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Something to Think About

COMMON CENTS

A reader of my Montgomery Advertiser article wrote me this week to ask what was the cause behind the recent market volatility. Over the years, we have established a pretty good dialogue, so I was happy to hear from him. I was also happy to see in the email he had posed the same question to his financial advisor in New Jersey; a guy at a big firm, who would undoubtedly regurgitate the company line. They almost have to do so, even if they feel or felt otherwise.

Was the current brouhaha over 'high frequency trading' the culprit? Succinctly, probably not; these guys have been operating for years, and the nature of their business is buying and selling positions within seconds. They focus on making pennies, or fractions thereof, on large trades, and don't really take a position in anything. The only thing they care about is having faster technology than everyone else, so they can fill the tiny window between when a trade is input into the system and when the system executes it. We are talking seconds or less; don't blink, or you will miss them.

No; the real issue with recent volatility is pretty simple: economics. You just can't get away from good old supply and demand. After all, when the amount of money going into stocks, or a particular stock, is higher than the amount of money going out, voila, prices tend to go up. The converse is true as well. So, if you want to be a real wiseacre when someone asks what happened in the markets on any given day, you can look at the price action, and conclude with certainty: "well, there were more outflows/inflows than inflows/outflows today. I have spoken."

Okay, that is so much common sense, but, again, why? Well, therein lies the rub, and here is how I responded to him:

> The market is on a roller coaster largely because of its construction. There are a few dominant players in the industry, which literally can move the markets with a simple buy or sell order. For instance, the trouble with Apple's stock last year had absolutely nothing to do with the company's performance or even Tim Cook or product pipeline, although those were the oft given reasons.
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> You see, at the end of 2012, the American Funds and Fidelity decided they had had enough, and reduced their holdings. The American Funds largely exited their position, and Fidelity simply went back to a market weight, for the most part, after Apple's massive, almost historic, run. The easy money was probably over, and they decided to take their marbles and go home.
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> However, in so doing, the number of shares for sale far outstripped the number of buys, and the stock slumped.

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There is a volatile mix, and that's because we're all intense. And there's no denying that.

Alex Van Halen

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> As it slumped, its weight in the various indices fell, which meant index managers had to sell shares in order to get their weights back in order....and this led to a domino effect. The company still doesn't have a lot of traction in the market, even though virtually every major firm with an opinion on the stock rates it as a "buy." I see your advisor at XYZ is on this email, and their firm's tech analyst has it as a buy with a target price of $625. The stock is trading about $100 less than that. (as a caveat, Oakworth owns AAPL).
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> The investment world has changed, thanks to mutual funds and ETFs. Many, if not most, individual investors use these vehicles in their 401K plans and personal portfolios. As a result, IF a large active manager decides to sell a particularly company, the rest of the market might not have the economies of scale to do much about it, because a lot of the new money from individuals is going into diversified funds as opposed to individual shares. IF the two largest active mutual fund families decided to sell a company, to lock in gains when the stock can't break out of a trading channel or to simply reduce an inflated exposure, the results are predictable, even if there is nothing fundamentally wrong with the company.
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> Ultimately, the stock market can be boiled down to basic economics: supply and demand. How much money is going in and how much is going out? Given the volatility we have seen this year, I would be willing to bet you a plug nickel the average investor and pension fund out there simply isn't increasing its equity allocation, after an extremely nice run since 2009. This is completely understandable, and is perhaps part of the reason why inflows into world stock, hybrid funds, and bond funds have dwarfed the amount of money going into US equity funds thus far this year.
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> In fact, investors actually took money out of equity funds in March, which is a huge part of the problem with the market the first week or two of April.

Okay, that might be overly simplistic, but, when boiled down, I would make the argument all day long, or at least until you could prove me wrong otherwise. So, IF you accept my reasoning, in order to ensure ever increasing, non-volatile stock market prices, you have to ensure a steady, dependable stream of money going into stocks. Second, you would to have to turn every mutual fund and ETF into a passively managed index fund. Also, you would need to ensure people have more personal income in order to save, and, therefore, invest. Finally, you need to mandate a static asset allocation for everyone, individual and institution, which will never change.

IF we do all that, yeah, sure, we will get that steady, dependable stream of funds going straight into a non-volatile stock market. This will ensure stock prices, in general, will go up. Of course, we will have essentially eliminated risk in the markets, which will even out security returns at a lower level. After all, you get paid for the amount of risk you take, and if you are taking less risk you will get less return. Since returns will be basically the same, the economy will distribute capital across all companies and industry sectors at stagnate index weights, which means it will misallocate it. Then, the economy will stagnate as large and/or inefficient, obsolete industries and companies are rewarded the same or greater than small and/or efficient, innovative ones.

When that happens, business creation will grind to a halt, personal income will fall. As a result, people won't have any money to invest, and returns will fall further still. Think Cuba, sort of.

As much as we all hate market risk and volatility, they prove one thing: the markets are working as they should, even if we don't like it. If we evened out market volatility and the business cycle, gee doesn't that sound great, if we eliminated risk of all sorts, nothing would get done. The potential to make a higher rate of return wouldn't be available, so why bother sticking your neck out? After all, IF you could make the same

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amount of money working at half effort for 30 hours/week as you could working as hard as you possibly could for 60 hours/week, what would you do? If your got paid the same amount for producing X units as you did 3X, how many would you produce? Please be honest.

But that is not how things are, yet, in the markets. You still get paid for risk! And with risk comes volatility.

Over the last two years, in particular, investors have, for the most part, thought the risk of losing the purchasing power of their money was greater keeping it OUT of the stock than putting it IN. This is completely understandable, as most interest beating vehicles at banks and even the bond markets currently yield less than the accepted, historical rate of inflation. So, why not put some money in the stock markets IF I am technically losing it by sitting on it? Indeed.

And this has worked out beautifully for a lot of people. So much so, most investors have made back everything they lost in 2008, and then some...in many cases a lot more. Hmmm. Perhaps the pension plan thinks: "okay, we have had a nice run being 'overweight' equities, why don't we lock some of that in and go back to a 'market' weight?" Maybe a whole bunch of 401K participants got their year-end statements, and thought: "man, that was an awesome year, but I can't have another 2008 and even think about retiring anytime soon. I should trim back my stocks from 75% to 60%, just in case." Finally, after seeing some of the early outflows, active mutual fund manager X decides: "you know, I have been running at 1% overnight liquidity, and we have seen a steady drip going out of the fund. Maybe I will take it to 3% to be safe."

You see, investors don't have to hate the markets in order for them to sag or demonstrate unwanted volatility. They simply have to not love them as much as they previously did. Such is the case today, now, as I type. Do people want to lose purchasing power in traditional banking products and short-term bonds? Not just no. However, do they feel more comfortable and/or confidant with their current wealth AND want to put a floor or safety net of some design beneath them? Yes.

A 5 year bull market will do that to folks….make them comfortable, and, therefore, less willing to take risk EVEN if they don't see it like that. As a result, money is changing hands, and going to its highest and best use, as investors search out the best possible return for the amount of risk they are willing to take. That is all volatility is: investors determining their risk/reward paradigm.

Certainly, there are times when people take advantage of the system, either ethically or unethically. However, where the rubber meets the road, the relatively free flow of capital in our country has always been one of our strongest economic advantages. We need to be extremely mindful of this before enacting any legislation and/or regulations to "protect the many from the few." There are always devils in the details and unintended consequences, and fortunes are normally made through hard work and/or business ownership, and not paper pushing.

So, volatility? I don't like it, but I will take it since the cure(s) for it are much worse.

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