

Stocks Rise on Katrina Cleanup, Oil-Price Drop

*Usually Slow Week Gets Very Busy
Market Study of Investors Shows
Downside of Frequent Trading*

BY JUSTIN LAHART

Wall Streeters came back from their Labor Day weekend holiday rested and ready to buy last week.

Cheered by lower oil prices, signs that there was finally some order to relief operations in New Orleans and a belief that the cash going into rebuilding efforts would allow the economy to bounce back strongly, traders pushed the Dow Jones Industrial Average up 231.19 points to 10678.56. It was the biggest weekly gain since May.

Meantime, analysts published reams of reports detailing how Katrina would affect everything from aluminum smelters to mobile-home makers for investors eager to make a profit. With so many people struggling to find an edge, what would normally have been one of the sleepiest weeks of the year was busy.

But whether investors who traded more than others gained any advantage isn't clear.

Overall, investors appear to be trading even more now than they were five years ago, says **Arun Kaul, principal at Toronto hedge fund Hillsdale Investment Management.** According to his recent research, 27% of the stocks in the Standard & Poor's 500-stock index have monthly trading volume that during a six-month period would equal or exceed the number of shares available for trading. Just 16% of S&P 500 stocks traded that briskly in March 2000, when the stock market reached its peak amid ads for online brokers extolling the benefits of cheap cyberspace trading.

Back then, many individual investors learned the hard way that frequent trading isn't necessarily a road to riches. Professors at the University of California confirmed in a study based on one large discount broker's trading records from 1991 through 1996 that investors who frequently traded had lower returns than infrequent traders. They also found that investors who switched their trades to the computer from the telephone traded more and saw their performance deteriorate.

Now, however, online-trading data show that individual investors aren't trading as rapidly as in 2000, says Sandler O'Neil & Partners analyst Richard Repetto. The implication is that the increase in rapid-fire trading is caused mostly by professional investors, with the swelling ranks of hedge-fund managers the most likely culprits.

Whether frequent trading is as dangerous to fund managers as it is to individuals is an open question. Some professionals have strategies that are built around taking advantage of small differences in the prices of different securities. Such strategies can entail very frequent trading.

But many fund managers are under intense pressure from clients to perform well on a short-term basis, and their frantic attempts to keep up with their peers may lead them to exit some stocks too quickly and buy into others too rashly.

Furthermore, professionals have a staggering amount of information at their fingertips, giving them the ability to quickly call up a year's worth of analyst notes on Wal-Mart on a whim. Being able to instantly know what Japan's economy did after the Kobe, Japan, earthquake may seem useful, but the risk is that having lots of information can make investors overconfident in their ability to predict the future. Among individual investors, the most confident tend to be the ones who trade most frequently.

Dresdner Kleinwort Wasserstein strategist James Montier says that overconfidence seems to be such an ingrained human response that even professionals can't escape it. Studies have shown that accuracy of bookmakers in setting the odds for a horse race, the ability of psychologists to reach a diagnosis and the ability of candidates for master's degree in business administration to predict earnings improve only marginally when they are given more than basic information. But their confidence in their abilities increases more.

Mr. Kaul says that new trading technologies and a proliferation of new products, such as Exchange Traded Funds, have allowed hedge-fund managers to develop fast-trading strategies

Trading Signals

Percentage of companies in the S&P 500 that have holding periods of six months or less



that limit their risk while generating good returns. But he also thinks that so many hedge funds have piled into those strategies in the U.S. that the possibility of generating big returns has been whittled away.

Whitney Tilson, managing partner at hedge fund T2 Partners, is puzzled as to why so many hedge funds focus on short-term trading. Most hedge funds allow clients to withdraw money only infrequently, he points out. That should give these funds' managers the luxury of entering into long-term trades that mutual-fund managers, whose clients generally can take out money at any time, won't risk. One of Mr. Tilson's favorite strategies is buying long-dated call options, which grant him the right to buy stocks at a set price years from now.

Robert Arnott, chairman of money manager Research Affiliates, reckons that one reason investors trade a lot is that they want to generate returns quickly -- a symptom that may apply to newly minted hedge-fund managers trying to make names for themselves and pull in money.

"People are impatient to succeed, almost assuring that they won't," he says.

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