Blog: Cutting Through the Noise

Where to Find Sanity Among the Sound Bites

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By Tom Bradley

"Isn't it funny when you walk into an investment firm and see the financial advisers watching CNBC. It gives me the same feeling of confidence I would have if I walked into the Mayo Clinic and the doctors were watching *General Hospital*."

This little jab at the investment industry is doing the e-mail rounds right now. Unfortunately, it's not such a rare scene and is a reminder of just how short-term-oriented professional investors have become. You can't have a conversation today without hearing the phrases "risk on" (the market is going up and risk is being rewarded) and "risk off" (market down, risk punished).

By tuning into all kinds of indicators, including the news flow on the business networks (CNBC and Bloomberg in the U.S. and BNN here), the pros are trying to determine whether their portfolios should be "on" or "off." If we're in a "risk on" environment, they want to be fully invested in stocks and higher-risk bonds, with perhaps some leverage thrown in. If it's "risk off," cash is king and shorting is the order of the day.

I don't like this trend, but I understand why it's happening. Markets have been volatile and traditional methods of holding stocks for the long term have been less rewarding. Investors want more, and are looking for managers who can get them in and out of the market at the appropriate time.

Of course, the implication of "on/off" is that the direction of the market is predictably linked to short-term news (it isn't) and there are people who have it figured out (there aren't). Are we to believe that someone can consistently get the on/off switch right? If asked at gunpoint, the economists, strategists and fund managers who appear on television would answer, "Of course not." It doesn't stop them, however, from making short-term pronouncements (it's an occupational hazard).

But it goes beyond entertainment and sound bites. The on/off phenomenon is having a huge impact on markets. Today there are hundreds of billions of dollars with hair triggers attached. Aggressive market timing and quantitative strategies (algorithmic trading) are no longer exclusive to little hedge funds in Connecticut. The amounts being moved around by large institutions are having a meaningful impact on trading flows and have increased the market's volatility.

There are products specifically designed to help investors time the market. Leveraged ETFs are the most extreme example – the warning labels say they're not suitable for holding periods longer than a day – but the proliferation of ETFs in general is feeding the frenzy. Broad market and sector-specific ETFs provide a perfect on/off switch for market timers.

The combination of trigger fingers and ETFs has meant that in recent months correlations between individual stocks and the overall market have risen. In other words, more of a stock's price movement can be explained by the overall market as opposed to the company's fundamentals. When a fund manager flicks the "off" switch on his Canadian stocks, he might put in an order to sell iShares "XIUs" [the ticker of S&P/TSX 60 Index Fund], which means that 60 stocks are sold, regardless of size, industry, earnings growth, balance sheet strength or valuation. So in the short term, security selection is being overwhelmed by what's happening to the overall market. Mining and technology stocks move in tandem, as if their business fundamentals are closely aligned.

As an industry executive, I'm bemused and somewhat discouraged by the preoccupation with on/off. As a fund manager, however, I'm jumping-out-of-my-skin excited. That's because the more investors who are making decisions for non-economic reasons, the better. The more dollars going into price-insensitive products, the better. The more investors making judgments based on flaky and quickly changeable factors (correlations are the flakiest of all), the better. And most importantly, the more investors and commentators who think they know what the market is going to do next week, the better.

Why better? Because the increasing focus on the short term has improved the chances that fundamental-based managers, who take a longer view and consistently invest for economic reasons (i.e. attractive valuations), will generate above-market returns in the long term. And that's what really matters to clients.

T: **1.888.888.3147** | E: **info@steadyhand.com** | **mobile**

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