

## Another Interesting May

*We are rolling out our new format for the VFT this month, and this issue is really packed with information and answers to some great questions.*

*In this issue we discuss the economy, the markets and answer questions about high-speed trading and dark pools.*

*In a new section dedicated to non-investment topics, we discuss the new digital version of your Social Security Statement.*

### It Isn't Just About Today

One of the things we lose sight of in tracking both the economy and the equity markets is that the markets reflect expectations of how the economy will perform in the future as well as other factors such as earnings growth, valuation and liquidity. What is happening in the markets today is driven by expectations of tomorrow's economic activity. It is very important to keep this in mind when monitoring the current headlines. Of course, we do sometimes see knee-jerk reactions to headlines such as Ben Bernanke's comments last Wednesday about possibly making changes to monetary policy in upcoming meetings. We got a quick reaction in the US financial markets and then an even bigger negative reaction in Japan overnight as that market reacted to slowing growth in China.

We know that markets can't keep going up without taking a break, so we have been looking for some level of pullback. However, there are still reasons for optimism, and we will talk about a few of these.

We had a solid 10% return on US stocks in the first quarter of 2013, and now we find ourselves once again in a market which is balanced between risk-on and risk-off mode as concerns have grown about the outlook for global economic growth and when the Fed will begin to make changes.

Markets declined the afternoon of May 22, 2013, as the Federal Open



Market Committee (FOMC) minutes from the May 1st meeting were released and as investors reacted to some of Ben Bernanke's testimony. These minutes reflected a little more willingness to adjust the flow of bond purchases downward as early as the June meeting. The financial markets were not very happy to see this discussion taking place concerning tapering bond purchases this soon. We believe that won't happen and expect



that it is more likely to be the September meeting of the FOMC where the decision might be made to begin reducing the \$85 billion per month of asset purchases.

Not too long ago the Federal Reserve stated that they will keep buying \$45 billion in Treasury bonds a month on top of the \$40 billion a month they are already buying in mortgage bonds until they see inflation likely to exceed 2.5% or unemployment declining to 6.5%. We are still a long way from these targets with the core CPI at 1.7% and unemployment at 7.5%. So, we do not anticipate an early end to the Fed's easy monetary policy.

We do have some concern about how the changes in the Fed's easy money policy will impact the increasing growth of the economy, but we are currently in a watch mode to see what their next steps will be.

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### There Are Positives

As for the economy, it will be impacted by what happens with budget negotiations in Washington and with consumers. Small business leaders remain cautious and need to be more confident in the economy before they start rehiring in a meaningful way.

The economy is likely to strengthen as we move through the year and reach higher levels of clarity on taxes and spending. We also expect

that housing will continue to rebound and that the economy will be buoyed by spending on autos and capital equipment.

When we look at all of these items together, we see the economy growing more slowly in the first half and strengthening in the second half of the year. The cyclical sectors of the economy such as housing and autos have been doing well. Housing starts were strong in March and then disappointing in April. There is still room on the upside for housing starts since the supply of homes is not high enough to meet current and growing demand.

Total vehicle sales have been coming in strong, in line with the 10-year averages and up significantly from levels seen 3 years ago. And the fact that Americans are still driving cars with an average age of 11.1 years means that there is still a lot of pent-up demand in the auto sector.

### Should We Be Worried?

In judging the health of the stock market, we look first at Federal Reserve policy and economic growth. Most central banks, including the Federal Reserve, are still conducting easy monetary policies that are supportive of economic growth. We next consider the valuation of the market and take a look at investor sentiment. We are almost through the Q1 2013 earnings season. Earnings are coming in above expecta-

tions for the most part while revenues are coming in slightly lower.

There are always risks in investing, and that is why we spend the time we do in determining the appropriate asset allocation for each of our client's portfolios. Geopolitical risks, for example, are always going to be there. North Korea and Iran easily come to mind, and Syria is becoming a hot issue. As we have recently been reminded, the risk of terrorist attacks on our soil remains as well. We cannot make any of these risks disappear, but we continue to focus on managing risk based on client objectives and concerns.



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The market tends to underperform historically from May to September and then outperform in the October to April time frame. We could well experience some type of market correction this summer as investors lower their expectations for global growth. For long-term investors, stocks continue to represent better value than either bonds or cash at current levels. If stocks were to sell off this summer, we would look for opportunities to add to accounts which are underweight in equities.

Interest rates are low and liquidity is abundant. The economy is still growing, although at a sub-par rate of growth compared to past recoveries. Valuations are not stretched, especially when considering how low inflation and interest rates are, and sentiment is nowhere near extremes of bullishness. This may be the most

doubted rally ever. We have climbed a wall of worry for some time, and we expect to keep climbing with some breaks in between.

## Social Security Has Gone Digital

Since 1999, the Social Security Administration has been mailing estimated Social Security Statements annually to workers. In an effort to save approximately \$70 million per year in printing and mailing costs, they have stopped mailing annual statements with one exception: workers age 60 and older who are not yet receiving Social Security benefits. We did find something interesting when we did an informal survey of some individuals who fit this criteria. The ones who had already signed up for an online account did not continue to receive statements.

The next step for most people is to go online to [www.ssa.gov/myaccount/](http://www.ssa.gov/myaccount/) to obtain their Social Security Statement. If you have already created an account, all you need to do is sign in with your user name and password. If you have not, you can create an account if you are at least 18 years of age, have a Social Security number, a valid email address and US mailing address. For your security, you will need to provide information about yourself that matches the information on file with Social Security



as well as some information that matches your credit report. Once you set up an online account, the information is protected with your unique user name and password. The digital version of the Social Security Statement is identical to the paper version. In addition to showing your earnings record, the statement shows your estimated Social Security payments at your full retirement age, at age 70 and at age 62. Full retirement age was 65 for many years. However, beginning with people born in 1938 or later, that age gradually increases until it reaches age 67 for people born after 1959. The estimates are based on your average earnings over your working lifetime and assume you will earn the same amount of annual income from now until retirement. The statement also shows the amount of survivors' benefits your child and spouse may receive.

Obtaining a digital version of your Social Security Statement is remarkably easy and straightforward. We encourage you to go online, set up your account and view, print and save your benefit record. Please remember to save your user name, password and challenge questions in a safe place.

Reviewing your statement on an annual basis is important for several reasons. The first is to make sure it accurately reflects your earnings, and the second is to make sure you are

familiar with any changes that have taken place in terms of estimates of future benefits.

While you may not think that you need to know your Social Security benefit estimates, especially if you are younger, and retirement is decades away, it is important to review your statement annually to ensure accuracy. Since your benefits are based on your highest 35 years of earned income, you want to ensure that the earnings reported are correct. Just this past year a client identified an error made in reported earnings on her Social Security Statement so you can't assume it is correct.

Another online feature provides links to information about applications for retirement, disability and Medicare, as well as instant benefit verification letters for those receiving payments. The letter serves as proof of income to secure loans, mortgages and apply for state or local benefits.

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## High-Frequency Trading and Dark Pools

Regulators and legislators are focusing their attention on high-frequency and algorithmic trading, the role of dark pools, and efforts to increase liquidity to smaller issuers, and many other challenges. Here are some of our thoughts concerning these issues and challenges in answer to some great questions clients have asked.

The use of high-frequency trading has expanded exponentially since it began about a decade ago as demand from institutional investors has increased and 100% electronic exchanges have been created. The expansion of high-frequency trading has led to a continued reduction in commissions. The cost of implementing a high-frequency trading operation can be prohibitively expensive, and for this reason alone, it is unlikely to be employed by all trading desks. Once a firm has made the investment, however, even small firms are able to compete versus the largest trading operations. It has been estimated that over 50% of all trades in the US equity markets are executed using automated computer programs.

Institutions contend they have a need for this type of trading because of the great size of the orders which they must place every day. In order not to cause imbalances in the stock market when entering either buy or sell orders, institutions can use high-frequency trading to break their large orders down into smaller orders which can be executed electronically over the course of the trading day.

The programs that direct these trades actively search for the best venue at which to execute the trade. This can include any one of

*Regulators and legislators are studying the many different*

*Facets of the structure of the equity markets this year. The*

*markets are far more complex now than they used to be.*

*Regulators want to assure themselves that they are on top of the situation.*

### What is high-frequency trading?

High-frequency trading is the automated, super-fast trading that takes place when sophisticated computerized tools are used to trade stocks, options or futures. This kind of trading takes place in markets with electronic access. High-frequency trading takes place in fractions of a second compared to the minutes required to execute a trade with human input. Proponents of high-frequency trading argue that such trading increases liquidity and reduces spreads (difference between the price at which an investor can buy or sell a security) and thus increases the efficiency of the trading in the market overall. Institutions such as mutual funds, pension funds, hedge funds, and Wall Street trading desks place orders in these markets.

## More Q & A



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the major exchanges, such as NASDAQ, NYSE, NYSE Arca or BATS, or one of the off-exchange dark pools which we will discuss later in this section.

Those who use high-frequency trading claim that high frequency has helped make markets more stable, transparent and efficient. On the other hand, the practice has been blamed for a number of glitches which have taken place on global stock markets in recent years. At this point, high-frequency trading is still in its early stages. We would expect and hope that as the market matures, more controls and self-policing mechanisms will develop. We also expect that regulatory bodies such as Financial Industry Regulatory Authority (FINRA) and the SEC, among others, will be increasing the attention they pay to high-frequency trading and most likely implementing further regulations of the practice as it develops. We will need to stay tuned as this evolves.

### What are dark pools?

Dark pools are equity trading systems that, in contrast to traditional exchanges, do not publicly display the size and price of orders and where buyers and sellers remain anonymous. Hence they are called dark. Dark pools have grown in recent years while volumes have been declining on open exchanges. US

regulators are now investigating the dark pools, which many have blamed for the decline in trading volume on open exchanges.

Dark pools are operated mostly by large financial institutions such as Credit Suisse, Morgan Stanley and Citigroup. They are regulated by the SEC and FINRA. Trading venues where professional traders can trade anonymously are not an entirely new invention. The ability to trade without the party on the other side of the trade being able to see how many shares one has to buy or sell and at what price has always been a major advantage for large traders. Supporters of dark pools contend that these off-exchange trading venues can minimize the market impact of large orders and achieve better prices for investors. Dark pools can also provide a cost advantage compared to the traditional exchanges. It is for these reasons that the SEC allowed more trading to occur off the exchanges in so-called dark pools.

Not only has trading moved increasingly from the established exchanges like the New York Stock Exchange to private platforms, but the percent of all trading taking place away from the public exchanges is now about one-third of all US equity volumes according to Rosenblatt Securities. The chief executives of

## More Q & A



the three top exchanges met with regulators in Washington recently to voice their concerns over the amount of trading which is taking place outside the public exchanges.

The traditional exchanges are trying to get the SEC to focus attention on what they perceive as the disadvantages from off-exchange trading. The exchanges maintain that pricing in the public markets is distorted by the increasing share of trading which is being done off-exchange and out of the public eye. They also object to the various levels of transparency which is offered by the dark pools, depending on the regulatory status of the dark pool and their reporting requirements. It is clear that the growth in off-exchange trading is hurting the bottom line of the exchanges and that it is understandable for them to be suspicious of the dark pools since many aspects of their operations remain opaque. Institutions who use dark pools respond that they have grown increasingly wary of the quality of trading available on big exchanges such as the NYSE and the NASDAQ. They cite the number of technological glitches that have occurred at the exchanges and the fact that exchange trading is now dominated by high-frequency traders.

So..... dark pools may be working well for those institutional traders who use them, but there are issues which arise from their use. Critics claim that trading in dark pools has

now come to be as dominated by high-frequency traders as the exchanges. They also claim that liquidity has been reduced as these off-exchange trading venues have proliferated. There are now about 50 dark pools and 13 public exchanges in the United States today. This creates a lot of competition and innovation from which investors should benefit. The question is whether all this competition and innovation have led to too much complexity and fragmentation. It may be that the fragmentation of the market has led to reduced liquidity and volume in the stock market overall. This reduced level of liquidity is one of the reasons why critics of dark pools think that there should be more trading taking place on the public exchanges.

This could well be one of the issues that contributed to the flash crash of May, 2010. Low levels of liquidity across many trading venues led to high levels of volatility. High-frequency trading firms have been criticized for selling out of their positions and then stepping back from trading altogether. While some firms might have done this, other high-frequency trading firms apparently continued to provide liquidity throughout the volatility. The presence of these automated trading firms may have helped to stabilize the situation and let the market rebound on that day.

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We welcome the attention that regulators are paying to the dark pools and note that investors would benefit if these off-exchange trading venues were subject to better controls and monitoring. Here, as well as in high-frequency trading, it appears that tighter regulation of the operation of dark pools may well be in the offing with an emphasis on greater transparency, including better reporting functions and audit trails. New trading innovations like high frequency trading and dark pools may have increased competition and reduced transaction costs, but they have also left markets more susceptible to errant, poor-

ly controlled trading in periods of high volatility, and this issue needs to be addressed.

For now we are concerned that these dark pools do “block the light” but remain optimistic that our regulatory agencies will figure this out before too long. In the meantime, we need to stay aware and monitor the activity in this area.

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As always, please keep us apprised of any upcoming cash needs which you may have. This enables us to raise cash well in advance of the need. The world of finance and investment is never dull and boring. Sometimes boring would be a really good thing, but until that day comes, we will continue to focus on ways to balance risk and return.

Have a wonderful Summer!

*Diabann*

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