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CLIENT BULLETIN

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- ***High Speed Rig***

With no financial or economic crises to fixate upon, the media has been attempting to focus your fear on something called high-speed trading in which firms use superfast computers to post stock trading orders at rates measured in thousandths of a second. The claim is that this high-speed trading rigs the global stock market, thereby victimizing every investor who owns stocks. The accusation gained steam when author Michael Lewis touted his newest book on 60 Minutes. This issue is different than “front running” in which a trading firm accepts an order from a client, but before placing the order on behalf of the client, makes a trade of their own knowing that the forthcoming client order will affect the price of the security. Front running is an illegal activity. Executing trades quickly is not.

- ***High Speed – So What?***

The media coverage around the book’s release has included the usual sensationalism, but thoughtful analysis reveals that in the long run, all of this algorithmic stock trading most likely cancels itself out – some computers win on any given day while others lose a little. Investors looking for an edge is nothing new and electronic exchanges are already popping up to level the playing field. Even if the market is rigged, the S&P 500 has increased nearly 20%/year since high-speed trading began to proliferate five years ago, so please keep on rigging it. Most importantly, the intrinsic value of companies in the long-run is a function of earnings, dividends and cash flows which are largely unaffected by short-term trading. Now if you want to claim that the ***bond*** market is being rigged by the Federal Reserve’s artificial repression of interest rates, we might have something to talk about.

- ***Poor Timing***

While high-speed trading has little or no effect on long-term financial success, the results of updated research from Boston-based DALBAR Inc. do. Over the past 20 years, the S & P 500 stock ***index*** has returned an average of 9.22% per year. The average U.S. stock mutual fund ***investor,*** however, netted just 5.02% per year over the same time period. This calculation was made based on the timing of the flow of money moving into and out of the funds themselves. It is important to not allow emotions to dictate investment decisions.

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- ***Why Do We Do It?***

Investors suffer the track record above mainly because of something called heuristics, which are mental shortcuts humans use to process large amounts of information when making decisions. See if you can find yourself in the following descriptions of common heuristics:

- Extrapolation Delusion: the belief that trends currently in place will continue in a straight line.
- Recency Effect: the tendency to give more weight to recent events than to events that occurred further in the past.
- Narrative Fallacy: we hear and tell stories as if they capture the deeper truths of economics or finances when in fact the stories are too rare to be representative.
- Hindsight Bias: individuals are sure **after** an event has occurred that they expected whatever happened, to happen.
- Loss-aversion: investors dislike losing money twice as much as they enjoy making money.
- Confirmation Bias: too ready a willingness to accept as proof any information that supports our pre-existing views.

- ***Keeping Score – the Old Way***

Congress has a bipartisan Joint Tax Committee that "scores" proposed tax bills based on whether they are projected to increase or decrease revenue to the federal government and what their effect would be on the budget. In the past, this committee's scoring was based on a ***static*** approach. A proposed change in tax rates up or down, for example, was merely applied to current income figures to determine whether the bill increased or decreased revenue to the government. If only economics and finance were so simple. In reality a change in tax rates has secondary, long-term consequences beyond the initial effects.

- ***Keeping Score – the Right Way***

I may be overreaching for an analogy, but economics bears far more resemblance to biology than it does to chemistry. In chemistry, you get a fairly predictable result when you combine two chemicals. In the world of biology, however, introducing a new species of animal into a habitat creates a nearly infinite web of changes that affect the entire habitat, not just one part of the food chain. The Joint Tax Committee has begun recognizing these follow-on effects of policy changes and now scores bills ***dynamically***. They take into account whether a bill or policy creates new jobs or fosters economic growth. The adoption of this dynamic scoring is very important and a positive development. We have an ominous government debt problem in the U.S. and there are only five ways to deal with it: 1) cut spending radically; 2) raise taxes on everyone drastically; 3) pass it to future generations; 4) default on it; 5) grow the economy. Option #5 has by far the greatest potential to address the debt problem and every proposed policy change should be evaluated in light of its ability to grow the economy which in turn will increase revenue to the government.

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