

One-Day Market Collapses - Time to Buy or Time to Run?

By Howard Spieler

You know the feeling. It's only lunchtime, but the Dow is down 200 points, the Nasdaq and S&P 500 are dropping like a rock and the announcers on CNBC are beginning to panic. Ask ten different investors, and you will get ten different answers on how to respond appropriately to these awful market days. Momentum players and technical analysts might prefer to sell immediately, fearing a correction or worse is possibly on the horizon. Other investors believe this represents a buying opportunity and purchasing on dips ("bottom fishing") is the best way to play the short-term game. We decided to examine these large declining days and see just how the market immediately responds to extreme, one-day drops.

For the purposes of this article, a three percent drop in the NASDAQ Composite Index based on the daily closing prices was deemed sufficient enough to cause at least a small panic in the overall market climate and change investors' attitudes. Please remember that only the percentage change on the next business day was studied, so this is a far cry from a trading system to buy on dips as an overall investment philosophy. However, this analysis provides some insight into investor optimism (or pessimism) when panic hits our financial markets and the public's response to selling pressure throughout the years.

The time period studied is from May 1971 through the present, covering approximately 7,200 daily observations on the NASDAQ. Since then, there have been 46 instances where the Nasdaq has fallen by 3% or more. Interestingly enough, 24 of those (over 50%) have occurred during the fantastic bull run of the 90's. The following chart illustrates how the market has fared historically the next business day after a 3% or worse decline.

46 observations	Nasdaq fell 3% or more in a single day
** 25 instances	Down the Next Day (54.35%)
** 21 instances	Up the Next Day (45.65%)
Average Up Day	1.97%
Average Down Day	(2.01%)
Average Next Day	(.019%)

As you can see the average return on the NASDAQ following the day after a large one-day decline is a negligible -.01%. However, when you separate the up (positive return) days from the down (negative return) days, you see the extreme market volatility that exists on these days – the average daily change is 2.13%. When the market is up, you secure a healthy gain, on average, of over 2%. But when the market is declining, it falls by another 2%. However, this study travels back to 1971. What if we isolated the 1990's, and looked at the results of the next business day?

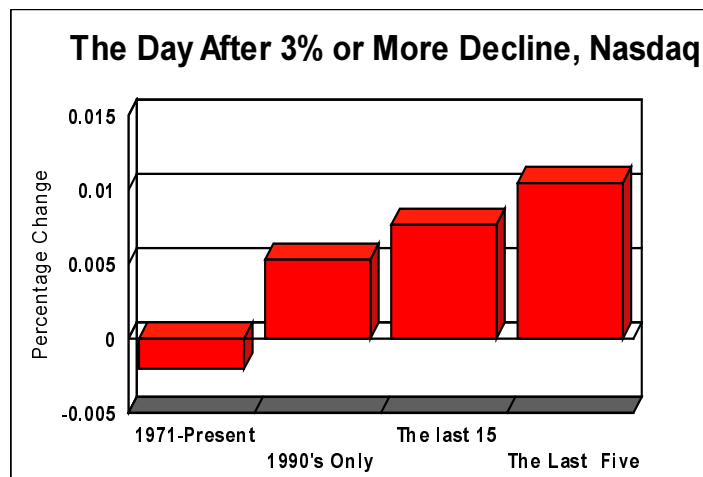
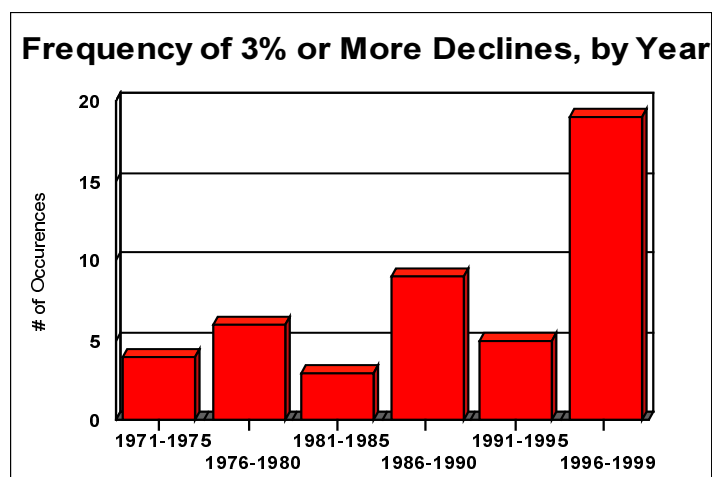
24 observations	Nasdaq fell 3% or more in a single day in the 1990's
** 14 instances	Down the Next Day (41.67%)
** 10 instances	Up the Next Day (58.33%)
Average Down Day	(1.20%)
Average Up Day	1.79%
Average Next Day	.55%

During the 1990's (a period where the Nasdaq has increased an astounding 500%), the strong secular uptrend in the Nasdaq proved profitable purchasing on dips, with the average daily change on the days after large declines resulting in a positive .55% return. Next, we will investigate the last 15 occurrences of NASDAQ market drops of at least 3%, to see if the upward trend persisted.

15 observations	Nasdaq fell 3% or more, last 15 occurrences (since January 9, 1998)
** 9 instances	Up the Next Day (60.00%)
** 6 instances	Down the Next Day (40.00%)
Average Down Day	(1.56%)
Average Up Day	2.31%
Average Next Day	.77%

Lastly, we will examine the last **five** occasions of market drops in the Nasdaq composite of 3% or more.

5 observations	Nasdaq fell 3% or more, last 5 occurrences (since February 9, 1999)
** 3 instances	Up the Next Day (60.00%)
** 2 instances	Down the Next Day (40.00%)
Average Down Day	(.20%)
Average Up Day	1.88%
Average Next Day	1.05%



Conclusion

Our data indicates that as we approach the year 2000, our average daily return increases as does our chance for the following day to be a profitable day following a large, one day decline on the Nasdaq. The 1990's have been so strong for the stock market, especially the technology sector, that investors have used the days where the market was falling as an opportunity to pick up stocks "cheaper". What is worth noting is the fact that over half of the 3% or more declines that were studied in this article occurred in the 1990's, which happened to be the strongest bull market of all time. This is most likely an indication of how volatile the Nasdaq Composite has become. As the stock market has gotten stronger, especially in the late 1990's, so has the likelihood that the market will rebound the day after a large percentage point drop. Since 1971, the average "up" day following one of these large declining days is well over 2%, leading us to believe that if we can isolate when the market is more likely to rebound, it can be a profitable way to "bottom fish". However, the average "down" day was a loss of 2% - making buying these dips a high-risk proposition.

Also worth mentioning is the frequency with which these 3% declines have occurred in the 1990's. Almost one third of all these declines (15 out of 46) have occurred since January 1998, just twenty months ago. Before then, the Nasdaq Composite, on average, had a 3% decline about once per calendar year, except for the period around and including the 1987 crash. Volatility has risen to such extreme levels that even in a period where the Nasdaq has risen well over 60% (January 1998 to present) assorted crises has led to panic selling by the investing public. (Remember the Asian Flu, the Thai currency devaluation, Russia's defaulting on IMF loans, financial problems in Brazil and Argentina and now the newest quandary, interest rate fears?) Of course, there are also the usual suspects to blame for the volatility, namely day traders, momentum players and an army of internet stock traders. Even in a period of unprecedented strength, the Nasdaq Composite between 1996 and the present has had a one day "correction" of 3% or more 19 times, or about one every two months! As most investors have now realized, the stock market, especially the technology sector, is in a historically high level of volatility. The best bet for the serious investor is not to panic, to remain focused on their investment goals, and to realize that volatility is now part of the investment game.

Any questions or comments feel free to e-mail SandF@Signalert.com