Scotty C. George
Chief Investment Strategist

October 26, 2015

Market Outlook:

Mind reading

As markets have now evolved into trading violently up and down by hundreds of points, some are asking whether there are new forces, new rules, which appear to govern stock market behavior?

Obviously, it has become more possible for stock averages to appear to make "large" swings....what used to be 3 or 4 percentage points thirty years ago was a number in the single digits. At 17,000 on the Dow Jones today, one percent is already a three-digit integer.

The question is whether this volatility is a "problem" that frightens away investors, or simply an uncanny opportunity to profit from big swings. Without implying that either scenario is good or bad, I do believe that we can ascribe a certain amount of stop-and-start behavior to the advent of technology and computerized trading programs. Irrespective of fundamentals or long-term objectives, the machines are programmed to execute at valuation ranges which condense the aperture of analysis. I know, because I am also the architect of such a data base.

The difference, though, between systematic "black box" investing and private client money management is that *real* people have *real* tolerances for risk, and a set of expectations about normal market behavior and trend patterns, whereas computers don't....or don't need to...factor emotion into their models. That's unfortunate

Since the onset of computer trading, the frequency of 4 percent (or more) moves in market averages has increased by several standard deviations above the frequency of their occurrence before the year 2000.

Regulators and legislators have noticed this change, and are highly curious, and critical, about computer's connections to market volatility. It hasn't gone unnoticed that there is a more pronounced decoupling from long-term fundamentals in today's financial markets, even as the impact of directional changes wreaks havoc upon the psyche and confidence of retail market players. The past decade and a half has been one of the most volatile in market history, while the aggregation of the most severe of those percentage gains/losses has happened only in the last decade.

Recoil or attack?

The best thing the "average" investor can do is to ignore the haze of exogenous noise, because trend lines tend to even out the extremes. As we have experienced with client portfolios, the numerical net-net of recent calamitous upside/downside volatility has only approximated "zero" change during a protracted period of time. It happened previously during a half-decade of S&P performance (2003-2008), and it occurred again subsequent to this summer's downside capitulation followed by the past few weeks' bounce-back. If you don't have a money manager who produces incremental upside gains during these fallow periods, you're not following the right disciple. For example, buying an index tracking fund and expecting anything different from the net index performance is being unrealistic.

Unfortunately, the drag on investor psychology and behavior caused by these sudden eruptions outweighs any euphemisms I might write about. Once the markets lose investor's confidence and trust, it is tough to regain it. Financial institutions and individuals have tested the patience of clients for too long. *"New normal"* or not, the markets have been alienating their target customer base with impunity, portfolio gains notwithstanding.

In a sense, this is a morality play at work....the struggle between moral persuasion versus technological efficiency.

But when the empirical laws of economics break the bond of trust and ethical behavior, one unfortunately runs out of fiscal or monetary solutions to repair the breach. No doubt, profits are good. But we have not really addressed the notion that some profits are more *socially* productive than others. It's also time we look at how the trend of increasing profit margins has, or has not, improved our quality of life.

One is always aware of the influence of exogenous and non-numerical factors upon data and market analysis. In like fashion, trying to manipulate vast secular (generational) momentum is analogous to turning a battleship in a bathtub...very difficult to do. The most critical element to all portfolio and economic analysis is *time*...time to remediate and effect trends; time to mobilize computer data; time to strengthen moral values; time to skew the politics of power; time to scrutinize the influence of business ethics; time to sit back and put things into perspective.

But, hey, who's got time for anything nowadays?