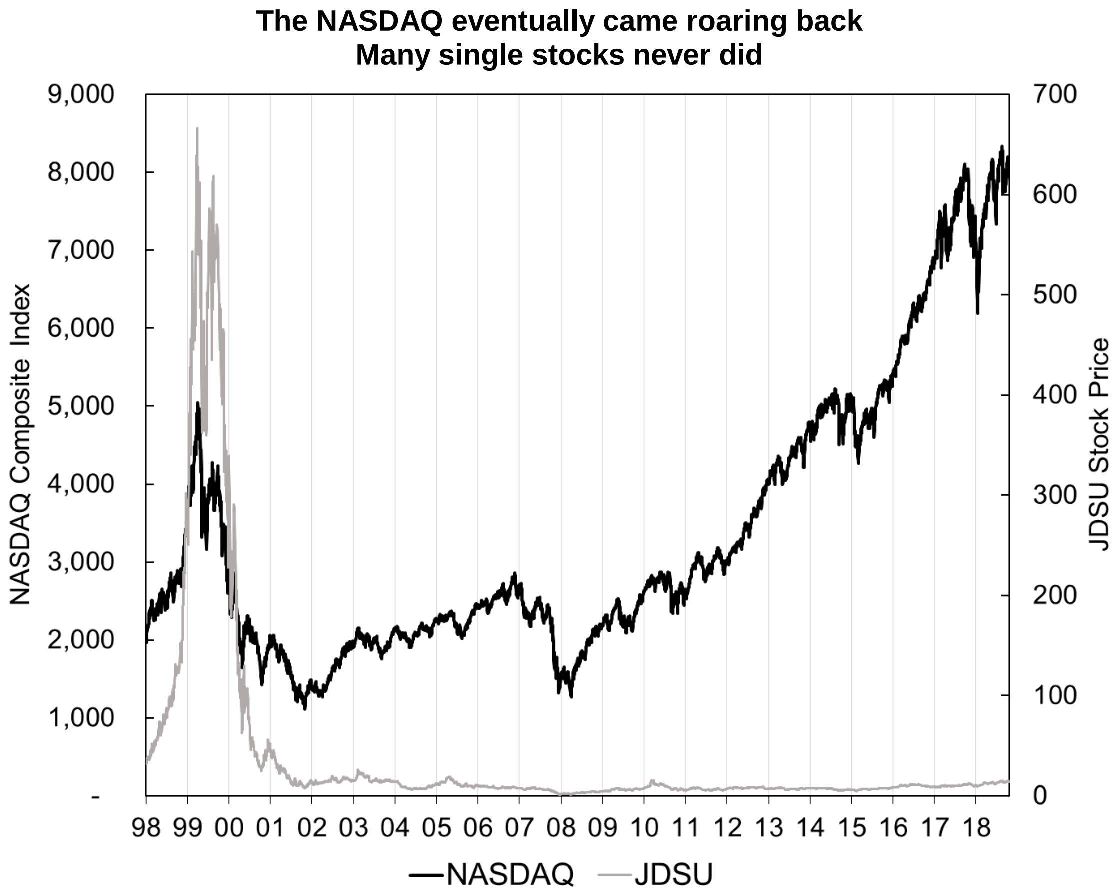
Also: That day was also high water for my P&L and the peak equity for my trading account. The NASDAQ made its final last gasp high a few weeks later. Never in my life was I more overconfident than in the weeks immediately following that day. By mid-2002, I shut down my account with a balance below $35,000 and I was out looking for a real job by early 2003. Insult to injury: I had to hit a ridiculous low-ball bid to sell my M3 to pay the rent. But like the tattoo says: No Regerts.

I got crushed by a confluence of overconfidence and some epic market-altering events. The two biggest changes that killed the day trading community were decimalization (effective April 2001) and the collapse in price of every single NASDAQ stock (around the same time).

My main strategy was to capture the bid/offer on high-priced stocks. Each morning, starting in 1999, I printed off sheets listing every NASDAQ stock trading above $100. In 1999, that list was four pages long. By 2002, it was four stocks.

Four lessons learned:

1. Markets don't stay inefficient forever. The NASDAQ was wildly inefficient from 1998 to 2001. If you find an inefficiency, make hay while the sun shines and stash away as many nuts as you can for winter. Winter is always around the corner.
2. If you are overconfident, the market will swiftly and harshly beat that overconfidence out of you.
3. Trading can be incredibly fun.
4. Indexes don't tell the full history…



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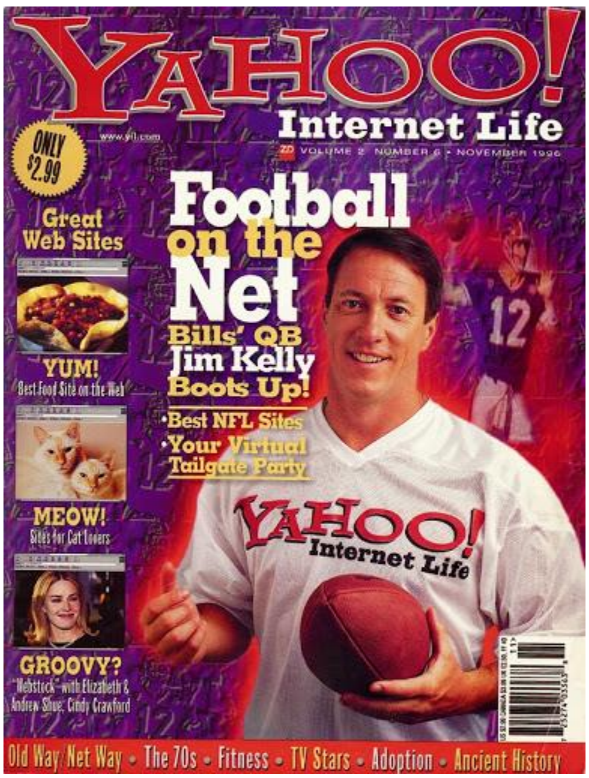
Thank you for reading today's Forexplainer. Back to regular AM/FX tomorrow.

Good Luck ↕ Be Nimble



The birth of the internet was a special time in history.

It felt kind of like the opposite of right now.

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