



Last Week's Wakeup Call

August certainly started off with a bang, don't you think? What a ride!

You may be shaking your head, wondering "what the heck is going here?" You are not alone, we are in uncharted territory. Never before have we seen the magnitude of these market swings in such a concentrated amount of time.

Last week was the icing on the cake, On Monday August 8th, the market was down 600 points, ON Tuesday it rallied 400. On Wednesday down big again, on Thursday another big rally.

How can anyone operate in such a crazy environment? I told a few friends after last Tuesday's session was over that I felt I was living in an insane asylum. The day had started out up 200 points, yet it felt like a fake-out. Kinda like when Lucy in the Charlie Brown Comics holds out the football for Charlie to kick with the promise not to pull it away too early.

Sure enough, she pulled the ball away and the market fell within minutes.

Later in the day, the market see-sawed wildly. Down 180---up 180 and so on. In the early afternoon the FED spoke and market started to dive and it looked as if we were in for another big down day. Yet in the last 45 minutes and for absolutely no apparent reason, the market rallied strongly.

What is going on here? Has something changed in the structure of the markets or the economy to cause these dramatic shifts we are seeing?

I think there is something different.

In the last 5 to 10 years many new products have entered the market place. In addition to hedge funds which have been around for a while, new funds called exchange traded funds have become very popular. Some of these ETFs are very straight forward, simply buying baskets of stocks like the S&P 500.

Yet quite a number of these ETFs have more complicated trading strategies. For example, there are funds which leverage the ups and downs of an index by a factor of 2 or 3, i.e. if the market goes up 1%, these should rise 2 or 3%. The same is true when they fall.

There are also funds that act inversely to the market. If the market falls 1%, these will rise 2 or 3% depending on the leverage they are using.

Many of these new products use leverage, or derivatives or futures to get the added boost they are trying to achieve.

In addition to this, there are more automatic programs designed to sell or buy a basket of stocks in a microsecond depending on a predetermined trigger. Add in standard investors with margin accounts and institutions using derivatives to hedge and offset other transactions and you now have an environment waiting to flare at the set of a match.

Think of your charcoal barbecue grill as you light it to get the coals to ignite.

You put a little lighter fluid in to get it started and all is normal. This is the same as the hedge funds putting in sell orders in an orderly fashion.

You may feel the coals are not hot enough so you decide to add a soaking of lighter fluid on top of the coals and you light your match and POW! Everything ignites in a large flame.

This lighter fluid is called an accelerant and these new funds and trading programs all act as accelerants to market trading. The magnitude of these ups and downs is caused by this new fuel to the fire.

But does this affect the real economy? So what if a bunch of traders are moving in and out of the market. Even though it's un-nerving and unsettling, the stock market is not the real world.

It won't always affect the real world, but this type of magnitude will worry many people, causing them to delay their spending for fear of what's coming in the future. This could have an effect.

There is another powerful factor that could affect the economy. Today, about 30% of the capital of our banks is invested in stocks. This capital is measured everyday in a way that is called "mark-to-market". As the value of these stocks decline, it directly lowers the capital structure of the banks. This in turn, reduces the amount of loans banks are able to make.

Something of this nature may have a serious effect on the real economy.

It wasn't this way 20 years ago. Back then banks would only adjust their capital if they had to take reserves against bad loans. This would happen in a slow and steady fashion and was not tied to the volatile market. Especially our market so inflamed by these new accelerants.

All this makes the economy MORE cyclical in nature. More sensitive to the flow of funds in and out of stocks and more vulnerable to a self-feeding negative spiral if one should occur.

All in all, just a more dangerous environment to operate in.

So what can you do about it?

First of all you need to start taking a closer look at the risk you are taking in your investments. Make sure that you have the time needed for your investments to cycle out the other way, i.e. that if the market declines precipitously, you have the time to enable it to cycle back higher. You don't need the money to live on. This is money put aside for the future.

2. Diversify. The best first line of defense against a market downturn is to have a broadly diversified portfolio across assets with little correlation to each other - so if one falls another holds, or even rises. Make sure you have some nice dividend paying stocks in there. These are simple and effective techniques that even an individual investor can deploy to get some downside protection.

3. Carefully use options to hedge.

Very simply, think of an option as insurance you can buy to protect your shares – you pay a certain amount up front to buy the option (this is called the option premium) and then have coverage for a finite period of time. When that coverage period expires, you can buy additional options to stay covered. Simple option strategies - such as selling puts to lower the cost of shares you want to buy; buying puts to protect your downside; or selling covered calls to lower your holding cost - are easy to understand and implement.

Beyond that, options get complicated in a hurry so do not venture into them without a proper guide or training.

4. ETFs. Most times, buying a basket of exchange traded funds (ETFs) gives you a level of diversification that you just do not get if you buy a basket of individual stocks. For example, you could buy an ETF called SPDR S&P 500 that gives you broad market exposure to the entire S&P 500 Index.

5. Inverse ETFs. Inverse ETFs can also be an effective part of your hedging strategy. An inverse ETF basically goes up when the underlying index goes down - so you gain on an ETF what you lose on stocks or the index, and in so hedging, minimize or even eliminate your losses.

Then there are more sophisticated strategies such as Market Neutral Arbitrage, Market Neutral Equity, Fixed Income Arbitrage, and many more. These are very specialized strategies that can be accessed through certain mutual funds and hedge funds. This is something you definitely do not want to try at home.

In all cases today, the buzz word is to exercise caution.

There is no doubt that you must take some risk in your investments in order to make any kind of decent return. After all you would only receive 2.25% if you bought a 10 year government bond. That's not enough to cover your rising cost of living after taxes in the next ten years.

You must take some risk to get a higher return.

Only now in this new environment, you have to think differently and act differently to get the kinds of returns that will create wealth for you in the long run.