

## Reduce Your Flash Crash Risk



May 6's flash crash shook markets and made headlines around the world. Most importantly, it impacted the individual investor who trusted the stock exchanges and their pricing efficiency. But when Apple (AAPL) traded at nearly \$100,000 a share when it should have been around \$235, investors can't help but wonder whether the market is no longer safe.

### What is a flash crash?

Today's trading environment combines a tremendous amount of fast computer trading and a large number of players (hedge funds, banks, mutual funds, high frequency trading firms). The speed at which these trades go through the system compounded by the number of trades can set the scene for the system to lose control.

Regulators, in trying to protect investors, have implemented some circuit breakers, but the jury is out on whether these measures will prevent a flash crash from happening again.

The flash crash was not limited to individual stocks. ETFs (exchange-traded funds which hold these stocks) plunged. I am a proponent of ETFs because you can buy and sell them easily and they offer diversification, performance and low fees. But on May 6, many ETFs fell far below the value of their underlying stocks. There was a huge disconnect in pricing.

So how does an individual investor invest in stocks and ETFs with the risk of flash crashes?

Avoid investing during times when there is strong news that would cause the market to panic. Market volatility is a sign that there may be a significant difference in the bid and ask price (the price the seller is willing to sell the stock for and the price that a buyer is willing to pay).

- Avoid buying right when the market opens. There is often less activity at that time so there can be a big difference in the price that is quoted and the price that you pay, especially for lesser known stocks and ETFs.
- As a matter of practice, whenever you buy a stock or ETF, start putting a limit price on your order. A limit price is the price you are willing to pay for a stock. When the stock's value reaches your limit price, it will trigger a buy order. That helps you avoid paying an outlandish price for a stock. The same applies to an ETF.
- When selling, you may not want to put in a limit order. A limit order is when you put in an order to sell a stock or ETF when it falls to a certain price. The problem during May 6's flash crash was that the orders could not be filled at

that price so many stop-loss orders were filled at prices far below the limit the seller set. To make matters worse, the market rebounded after the incident so many people got out at the bottom.

- Consider buying an index mutual fund or a sector mutual fund if it is too much work for you to watch the market to get a limit order executed. But remember, mutual funds can only be bought and sold once per day. ETFs trade like stocks.



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