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## The waterfall effect, and why traders go rogue

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Market traders' exposure to extreme volatility may distort their perceptions of risk, which might explain why some of them go rogue.

According to new research, published in the journal *Current Biology*, the perceptual bias that comes with prolonged exposure to stimulus can be as readily applied to markets and traders as anything else.

The research, by academics from the University of New South Wales, Swiss Finance Institute and University of Geneva, found that just as someone watching a waterfall for a while begins to see the rocks around it moving up rather than the water down, so too, market-watchers in front of a Bloomberg screen might lose perspective.

The team arrived at this link via a number of tests.

In one, 56 test subjects are exposed to 50-second periods of Bloomberg-style market stimulus, split evenly between moments of high volatility and moments of low volatility.

Each exposure period was immediately followed by a test phase comprising 20 seconds of medium volatility.

Participants were then asked to rate the perceived volatility of the test stimulus on a five-point scale, using the medium volatility as the baseline.

Those exposed to high volatility saw less difference between that and the base period, while those exposed to low volatility saw more of a gap.

The study's author and UNSW Business School senior lecturer, Elise Payzan-LeNestour, said the research may help to explain rogue trading, which is usually attributed to a heightened appetite for risk, inadvertently encouraged by management oversights and regulatory pitfalls.

Cases of these abound.

In September 2011 the chief executive of UBS resigned after unauthorised trades by the head of the Swiss-based investment bank's global synthetics equities team cost it more than \$US2 billion (\$2.76 billion).

More recently, bankers in Britain have been accused of manipulating a key interbank interest rate to maximise profits.

Closer to home, Australia's securities regulator has alleged that some of the country's biggest banks did the same with the Australian equivalent.

In its latest statement of claim, the [Australian Securities and Investments Commission \(ASIC\) alleges that Westpac manipulated the bank bill swap rate to favour its own positions in the market.](#)

"Our findings point to a complementary root cause, an adaptation to chronically high levels of risk and subsequent risk blindness," Dr Payzan-LeNestour said.

*This story was found at: <http://www.smh.com.au/business/markets/the-waterfall-effect-and-why-traders-go-rogue-20160516-govjup.html>*