The Financial Navigator – August Newsletter

Some of you may remember the stock market 'flash crash' of May 2010 when the Dow Jones Average plummeted 700 points in minutes. Something similar, but on a smaller scale, occurred earlier in the month, along with the same commentary about the evils of computer trading and how the stock market is nothing more than a roulette wheel stacked against the average investor, etc.. While some of the criticism is warranted, I thought the following article would put this event in context especially for the small investor. In addition, an unusual event has been occurring around the globe; investors are purchasing government bonds with negative interest rates, as explained in the following article - 'The Cost of Safety'. Essentially investors are paying the various governments to hold onto their money; might be something to consider if you are one of those taking the opposite tack by taking on higher risk trying reach for yield.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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Knightmare on Wall Street

Weston Wellington, "Down to the Wire", Vice President-Dimensional Fund Advisors.

Question: Which of the following statements applies to early August's stock market behavior?

- Computer errors at a major trading firm generated millions of faulty trades, causing dramatic and puzzling price swings in dozens of stocks on the morning of August 1.
- A New York Times columnist fumed that "Wall Street has created its own Frankenstein. The machines are now in charge."
- Stocks on the fifty-two-week new low list included Dell, Facebook, Ford Motor, Hewlett-Packard, and Office Depot.
- Stocks on the fifty-two-week new high list included AT&T, Abbott Laboratories, Allstate, Berkshire Hathaway, Coca-Cola, Colgate-Palmolive, Consolidated Edison, Gap, Heinz, Johnson & Johnson, Kimberly-Clark, Monsanto, PepsiCo, Pfizer, Philip Morris International, SprintNextel, Target, Time Warner, Union Pacific, Verizon, WalMart, and Wells Fargo.
- The S&P 500 Index rose 0.16% for the week, reaching its highest level in three months on Friday, August 3.

Answer: All of the above.

The trading session on the 1st of August was marked by unusual activity in 148 stocks listed on the New York Stock Exchange, many of which swung sharply in the first hour of trading due to an apparent error in a newly installed software program developed by seventeen-year-old Knight Capital Group Inc., one of the country's largest market-making and trading firms. The NYSE canceled trading in six stocks, including podcasting company Wizzard Software (WZE), and oil and gas company Quicksilver Resources (KWK).

For some, the incident was an unwelcome reminder of the so-called "flash crash" on May 6, 2010, which saw the Dow Jones Industrial Average plunge over 700 points in fifteen minutes. Wall Street Journal columnist Jason Zweig sounded out a number of individual investors for their thoughts on Wednesday's market gyrations and got an earful. One college professor, dismayed by the unusual volatility, fretted about the possibility of investing for many years only to see "everything you have built up disappear in five minutes." A New York lawyer observed that the investors he talks to are convinced "the game is stacked against them" and that earning a pittance in safe fixed income investments was preferable to "losing it all on a roulette-wheel stock market."

Cash flows for equity mutual funds have been generally negative over the past two years, and incidents such as the "flash crash" are often cited as a contributing factor to investor skepticism of equity investing. A recent article by Ron Lieber appearing in the New York Times suggests this anxiety is becoming more widespread. Responding to the desire by some readers to avoid traditional financial service companies, he explores a range of alternatives, including credit unions, direct ownership of rental real estate, and so-called peer-to-peer programs that facilitate direct lending to individuals. He finds possibilities but no easy answers, and cautions those who intend to pursue this alternative approach to consider the chance that they will have to "save even more, spend less, and work several years longer to make up for any shortfall in returns."

One can sympathize with investors who fear that the investment industry machinery somehow places them at a disadvantage, but we think such concerns should be placed in a proper context. We live in a complicated world, and it's unrealistic to expect power plants, airliners, or stock exchanges to work perfectly 100% of the time. The lights go out, flights are canceled on short notice, and computers freeze up just when we need to print that important document. These malfunctions serve to remind us that technology is a mixed blessing, but few of us would prefer a permanent return to the era of spinning wheels and candlelight.

Electronic trading has received a well-deserved black eye due to the early August fiasco, but before we throw out all the computers in angry frustration, we should consider what transaction costs might look like in their absence. Some of us are old enough to remember the commission schedule at NYSE-member firms in the days before negotiated commission rates and high-speed trading algorithms. A 100-share order of IBM or Procter & Gamble cost $80.73 at Bache & Company, E.F. Hutton, Kidder Peabody, or anywhere else. These days, a Wells Fargo customer with a meaningful checking account balance can execute one hundred trades a year for free. How many of us would vote to bring back the old system? More traders and more trading paves the way to greater liquidity and lower transaction costs. If we banished all short-term traders, who would be there to take the opposite side of our order when it's time to sell some shares to pay a college tuition bill?

Although some journalists were quick to accuse Wall Street insiders of using their trading tactics to fleece small investors, it seems the reverse was more plausible in this case. Knight Capital—the epitome of the wired-in New York trading firm—suffered over $400 million in trading losses from errant trades on that Wednesday morning, and appeared at one point to be in danger of failing. There are two sides to every transaction, and if some market participants—whether man or machine—demand instant liquidity regardless of price, we should not be surprised if the price of that liquidity occasionally becomes very steep. Knight Capital's loss is someone else's gain, and it appears that floor traders and other market participants responded quickly to the peculiar price patterns and took the opposite side of Knight's trades to their advantage.

What about the buy-and-hold investor? Zweig's column cited four widely held stocks affected by the trading glitch. We note that the spread between high and low prices on August 1 ranged from 1.96% (Berkshire Hathaway) to 14.64% (Harley-Davidson). While the intraday swing was unusual, the net change for the day was considerably smaller (–1.85%, on average), and smaller still for a diversified S&P 500 strategy (–0.29%). Investors who are traumatized by this degree of volatility are probably not good candidates for equity investing under any circumstances.

We also wonder how many investors were even aware of the trading gyrations as they were taking place on August the 1st. We suspect those expressing the greatest alarm were accustomed to watching market developments minute-by-minute on financial websites or television programs. Here again, advances in technology can be both a blessing and a curse.

In this regard, we cannot improve on Jason Zweig's observation, so we'll quote him directly: "It's harder than ever for long-term investors to ignore the trading madness of Mr. Market. But ignoring it remains the very essence of what it means to be an investor."

The Cost of Safety

Jim Parker, "Outside the Flags", Vice President-Dimensional Fund Advisors.

Investors are now so risk averse they are willing to pay the German government to look after their money; not a risk-free return, but a return-free risk.

Yields on two-year German notes sank to an all-time low of -0.005% on June 1. Looked at another way, anxious investors were prepared to accept a negative return for the comfort afforded them by parking their cash with the German government. And this was even before taking inflation into account.

This isn't the first time this has happened. Back at the height of the financial crisis in late 2008, negative yields were observed in US Treasuries—a consequence of investors at that time being willing to pay to park money in a safe asset.

The extreme state of risk aversion in global markets is reflected not only in German bunds. In the US, Treasury bond yields have hit record lows, as have their equivalents in Australia, the UK, France, Austria, Finland, and the Netherlands.

The causes of this mass shying away from risk are well documented: worries that the Eurozone will break up, concern that the US economic recovery is stalling, signs of a slowdown in China, and a loss of momentum in emerging markets. Anyone who takes note of media and market commentary will know that there are a wide range of opinions about the likely outcomes of these issues. The important point for the ordinary investor is that all those opinions and uncertainties are already reflected in current prices.

Investors' willingness to pay to park their money in German bunds is an indication of higher risk aversion. Think back to what we saw coming out of the first stage of the financial crisis in March 2009. Risks were high, and prices of risky assets went down. Many investors, overcome by the uncertainty at that time, sought refuge in government bonds. Due to this generalized increase in risk aversion, investors demanded a higher premium before putting their money into equities and corporate bonds. But as risk appetites revived that year, those risky assets paid a very substantial return. Share prices rebounded, and the spread of corporate over government bonds narrowed sharply.

The takeaway is that sheltering in what are perceived as the safest government bonds may provide certainty for a time, but also comes at the cost of forgoing the significant increase in risk premiums that may be available.

This is not to argue, by the way, that increasing one's allocation to risk-free assets is never a legitimate decision. Such a course may well be appropriate for the individual investor, based on his or her own tastes, circumstances, liquidity needs, and investment objectives. If possible, however, it is best to develop appropriate asset allocations for individuals based on their risk tolerances outside these periods of distress. That's because selling risky assets at such times can be expensive.

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