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Skipping trades at the open



By Staff Writer Alex Frew McMillan May 3, 2000: 10:30 a.m. ET

Individual investors may not realize how much value their orders have

NEW YORK (CNNfn) - If you trade at the opening bell or in the first hour of trading, you're taking your investment into your own hands, investment world insiders say. Likewise if you place a market order while the market is closed.

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In fact, thanks to entirely legal games that some Wall Street companies play that some call "information arbitrage," individual investors regularly may not get quite the best deal. But the problem is particularly severe when trading opens.

The most active time of the day

"If you watch the first hour of trading, it's like the Wild West," said Bill Burnham, a general partner with venture capital company Softbank Capital Partners. Along with the close, it's the most active part of the trading day. Most investors would do better to wait until the market quiets down before placing a trade, he thinks. "There's clearly less hanky-panky going on after the first hour."

Why? Often, there's a build-up of orders to buy or sell stock that has accumulated overnight at brokerages, from individual or "retail" investors placing orders after hours. Like they do during the day, the brokerages then typically sell the orders to market makers.



Market makers are brokerages that create the markets in Nasdaq stocks by offering to buy and sell them. The largest are companies such as Knight/Trimark, Herzog Heine Geduld, Bernard L. Madoff Investment Securities and Schwab Capital Markets, formerly Mayer & Schweitzer.

The power of information

Though Joe Investor doesn't see his trade as particularly meaningful other than to himself, the retail volume is very valuable when it gets aggregated. Thousands of orders in a certain direction do paint a clear picture of what's happening to a stock. That happens at a market maker, and that's one main reason they pay for the order flow.

The amount they pay varies depending on the kind of order and the stock. But it's common to pay around \$2 a trade, according to Burnham, a former online-brokerage analyst with CS First Boston. It's worth the market makers' while because they make the money on the spread, the difference between buying a stock from one investor at one price and selling it to another at a slightly higher price.

But it's also worth their while because the information is very valuable. If a market maker can corner even 20 percent of the trading volume in a stock, it starts to get a good idea of how demand is shaping up. They can use that information to their advantage.

Best price not what it's cracked up to be

For instance, if the market maker realizes there is pent up demand for a stock building overnight in the form of market orders to be executed when trading opens, the market maker can buy stock for

its own account on electronic communications networks, or ECNs, such as Instinet and Island ECN before trading opens.



When the stock does open, the market maker can typically "walk the price up." That means it steadily raises its bid price to buy stock. Sometimes it may move the price so aggressively and rapidly that it rises above the offer price other market makers were selling at. That process, called "crossing and locking" the market, then forces all the brokerages to move their prices up.

The market maker can then sell the stock it bought on the ECNs to individual investors at a profit. The investor ends up paying a higher price at the open or soon after than he or she would have received at the close of the previous day's trading.

A free option

As a result, submitting a market order before the market opens is "handing a blank check to some traders," Burnham said. (See the bottom of this article to a link to a story he wrote on the subject). But even limit orders can play into market makers' hands.

Say there's a limit order on the books at a market maker to buy XYZ stock at \$10. There is also a market order on the books to sell at \$10. The market maker could cross those trades and look to profit on a spread from the limit order.

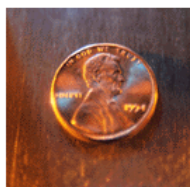
Instead, Burnham says, a market maker with a large amount of retail orders to buy XYZ may choose to "improve" the price of the market order. So the market maker sells to that investor at \$10.0625.

The key to why a market maker would do that is the retail order information -- the market maker has orders to buy the stock, and therefore a very good idea the price is moving higher. So it pays 1/16 for what amounts to an option on the stock. The downside is negligible -- if the stock does drop, the market maker can offload the stock to the investor with the limit order.

Most investors don't know or care

Paul Schultz, a professor of finance at Notre Dame, has often heard the "free option" strategy tossed around. "I don't know how frequently they exploit it," he said, but it makes sense they would.

"If you have a large proportion of the order flow, you have a better sense of where the market is moving," he said. "If you have a considerable amount of the order flow, then you can exploit that information." He agrees the situation is particularly pronounced during the first hour of trading.



But most investors don't care or don't know. "Most of the public is naïve about this," he said. For good reason -- the price any one investor ends up paying is normally negligible, since market makers have time constraints and "best execution" rules that protect investors. "You're going to get knicked for 1/16th here or an 1/8th there," Schultz said.

Big deal, right? But the more you trade, the more significant the impact. Same with the larger the block -- give up 1/8 on 500 shares and you're talking \$62.50.

Other trading tips

How else can investors protect themselves, other than avoiding trading at the open? It is easier for market makers to corner more of the volume in moderately or lightly traded stocks. So sticking with the largest capitalization companies offers some protection. Investors can check what portion of the volume in a particular stock goes through specific market makers on the Nasdaq Trader Web site.

Investors can also seek out brokerages that don't accept payment for order flow. But Schultz pointed out these are virtually impossible to find -- a few advertised the fact only to discover that investors didn't seem to care, he said.

Another step investors can take is to look for brokerages that direct orders to an ECN. ECNs link trades electronically. Their main incentive is to execute as many trades as quickly as possible, and

they don't trade for their own account.

Finally, Schultz suggests that investors just not trade frequently. Though commissions are dropping, these less obvious costs are more important the more you trade. "Even though trading costs are lower than they used to be, it's going to add up," he said.

Execution may get more attention

David Whitcomb, who runs a computerized-trading company called Automated Trading Desk, said his company makes most of its money from trading during "fast markets" and times like the open, when the price of a stock is rising or falling rapidly. But it profits electronically from the small kinds of inequities that may victimize small, individual traders.

He agrees they should probably trade at other times. Most investors only pay attention to commissions when they're getting trades executed. But Whitcomb thinks execution will become more of an issue as investors get wise to something that certainly has an effect on them.

"If you're the very occasional trader (who) loses 1/16th or even 1/2, but he only trades three times a year for 200 shares, that's hardly noticeable," Whitcomb said. "But if you trade dozens of times a year or even dozens of times a month, it's really worth the trouble to get best execution."

Whitcomb thinks the importance of getting trades executed quickly and at the best price will lead to an increase in popularity of brokerages such as CyberCorp, now owned by Charles Schwab, and Tradescape.com.

Tradescape.com is backed by Softbank, Burnham's company, so he is not entirely disinterested on the issue. Burnham points out that Softbank was also an early investor in E*Trade, which accepts payment for order flow and helped start the big market maker Knight/Trimark. Schwab, which owns a market maker, also now owns CyberCorp, which effectively reduces the market makers' advantage.

In any case, Whitcomb expects investors to hone in on such brokerages that provide "direct access" to ECNs. Using intelligent order-routing software that looks for the best price on the different trading platforms, enabling active traders to get trades executed fast and efficiently.

"Once customers start complaining and migrating to brokers that do offer best execution, I think more online brokers will offer it," he said. ■

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