WILLINK
ASSET MANAGEMENT LLC

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July 2013: *Up and Down. Up and Down.*

It's been a better than decent 12 months for domestic stocks, so far, and despite recent pull-backs. Yes, China's economy is slowing. European debt woes continue. Here in the US, the troubles of others have translated into better sales for US based competitors. Dividend-paying US companies with familiar and comforting names have raised their dividends again. Home values are up. Our clients' portfolios have participated in the recovery.

So, why does the stock market seem more volatile lately–dampening the good news with one and two percent prices swings almost daily?

The institutional trading communities, those investment organizations that focus on shorter-term profits, are much of the reason. Today they represent a much larger percentage of stock ownership than that of the long-term investor that our firm serves. Institutional investors, including traders, once the minority only thirty years ago, now account for more than half of all stock ownership. They have very different frames of reference and employ much different investment strategies than most more conservative investors like you.

One group of traders in particular–the hedge fund companies–have an outsized effect on market volatility that is disproportionate to their number.

Below are some simplified examples.

You invest one hundred dollars conservatively, half ($50) in stocks and half ($50) in bonds and cash. During the day, it is announced that Iran is amassing troops on its border near Iraq, and that Spain and Italy are on the brink of defaulting on their national debt, putting the European Union at peril. (Pick your own "bad" news).

By day's end, the stock market has tumbled 2%. For the moment, the stock side of your account is also down 2% ($1). No help from bonds yields at historically low yields. Your account value is now $99. You worry briefly during the nightly news about what will happen next—and then go about your business. You hope that your advisor has you positioned well enough to weather most storms. [(1)]

At **Short Term Traders Inc.** (not a real firm), their "hundred" [(2)] is almost entirely in stocks. By day's end their account is down almost 2% percent and their hundred is now valued at about $98. They have been active all day, reconfirming which stocks to sell if things get worse, and which stocks to buy—hopefully at a bargain. It is just another day for them and their ultra-wealthy funding sources who can afford the risks of non-diversification and hyperactive trading.

Over at **Willow Ridge Opportunities Inc.** (not a real firm, but hedge funds often come with a nice name) things are a little different. The funds they manage are also almost entirely in stocks. But they used their client's "hundred"[2] dollars as collateral to borrow $900 (from a specialized bank catering to hedge funds). The borrowed money plus interest must be repaid in days.

Here is how their day unfolds. At dawn, their account value is now $1,000 (the $100 plus the $900 loan). Rumors of Iranian troop movement and woes in Europe have been on their radar all night. If stock prices should tumble that day; even just 2% percent, the original hundred plus the borrowed funds will be down twenty dollars– and that is a 20% loss on their firm's one hundred.

There may not be time to recoup the loss before the loan is due. There may not be time for human traders to act as the market opens. The market could tumble further on worse news, and the losses would be magnified. A 10% drop in the stock market would represent a 100% loss ($10 of the original $100 and $90 of the borrowed $900). Willow Ridge would be wiped out.

So, here is what happens next. Willow Ridge, like its competitors, has a bank of high-speed computers at the ready. There is no need—or time—for Willow Ridge's traders to act. Their high frequency computer programs will be triggered to act within microseconds as prices begin to slide. And the hedge fund will survive to speculate another day.

After all, the borrowing leverage works two ways. A 2% market gain will translate to a one-day gain for the fund of about 20% on the original $100.

Meanwhile, Iran is having second thoughts. Spain and Italy have tentatively agreed to a repayment plan.

And it's been another wild day on Wall Street, thanks in part to Willow Ridge and firms like them.

Company earnings will chug along, sometimes higher, sometimes lower. Stock prices reflect traders' anticipation of those earnings along with the events that may alter expectations. Non-diversified and leveraged bets will accentuate the price swings. The portion of your portfolio committed to the longer term will feel some of that. And longer term, you need be much less concerned.

Fred R. Fadel, CFP®

(1) Phone calls are welcomed whenever you are wondering about that
(2) Or, rather, a billion