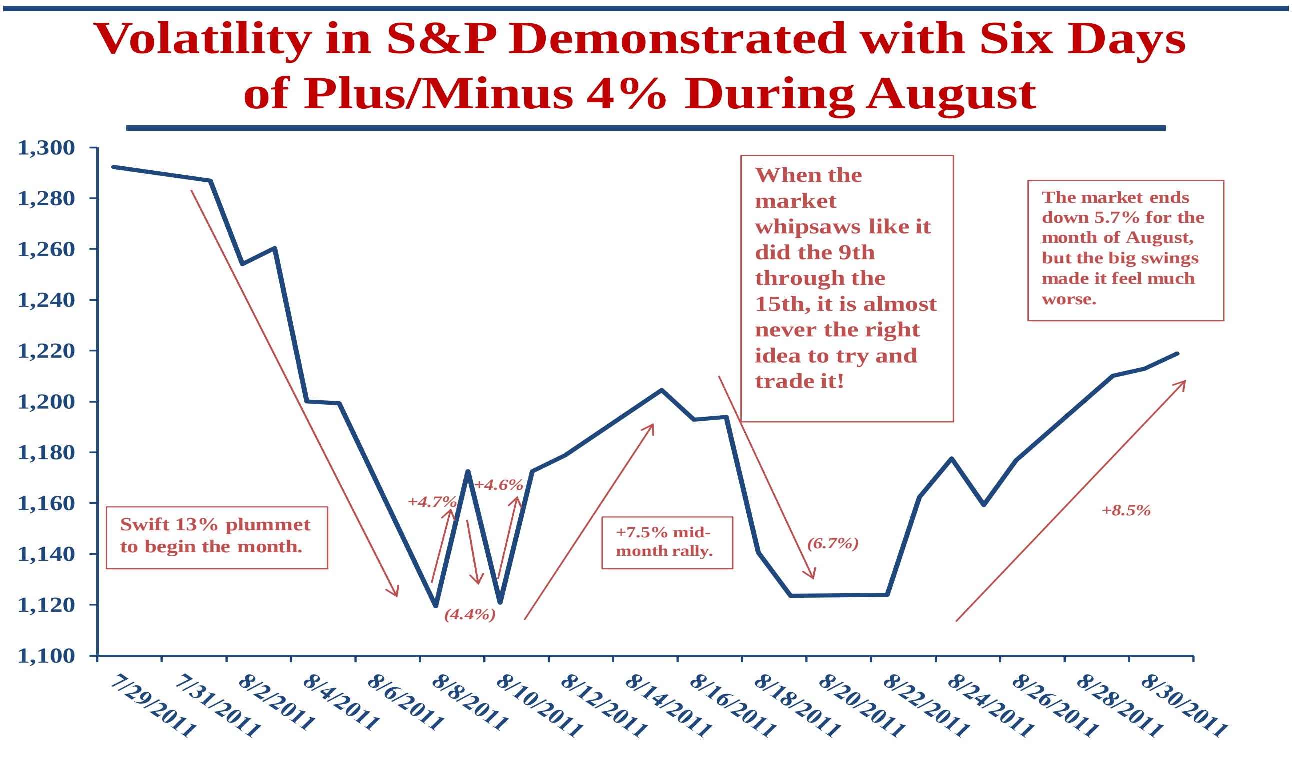
Is High Frequency Trading Feeding the Recent Volatility?

Heightened volatility in the stock market makes investors nervous. The S&P 500 displayed this prominently during the month of August. From August 8th through August 11th the S&P 500 experienced four plus or minus 4% days in a row, but ended down for the entire month just a bit more than one of these single day fluctuations. During this period Darrell & King took time to reevaluate internal economic expectations and to focus sharply on companies that can continue to grow during very slow economic expansion.

Graph 1: S&P Price, in US dollars



It's not a surprise that investors question the trading volatility and volume in the current marketplace. One source of blame for the stock market volatility described above lies with a new activity called High Frequency Traders (HFT). Several institutions, including large banks and hedge funds, seek to make a small profit margin (pennies or less) on trading in and out of stocks quickly using computers. The firms themselves claim to supply liquidity to the market by narrowing the range between the bid and ask spread, making trading cheaper for other investors.

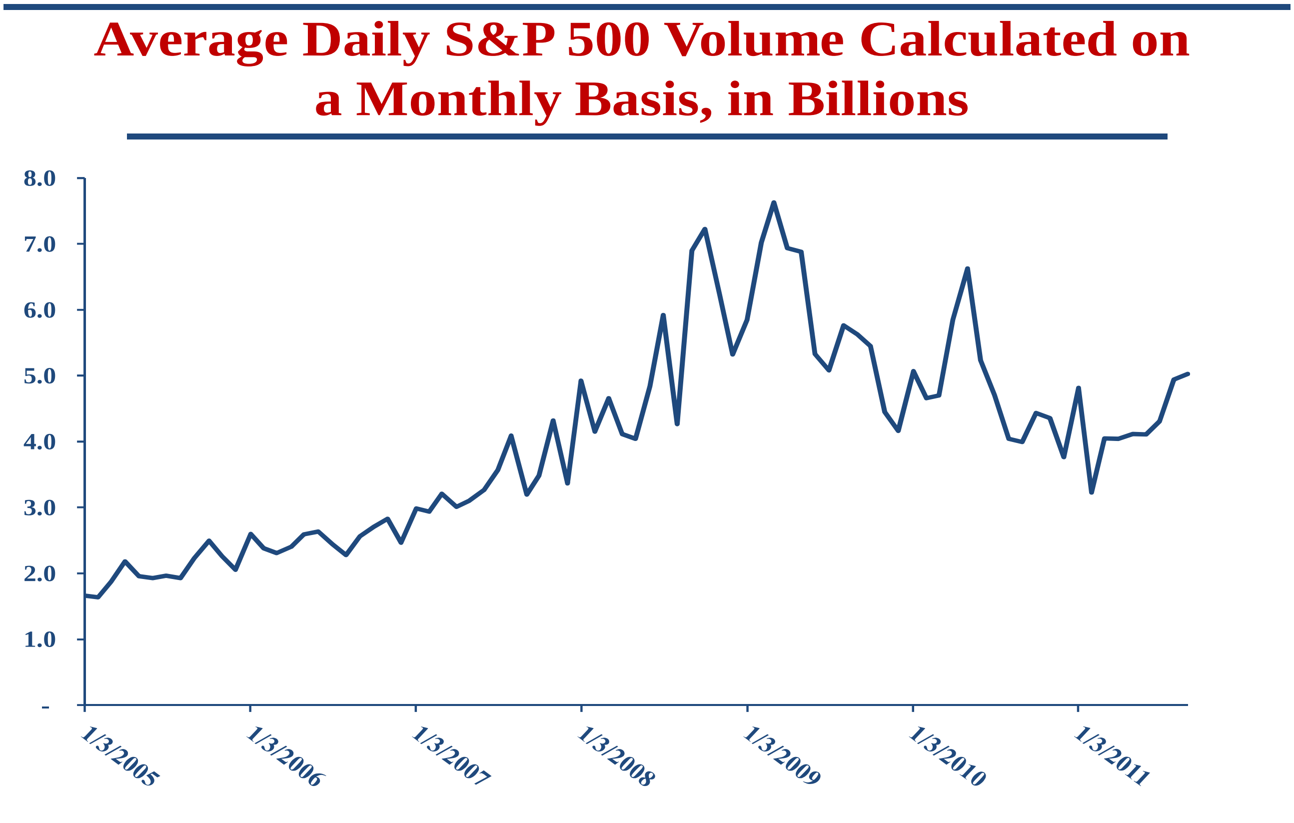
In fact, the function is similar to what specialists provide in selling stock when there is a lack of stock for sale and buying shares when there are not enough buyers. Although they can facilitate individual trades, HFT firms are not trying to invest in companies for the longer term, **and generally close their positions by the end of a trading day.**

The Securities and Exchange Commission (SEC), which has allowed High Frequency Trading, has requested details of the participants trading strategies. Presumably, the Feds are attempting to reach a judgment on the actual market impact of HFT's as well. The bottom line is that the practice has increased daily trading volume significantly.

However, their trading does not create or destroy long-term valuation trends in the marketplace.

The chart below shows average monthly S & P 500 trading volume from 2005 to the current time. One glance reveals from 2005 through September 1, 2011, volume has increased more than 200%, from 1.7 billion shares a day to about 5.0 billion. The High Frequency trades have helped balloon the volume indicated.

Graph 2:



However, we believe that a second source of higher volatility has been a much higher focus on news items (even old news) impacting the trading direction for the day. The news impact seems to be having a greater impact than in prior market and economic cycles – something facilitated greatly by technology. PC's, I-Pads, notebook tablets, I-Phones, etc., hum an endless "drumbeat of daily trivia." The market today moves with every single word out of Washington or Greece, regardless of how meaningless.

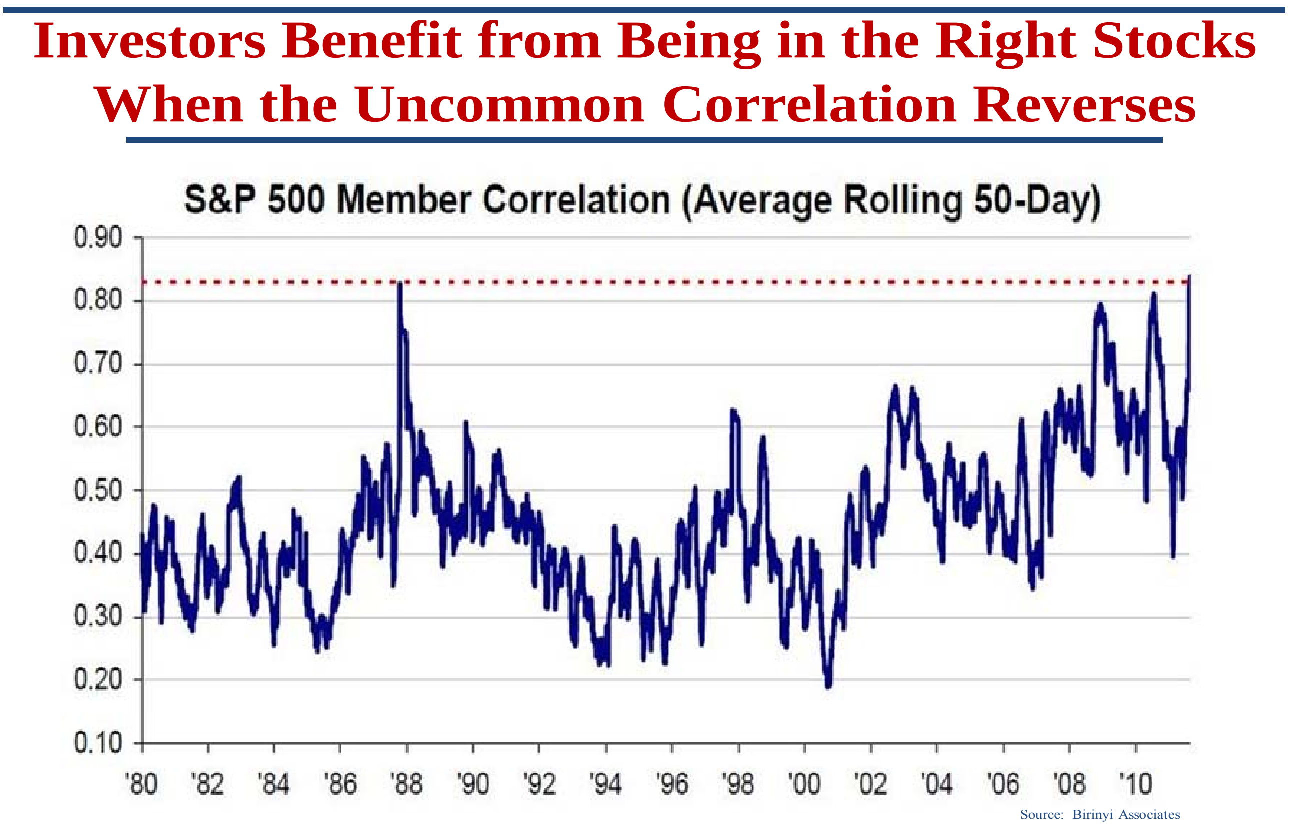
Our 1st Quarter 2010 newsletter mentioned Greece's debt crisis. It does not make sense that the market would move down 4% one day and up 4% the next because Greeks are more or less likely to accept pension austerity – yet it does sometimes. The price of stocks should include that information at this point. We do not mean to minimize the seriousness of the debt problem worldwide – we realize that the

European countries and the United States must begin to tackle their debt structure, and start to live within their means over the longer term.

Our current market situation results from a complete lack of ability to analyze the political and economic situation and formulate an investment strategy for the longer term. That lack of ability and the *emotional group think* has led stocks to move together in unison, which adds to the volatility.

Graph 3, below, illustrates how closely each stock in the S&P 500 moves with each other. We are currently near an 80% correlation, which means 80% of the stocks in the S&P are simply moving together in the same direction – up or down. The lack of analysis and discrimination between individual stocks with different outlooks has led to a "simple think" – buy or sell based on the emotional news of today. Such speculation will not work and soon those participating will realize that and change.

Graph 3: S&P Member Correlation



So what do we do? The keys remain the same as all 37 years that Darrell & King has been in business. Find strong companies with healthy financials that will outperform in the market that prevails during the current cycle. Once the "knee jerk" correlation discussed above returns to more normal levels, there should be excellent performance in good companies. Investors will discriminate among stock selections again with sharp analytical tools. Investment in those stocks should lead to above average performance for your portfolio over the next 3 to 5 years.

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