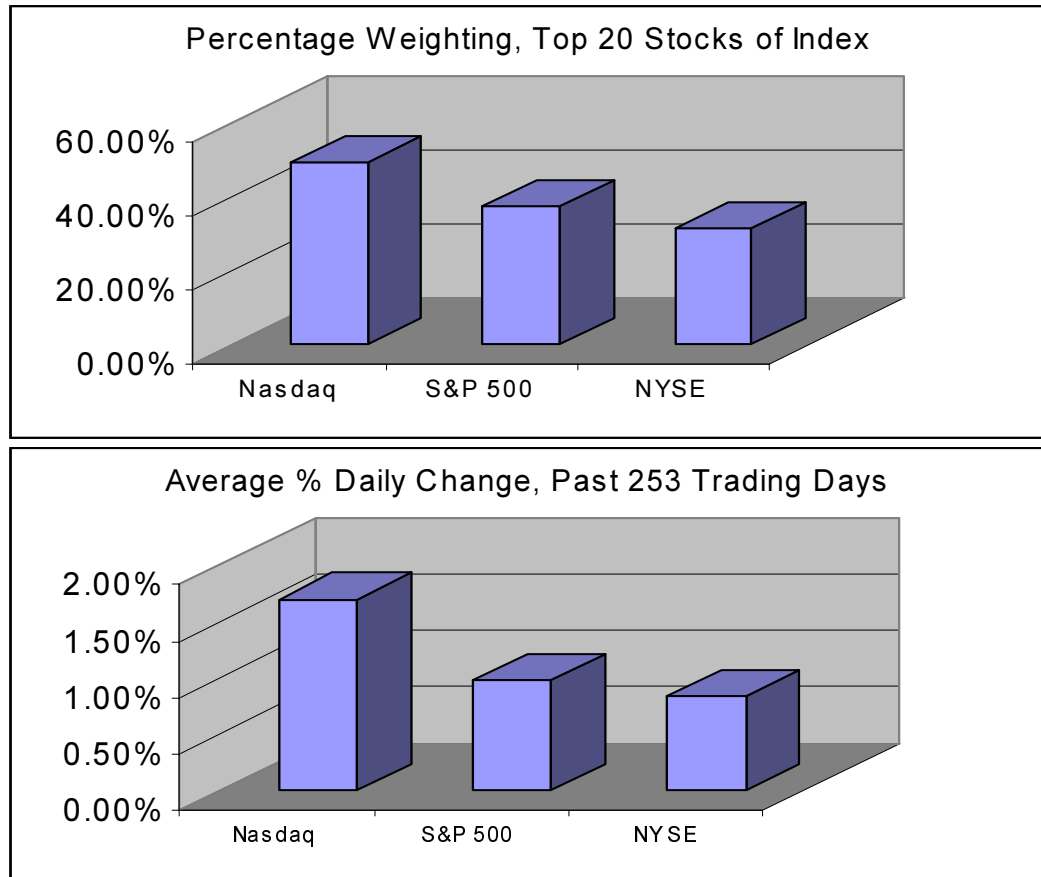


Volatility in the stock market rising ... what's to blame?

By Howard Spieler



With stock market volatility increasing, several theories have been put forth as to why the major indexes have been undergoing such swings over the past several years. Some influence is probably associated with the increase of online brokerage accounts, which allow investors to purchase stocks at low commissions from the comfort of their home or office. Day traders, who now comprise 25% of the activity on the Nasdaq, probably add to the market's volatility as well. The pure strength of the bull market, which has seen many billions of institutional dollars pour into the stock market, mostly into index, growth or aggressive growth mutual funds, as well as steadily increasing trading volume have all been factors in the increased volatility. With so much money chasing relatively few stocks, the major indices began to reflect these changes as the market capitalization of those stocks began to surge. The Nasdaq Composite, the NYSE and the S&P 500 are all capitalization-weighted indices, which means that the higher a company's outstanding shares times share price, the more representative it is in an index. Therefore, as a company grows in terms of price (and therefore market capitalization), the more it is represented in its respective index(es). For example, the three largest Nasdaq companies, Cisco, Microsoft and Intel comprise over 25% of the Nasdaq. It would take the movement of 4,702 companies to offset the price movement of the twenty largest companies listed on the Nasdaq Composite.

As the concentration of stocks as a percentage of an index has risen, so has the volatility of that index.

The lower of the two charts above tells us that the 253 day average percent change of these three indexes are at 1.69, .97 and .83 for the Nasdaq, S&P and NYSE respectively. If you reference the higher of the two charts you will also see the percentage weighting the top 20 stocks have on each individual index. It is no surprise that the higher the representation in an index of the top 20 stocks, the more volatile that index appears to be. Incidentally, for each index, the 'halfway point', or the point where the largest stocks in an index make up more than half the movement, are after the 23rd largest stock in the Nasdaq (out of 4,722), the 36th largest in the S&P (out of 500) and after the 53rd stock on the New York Stock Exchange (out of 2,796). This concentration into a handful of stocks has surely been the cause of much of the movement in these indices the past several years. (Note: The world's most followed index, the Dow Jones Industrial Index, is price weighted and not cap weighted; therefore the size of the company is not relevant to computing the index, just the price).

Implications of this volatility question the validity of the technology-led bull market of the last several years. The Nasdaq Composite was clearly carried by their biggest stocks, some of which have had remarkable runs by as much as several hundred percent. We saw in April what could happen if these stocks started to sell off - many of the biggest fell by as much as 25%, causing a Nasdaq correction that won't soon be forgotten. Perhaps the men and women who compute these indices should reevaluate the methods employed.