

# GREY VALUE MANAGEMENT, LLC

## LIVEDOOR / TSE BREAKDOWN TRADE

### iShares MSCI Japan Index ETF (EWJ) Trade on Overreaction to Livedoor Scandal and TSE System Breakdown (January 2006)

This trade was based on a very unusual confluence of events: (1) An exceptionally strong reaction to a scandal surrounding alleged violations of disclosure rules (among other regulatory concerns) by a Japanese company called Livedoor and (2) A technology-related breakdown of order flow on the Tokyo Stock Exchange (TSE).

On January 18<sup>th</sup> 2006 the TSE, the second largest stock exchange in the world, was so overwhelmed with order flow that for the first time ever it shut down trading early. The Nikkei 225 average, which rose by 40% in 2005, declined 5.7% in two days, as did the broader TOPIX Index. Despite the fact that Livedoor wasn't even listed on the TOPIX, one theory making the rounds was that so many online traders used Livedoor shares as collateral that a multiplier effect took hold. Historically speaking, this type of cross-security contagion isn't without precedent. The advent of online brokerage accounts and powerful influence of program-driven trading inevitably increases the odds of self-reinforcing declines in the market. Exchange officials certainly didn't have to exacerbate the problem on the 18th by announcing at mid-day that they might close the TSE early that day. It's hard to think of a better way to trigger a stampede.

What does any of the preceding have to do with the apparent recovery of the Japanese economy or the companies that comprise the iShares MSCI Japan Index ETF? *Absolutely nothing*. It was a dislocation triggered by technical factors that had no relationship with the fundamentals underlying the index and assets it comprises.

Hence, this was a rational speculation both entered and exited very aggressively, although for divergent reasons. Shortly after I put the position I began to suspect that in order to have a substantial return the trade would likely have to be held for an extended period. Even if the EWJ proceeded to over-correct to an overreaction, it was unlikely to bounce back hard enough to deliver a significant profit.

Having not contemplated the big-picture fundamentals when I legged into the trade, I resisted the potentially lethal temptation to convert a short-term trade into a long-term investment. From a speculative viewpoint, the round trip wasn't a bad maneuver, but there were no victory laps when I closed out the position. I had only succeeded in picking an easy nickel up off of the pavement before the steamroller got too close to my fingers.

Average Purchase Price	\$13.26
Average Selling Price	\$14.00
Gross Return on Trade	~ 5.5%
Timeframe (2006)	~ 6 days

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