The
Financial Update

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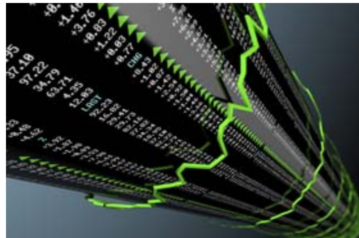
High-Frequency Trading: Big Profits In Small Doses

In September 2009, when the Securities and Exchange Commission officially proposed a ban on "flash trading," SEC chairwoman Mary L. Schapiro said the agency wanted to balance the often competing interests of long-term investors and short-term traders. The proposed rule change focused attention not only on flash trading but also on a broader phenomenon, high-frequency trading, which now accounts for well over half of the volume on U.S. exchanges. High-frequency trading, like flash trading, is complex and poorly understood. But it favors market insiders at the expense of ordinary investors, and could be increasing market volatility and threatening the stability of financial markets.



Most stock trading used to be done on the floors of exchanges, with traders shouting and signaling to each other in haggling to match buyers and sellers. The pace was often frantic, but it produced nothing like the speed of computerized trading, which has gradually supplanted most old-style trading. And as computers have gotten faster, so has the speed of trades. Though there's no precise definition of high-frequency trading, which is handled mostly by supercomputers, it involves shares changing hands in the space of a few millionths of a second.

With great speed comes great opportunity for those in a position to make and monitor trades. Trading firms use sophisticated computer programs to look for even momentary movements in the prices of stocks, options, and other investments that they could profitably exploit. When software detects inefficiency, such as a fleeting imbalance of buy and sell orders, it can pounce, making virtually simultaneous trades that may earn a few pennies a share. Those tiny gains add up. By one estimate, high-frequency trading generated about $21 billion in profits in 2008, and rapid-fire trading may be one reason many large financial firms managed to post strong earnings just months after being on the brink of failure.

Flash orders, which the SEC wants to ban, make up a small though growing proportion of high-frequency trades and in recent months have accounted for 2% to 3% of total volume on U.S. exchanges. In a flash order, if a trading firm on a particular exchange doesn't have an immediate match for a customer's order, it can delay publicly posting it for a fraction of a second, in the meantime "flashing" a glimpse to the computers of traders who have paid for the privilege. For the firm that took the order, that can be an advantage, because instead of paying a fee to another firm for matching the first firm's offer, that trader may earn a rebate from other traders that swoop in to make the trade. And those who see the order might instantaneously post a competing order.

Critics say flash orders foster front

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Fed Policies Make TIPS Popular But They're No Panacea

If you think conditions are ripe for higher inflation, you might invest in Treasury Inflation Protected Securities, or TIPS. But keep in mind that these investments can be more complicated than they seem.

TIPS are popular now in part because of the steps the Federal Reserve has taken to pull the economy out of its deep recession. By increasing the money supply and pushing down interest rates, the Fed has helped banks and the rest of corporate America begin to recover. But those policies could have the unintended effect of spurring rapid price increases.

If inflation spikes during the next few years, TIPS could minimize the impact on your portfolio. Like other Treasury bonds, TIPS pay interest at a fixed rate until the bond matures. But there's a bonus: a TIPS' principal adjusts up or down each month to keep pace with changes in the Consumer Price Index. When TIPS mature, the government returns either your original principal or the adjusted amount, whichever is greater.

However, like other bonds, TIPS sold before maturity may gain or lose value based on changes in bond yields and inflation. And TIPS' yields tend to be lower than those of comparable Treasuries without inflation protection. Recently, a 10-year TIPS was yielding less than half of what a 10-year Treasury note provided. So, if inflation rises less than the breakeven level reflected in TIP yields, this investment may not pay off.

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Veil Lifted From Municipal Bond Market

Municipal bonds have long been prized for their tax-exempt status and because they aren't as likely to default as are corporate bonds. However, the default rate has skyrocketed amid the global economic crisis, increasing the need for transparency in this specialized market.

Regulators have responded with three new measures designed to help investors navigate the complex world of municipal bonds, which are debt instruments issued by cities, counties, and local agencies such as school districts, publicly owned airports, and development agencies. Munis pay for projects such as hospitals, schools, public buildings, roads, and utilities. Bonds that fund programs for the public good are usually exempt from most taxes, including federal. While mutual funds, banks, hedge funds, and corporations all invest in the $2.7 trillion municipal bond market, 64% of muni investors are individuals.

In 2008, 140 issuers defaulted on $7.6 billion in muni bonds as states and cities across the nation faced massive budget deficits. That compared with just $226 million in defaults during 2007. This trend, which is likely to continue, makes munis a bigger risk, and means investors need timely information more than ever. Here are three ways the federal government is bringing more transparency to the muni market.

Putting it all online. Over the summer, a new website called Electronic Municipal Market Access (EMMA, at http://emma.msrb.org) began offering free information, from financial filings to trading records, on most of the 1.2 million outstanding municipal bonds. Operated by the Municipal Securities Rulemaking Board (MSRB), the site allows investors to research municipal bond issues and keep track of new filings. In the past, investors often were not aware if an issuer had failed to file statements or had taken some action affecting a bond or its rating. The site also offers educational materials.

Into the open, and quickly. The Securities and Exchange Commission has proposed a new rule that would force issuers to disclose on EMMA any change in their financial status within 10 days. That would include changes in an issuer's credit rating, withdrawals from reserve funds, and late payments of principal or interest. In the past, investors have complained about delays in receiving this information and issuers' failure to file required disclosures.

Turning up the heat. The Financial Industry Regulatory Authority (FINRA) is looking into the sales practices of brokerage firms that sell municipal securities and has asked for detailed information on business conducted during 2009.

All of these actions should make for a more transparent municipal bond market. If you have questions about municipal bond investing or your muni holdings, please give us a call.

Yield vs. Risk In Emerging Market Bonds

Stock markets around the world improved in 2009, but the spectacular growth came in emerging markets, which gained more than 75%, according to Barron's. Foreign stocks and bonds swept up a record $64 billion of American investor assets, with just more than half going into emerging market equities, $2.7 billion into emerging bonds, and the rest into developed market bonds. Meanwhile, U.S. equity mutual funds lost $40.3 billion in assets in 2009.

While the money flowing into emerging market bonds represented a small proportion of foreign investment, it was nevertheless a remarkable development. U.S. investors had paid little attention to those fixed-income securities until the global financial crisis reduced yields on U.S. government bonds to next to nothing. Because bonds of developing countries are considered riskier than U.S. Treasuries, they pay more—and recently, a lot more. Some emerging market debt now pays more than U.S. corporate high-yield bonds.

Emerging market bonds provide a good example of the trade-off between risk and return. U.S. Treasuries have historically been considered "risk-less" and pay little. Emerging bonds, which pay plenty, may bring considerable risks. The Dubai scare, when Dubai World announced in December 2009 that it had to renegotiate at least some of its $59 billion in debt, reminded investors of the 1998 crisis, when Russia defaulted on its bonds. Back then, some emerging market bond funds sported yields well into the double digits, as they did again in 2008, according to The Wall Street Journal.

Yet despite their volatility, emerging market bonds can serve as an effective tool for managing risk. They can squeeze a little extra yield out of the income portion of a portfolio while also decreasing risk, thanks to their

A Good Time To Reassess Your Risk Profile

The recent past has given investors an invaluable lesson in risk, which makes now an ideal time to reconsider your "risk profile," the amount of volatility you're willing to accept. From the happy heights of late 2007, the Standard & Poor's 500 stock index lost 55% of its value by March 2009, and much of the damage came sickeningly fast, with a 40% freefall between September and November of 2008. Then came a dizzying recovery, as the S&P rallied 60% between March and December 2009. Yet even after the comeback, the large-company index remained some 30% below its record high.

How your portfolio has fared during this remarkable period depends on how much risk was built into your investments, and on how you responded when conceptual risks became all too real. Many investors, lured into volatile areas of the market when most investments were rising, were shocked when numerous sectors suddenly dropped by more than half. Some of these investors watched helplessly, unable to sell as holdings kept plummeting, while others got rid of everything, determined to stick with cash for the foreseeable future.

Neither predicted outcome was good or anticipated. The purpose of determining your risk profile is to use it to build a portfolio that minimizes disruptive surprises. If you think you can handle a 15% annual loss but would be apoplectic if your investments dropped twice that much, then you need a portfolio that, in most economic and market scenarios, wouldn't dip by much more than that "comfortable" 15%.

But markets don't always behave as predicted. The recent financial crisis highlighted the reality that assets under duress can move together. All manner of stocks—from shares of enormous, normally rock-solid companies to those of small, fast-growing firms and stocks in once-hot emerging markets—headed down together. And while some bonds fared a little better, Treasuries fared the best as safety-obsessed investors bid up prices and caused yields to decline considerably. And alternative investments, including real estate, commodities, and hedge funds, had major issues of their own.

As a result, most investment portfolios did worse than expected, and that exacerbated the problems of investors who had taken on too much risk. Panicking, many sold when investment values were at their lowest point, and with losses locked in, they've missed out on stocks' historic rally.

Reassessing your risk profile now, and making appropriate portfolio adjustments, could help you prepare for the next financial upheaval. This process may involve several steps. The first is to understand how you really feel about risk. How did you react in September and October of 2008, when account balances slid lower almost every day? Were you able to take a long view, assuming that even this bear market would pass, or did you treasure safety above all else? Would you rather stick with less volatile investments even if that means accepting lower long-term returns?

Your answer to that last question depends in part on what you need your portfolio to achieve, and re-examining your financial needs is step two of this process. Perhaps the prospect of postponing retirement or spending a little less during your later years seems like a reasonable trade-off for the comfort of holding less volatile investments.

Once you've figured out how much risk you're willing to accept, and how much you need to reach your goals, the third step of the process is to incorporate your readjusted risk profile into a formal "investment policy statement." This document puts your strategy in writing and commits you to the discipline of a plan built around your financial objectives, risk profile, and investing timetable.

You'll also need to rebalance your portfolio, selling some holdings and buying others, first to get in line with your new risk profile and then to keep allocations steady as markets fluctuate. Finally, it's important to monitor your investments, periodically re-evaluating what you own in light of your evolving personal circumstances.

We have the tools, experience, and expertise to help investors successfully complete this crucial post-crash process, helping position investments for a potentially smoother ride through the next crisis and steady progress toward financial goals. If you would like to speak with us about your portfolio, please give us a call. ●

diversification value, and may provide a hedge against the fluctuating value of the U.S. dollar, as long as the currency of the country issuing the bonds isn't pegged to the dollar.

The governments of many developing countries have received high marks for their handling of the global financial crisis, and if they can follow up with sensible policies as economic growth returns, investors may be more willing to hold their bonds. At the end of 2009, the "risk premium"—the additional return investors receive for putting money into less stable holdings—on developing world bonds, as measured by JPMorgan's Emerging Markets Bond Index Global, had fallen to just under 3 percentage points above Treasuries.

Many investment experts believe U.S. holdings should account for a smaller proportion of investors' assets than they have in the past, and increasing exposure to international markets could include buying debt in developing countries. We can talk to you about the risks and rewards of such investments and help you review your portfolio mix. ●

Inflation-Protected Bonds Are Still Bonds

One major threat to fixed-income investments—and to the retirees who depend on various kinds of bonds to deliver cash to pay their bills and support their lifestyle—is inflation. When the cost of living rises, a dollar doesn't go as far as it did before, and your savings may not last as long as you'd hoped. A special kind of investment—Treasury Inflation-Protected Securities, or TIPS—addresses that risk directly, by adjusting bond principal to keep pace with changes in the Consumer Price Index (CPI). Yet while TIPS may have a place in many portfolios, they're not a cure-all. TIPS are still bonds, and they're still subject to non-inflation risks that can hurt their value.

TIPS were created in 1997 as a variation on garden-variety U.S. government bonds. Like regular Treasuries, TIPS have a fixed interest rate or coupon that determines how much income they'll provide until they mature. But the principal of TIPS adjusts up or down every month as the CPI rises or falls. If inflation rises, so does the principal, and the fixed return on that larger amount means additional income for the bondholder. When TIPS mature, the government pays you the adjusted principal (or the original amount, in the unlikely event that the CPI has fallen during the bond's term).

These bonds' prices and yields factor in an expectation that inflation will rise. That's why, recently, the yield on a 10-year Treasury was about two and a half times the yield on a 10-year TIPS. The only reason to accept the much lower current return on the TIPS is if you expect its principal, and thus its effective yield and its total return, to rise significantly during the time you own the inflation-protected bond. If consumer prices rise less than expected, that 10-year Treasury may turn out to have been a better deal.

But mild inflation isn't the only risk that these bonds bring. Because TIPS are bonds, interest rates are also part of the equation. When real interest rates rise, newly issued bonds will offer higher yields. That reduces demand for existing bonds' below-market yields, and lower demand translates into lower prices. That's why it's often said that bond prices and yields move in opposite directions.

It's not clear when, and how quickly, inflation may accelerate. But almost everyone believes interest rates are on their way up from what have been very low levels. That means the prices of bonds—including TIPS—will suffer. And while TIPS can help diversify a bond portfolio, and could serve as a hedge against inflation, deciding whether to add them to your investment mix is complicated. We can help you consider your options in light of your financial situation and goals. ●

High-Frequency Trading

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running, an illegal practice by which trading firms use advance knowledge of pending orders to generate profits in their own accounts. The mechanics of flash orders—and of high-frequency trading in general—may also lead to market momentum that has nothing to do with investment fundamentals, as investors react to apparent trends that have been artificially induced. As high-frequency trading has taken hold, daily market volume has soared, almost tripling during the past few years, and market volatility has also risen to record levels.

To see how all of this might work in practice, consider a company that has just reported higher-than-expected earnings. Investor interest soars, and buy orders begin to be posted. Instead of immediately filling those orders, though, the exchange may give its Flash Order System members a few milliseconds to see them. Getting a heads-up about surging demand, those flash system members can buy shares instantly and then begin selling them at prices that rise as the original orders are filled. Their profits increase while the share price likely rises faster and higher than it would have if everyone had equal access to the same information. Ordinary investors end up paying more than they should have.

In announcing the proposed ban, Schapiro said the change was needed to avoid the creation of a two-tiered market, in which only selected participants have access to information about the best available securities prices. "Flash orders provide a momentary head-start in the trading arena that can produce inequities in the markets and create disincentives to display quotes," she said. Though the current proposal applies only to flash orders, additional scrutiny for other kinds of high-frequency trading could follow, as the SEC seeks to restore investor confidence after tumultuous recent events. ●

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