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OBSERVATIONS ON THE MARKET

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Exxon, AT&T, GE, and Pfizer. These are all companies that are supposed to be the foundation of the American economy; investments that can weather the storm of recession and economic uncertainty. GE is the only company of these four that showed real strain two years ago as the financial system struggled, largely due to its financial unit. These companies used to be the definition of financial stability, maybe not the fastest growers, but predictable performers. These stalwarts also pay very attractive dividends, 3% to 7% (except GE), another test of financial stability. Then came high-frequency trading (HFT).

Most investors don't care about HFT, or even know what it is. The old saying that 'what you don't know won't hurt you' couldn't be farther from the truth in this case. The "flash crash;" the period of 20 minutes when the market declined by 900 points last month, was probably caused by HFT. The simple explanation of HFT is trading that is executed by computer, and the shares may only be held for a few seconds before they are sold. Why this matters to you is because it has changed the dynamics of the market. There is a study that suggests since the first of the year, the 30 companies most likely used for HFT has outperformed the S&P 500 by 1%. Among the 30 companies are Exxon, AT&T, GE, and Pfizer. The downside is that these stocks have been 50% more volatile, meaning if the stock market declined by 10%, these blue chip companies declined by 15%. If the market recovers by 5%, they advanced by 7.5%. It hardly seems worth an extra 1% in return. It is also estimated that 70% of the volume in the stock market is due to HFT. It is pretty easy to see how news headlines can become exaggerated by computer trading that attempts to capitalize on very

short-term momentum. Throw politics into the equation, and what chance does an investor have?

May was a month that was mostly dominated by news from Europe. News that Greece was close to defaulting on their debt, followed by fears of contagion spreading to Spain and Portugal left investors on edge as to what was going to happen next. On Friday, June 4th, Hungary made an announcement that they would be next on the list to require emergency assistance. The market declined 3% on the news, and the Euro dropped to a four year low. Nobody seemed to notice that Hungary wasn't really on the financial causality list. The new Hungarian government that is transitioning into power had decided to use the current economic uncertainty as leverage to try and push through an aggressive austerity program. They backtracked from their comments within 24 hours and confessed that the remarks were reckless. Hungary's debt to GDP is below 80%, and their budget deficit was 4% in 2009. This makes them one of the healthiest economies in the European Union. The one-day 3% market decline was probably magnified by HFT, which shoots first and asks questions later.

It is tempting to think the game is rigged, so why bother? The underlying message is that fundamentals do win out, but it takes conviction to not be shaken by the market's volatility. Investors can even use the higher volatility to their advantage if they use the weakness to buy. However, it is imperative that you have conviction and have a clear definition of what value means to you. What you thought was cheap may become cheaper in a manner of minutes, but the fundamentals still matter.