

April 8, 2014

2014 First Quarter Review
“Flash in the Pan”

For all the drama on the international scene during the first quarter, the stock market ended very near where it began. The Dow Jones Industrials lost 3/4 of a percent while the Nasdaq Composite gained a half-percent. The S&P 500 did a little better by gaining 1.3% for the quarter. In a reversal of last year’s trend, bonds outpaced stocks, as reflected by the Barclays 20+ Year Treasury ETF rally from \$101.86 to \$109.10 in the first three months of the year.

You might think that not much had happened if you looked only at those opening and closing prices. However, from peak to trough, the Dow Industrials dropped 7.5% (down 1,200 points) with a similar 5.75% decline in the S&P 500 from the beginning of the year through early February. Then prices rose quickly in February and March to make back all the ground lost in January. So, the indexes made up the lost ground, but it masked a subtle change in the identity of the winners and losers within the stock market.

We have written in the past about “The Great Rotation” out of bonds and into stocks. During the first quarter there appears to have begun another “rotation” in market leadership from the popular “high-flyer” stocks to the more value-oriented ones. Although the market as a whole does not appear to be “in a bubble,” certain areas have exhibited some bubble-like characteristics. Two of those areas were “momentum” stocks and initial public offerings (IPOs). Twitter, Tesla, Amazon, Google, Netflix, and Splunk are just a few examples of very popular stocks that fell hard in recent weeks (some from 20% to 40%). The onslaught of new IPOs has caused many to wonder if it is another example of insiders hurrying to sell before investors come to their senses. A whole slew of IPOs have recently traded up initially, and then have fallen to a fraction of their post-offering highs. The upshot is that some air has been coming out of the speculative balloon. Even Bitcoin, the rage of the financial press just this past fourth quarter, has fallen from \$1,200 to \$450 per virtual coin. In reaction, many more conservative stocks like the ones we own have benefitted from money moving to safer investments as the risks of speculation have become more apparent.

The speculators have good reason to be nervous. We are five years into a bull market that has had few major pull backs. Margin borrowing and bullish sentiment are at extremely high levels. International tensions are running high. Economic growth is slow and may be fragile. The massive monetary stimulus is scheduled to be reduced with the Fed’s “tapering” bringing it to a close in the fall of this year. At the end of each previous stimulus, the equity markets have swooned. However, the Fed ended their QE1 and QE2 stimulus programs only to step back in again when markets faltered. Ostensibly, the Federal Reserve is pumping money and holding down interest rates to make life more affordable for the average Jane and Joe. Unfortunately, the unintended consequences include the impoverishment of savers and the reflation of assets that disproportionately benefits Wall Street as opposed to Main Street. And Wall Street is not getting too much sympathy in the news lately.

I am delighted that the new book *Flash Boys* by Michael Lewis has created such a stir. In the late 1980’s Lewis worked for Solomon Brothers on the bond trading desk when I was a young cub a few floors down at Oppenheimer and Co. in One New York Plaza, the building at the very southern tip of

Manhattan. Michael's first book *Liar's Poker* was about that era, and it is a hilarious and very accurate (if unflattering) depiction of standard Wall Street bond trading practices at the time. I hope the scrutiny that his new book brings to the practice of High Frequency Trading (HFT) on Wall Street is effective in helping to halt the practice. HFT has been going on for years and most investors who were aware of it wanted it stopped long ago. However, no action has been taken, as none usually is until there is a disaster that brings a "hue and cry" after the fact. I hope it won't take a "flash crash" with lasting damage to bring that about.

I do want to clarify one aspect of the HFT discussion, however, that is easily misunderstood. The statement that the markets are "rigged" misrepresents what is actually happening. It does not mean that the long term outcomes of stock investments are predetermined by the HFT traders. They have very little influence on whether Corning Glass goes from 11 to 21 over several years' time (as it has). Their activity represents a scalping of pennies or fractions of pennies from many stock market transactions. Some people argue that the advances in technology have made "spreads" so narrow now that transactions are still drastically cheaper than they were just a few years ago. That is true. However, it does not justify allowing a few traders to purchase an unfair advantage with advance information on trades, thereby making those trades even slightly more expensive for the rest of us. Even though the cost to any single investor may be negligible, the greater threat may lie in the magnified volatility they can induce (e.g. the "Flash Crash" of May 2010 where the Dow Industrials lost and then regained over 1,000 points in a little more than 15 minutes.) HFT undermines the integrity of the system for the benefit of the few. The practice is being protected by those standing to profit. It should be stopped. I hope it will be.

One of the endlessly fascinating things about investment markets is that they tend to be affected by, to greater or lesser degree, events and developments around the globe whether they be political, technological, ecological, meteorological, etc. Further, the effect of those developments is often counter-intuitive (markets sometimes go up on bad news, down on good). As we've mentioned before, it is a fool's game to "trade with the headlines" or a tout from a talking head on CNBC. No one can predict the events that will influence the market, and even if they could they would not know the magnitude of the effect, or whether its influence would be overwhelmed by other, more important factors. A good case in point has been this bull market where most other factors have been overwhelmed by the massive influx of monetary stimulus and zero interest rates. By focusing on valuation as opposed to the latest news, we try to reduce the statistical noise and hone in on what will make the best profit with the least risk. Many times those types of investments are unexciting. As my friend Tim Melvin writes, "*The noise doesn't matter. The value of what you are buying, relative to the price you are paying, is the only metric you need to find long-term success as an owner of stocks.*" Speculation is often exciting, and just as often expensive.

Enclosed you will find your quarterly reports. Please feel free to call us at any time if you need extra copies of any documents from 2013 to prepare your taxes. Also keep in mind that management fees that are paid from a taxable account are deductible on your tax return. If you'd like, we will send your information directly to your tax preparer to save you the trouble.

Thank you and Happy Spring (finally)!

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