GLOBAL FINANCIAL
Private Capital
COMPREHENSIVE WEALTH MANAGEMENT

Five Lessons Learned From Last Week's Volatility

SYNOPSIS

- Volatility surged last week, which resulted in unfortunate losses for individual investors who sold into the panic.
- It's easy to get frustrated over succumbing to the emotional forces in financial markets, but the lessons learned from this recent volatility spike can help us all going forward.
- Mistakes only benefit us over the long run because they are an opportunity to learn how to become stronger and more experienced investors.

VOLATILITY SPIKES ARE LEARNING EXERCISES

One of the more comical assumptions widely accepted in modern finance theory is that investors are rational. Those who are skeptical of such a statement only need to look to last week's market activity for evidence of the contrary.

U.S. equity markets opened on Monday, August 24, with so many sell orders that brokerages were unable to execute trades. In fact, several investors could not even access their accounts online because of the spike in internet traffic, and stock exchanges halted trading in several securities for hours.

The unfortunate investors who were able to actually sell that fateful morning are most likely frustrated and disillusioned with equity markets at the moment. After all, the S&P 500 ended the week up 1%, so it's tough to say that the decision to sell was the right one (especially since the fundamentals of our economy keep pointing in a positive direction).

It's easy to sit around and beat yourself up at the moment, but why waste time on such a useless exercise? Instead, let's talk through five important lessons that we all learned last week that will help us make money the next time we see volatility spike, rather than lose it.

How we reflect on times like last week can either make us better or worse investors.

1. DON'T USE MARKET ORDERS

A "market order" is a type of order that an investor places to buy/sell a security immediately at the best available current price. Market orders almost always guarantee execution and low commission charges because there's not much work required for the broker, and there are no restrictions on the price or timeframe for the order.

The problem with market orders is that they risk major losses to investors during times of volatility. Last week, so many sell orders hit the exchanges that quoted prices often did not reflect the price where trades were being executed.

For example, if a stock's quoted price was $50, and an investor entered a market order during the panic with the expectation that the sale would close at $50 a share, the order could have easily executed lower than $40 because of the erratic trading. To make matters worse, the volatility could have then pushed the price back up to over $50 in a matter of seconds. It's imperative to always remember that market orders are the default option for brokerages, and highly volatile times or less liquid stocks pose tremendous risk to those who use these orders.

Hence, it's up to you to place "limit orders" instead. Limit orders allow investors to set a price and attach other conditions to the trade when needed. By setting restrictions on a trade, investors can protect themselves during times of intense volatility.

In our example above, an investor could have stated that the trade only be executed at a price of $50 or better. Doing so, would have protected the downside from the violent price swings that we experienced early last week.

Simply put, investors should not use market orders because you lose the control of how the order gets executed, and most importantly, at what price.

2. NEVER USE STOP LOSSES

Admittedly, market orders are not always dangerous or inherently risky. Selling 100 shares of Apple on a slow day in the market won't pose much risk to an investor because it is one of the more liquid stocks in the world.

What will harm investors over the long run are "stop loss" orders, and they are never to be used under any circumstances. These orders are designed to limit an investor's loss on a position by instructing a broker to sell a specified price.

For example, if an investor bought a stock at $50 with a stop loss at $40, the stock would be sold on the next price after hitting $40.

At first, the appeal of such an order is obvious. Capping a potential loss on an investment to prevent a major drawdown in a portfolio sounds great on paper, but <u>stop losses are never to be used for two reasons</u>:

1. **Execution**: Stop losses do not guarantee execution at a specified price. Once a stop loss is triggered, the order is entered as a market order, which exposes it to the issues explained above. Hence, it's the worst of both worlds during volatile times.
2. **Intent**: Short-term traders use stop losses to limit their exposure to the market, but long-term investors should never sell a stock simply because it drops below a price threshold. It's rare to buy stocks at the bottom, and trying to time bottoms never works consistently.

Last week's volatility is all the evidence I need to support my claim. Stop losses acted as gasoline on a flame because panic selling triggered stop losses, which then dumped even more market orders into the system.

J.P. Morgan's stock (ticker: JPM) was down over 20% at the open on Monday morning. Long-term investors who owned JPM, but who also used stop losses anywhere up to 20%, may have locked in a loss even though the stock recovered within seconds.

In summary, while market orders are not always a risk to a long-term investor's portfolio, stop losses offer zero upside to investors and should never be considered.

3. EXCHANGE TRADED FUNDS ARE NOT PERFECT

An exchange traded fund (ETF) is a marketable security that tracks an index or a basket of stocks, bonds, and/or commodities. The fund owns the

501 North Cattlemen Road, Suite 106 • Sarasota, FL 34232 • Tel: (866) 641-2186 • Fax: (941) 312-6512 • www.gf-pc.com

underlying assets and then divides ownership of those assets into shares. These shares of the ETF are then traded on stock exchanges.

For example, if an ETF was created to track social media stocks, the fund would buy Facebook, Twitter, and other stocks in the sector, and then issue shares to investors that gave them a claim on a portion of the value of the fund. ETF share prices change throughout the day in response to the prices of the underlying holdings.

During the open last Monday, ETFs came under intense pressure because the holdings inside ETFs were selling so fast that the ETF could not track properly. The discrepancy got so large in many ETFs that the exchanges halted trading as a safety precaution.

For example, several ETFs had fallen over 30% in value, when the combined losses of the stocks within them only totaled a loss of 3%. In short, ETFs exposed flaws that nobody had seen before.

Investors were furious when the exchanges halted trading because they were anxious to sell and protect from any further downside. Market pundits also used the halting as a weapon against the ETF industry, stating that these products are flawed because they did not give investors the liquidity they had expected during times of stress.

***NOTE**: I don't see how being prevented from selling into panic at a price that is not even close to accurate is a bad outcome. Those investors who were fortunate enough to not get their orders executed were spared gut-wrenching losses.*

The lesson here is that ETFs are not perfect, but investors should not use last week as a reason to shy away from using ETFs in the future. I would expect to see a swift response from ETF providers and the exchanges to address this situation. Until then, if we see a repeat of last week in the ETF world, don't panic because when exchanges halt ETF trading, they do so to protect investors rather than hurt them.

4. WAITING FOR THE PULLBACK PROBABLY HURT MORE THAN HELPED

It's pretty obvious that any rational investor seeks the best price for an investment. Nobody wants to purchase a stock and then watch it fall 10% before it begins its gradual climb up over the next two years as a thesis plays out.

However, timing entry points is extremely difficult, and those who had been waiting for the pullback last week before buying, were forced to watch the market do nothing but climb higher over the past four years. Sitting out of a market that has surged over this time period, just to save 10%, has done more harm than good. Think of all the potential gains that an investor has missed by sitting in cash.

Therefore, the next time you are forced to listen to a friend bragging about getting in the market during the selloff last week, ask them how much and how long they sat in cash until they put it to work. I'm guessing that their "victory lap" will quickly end once they consider how much they missed out while sitting on the sidelines.

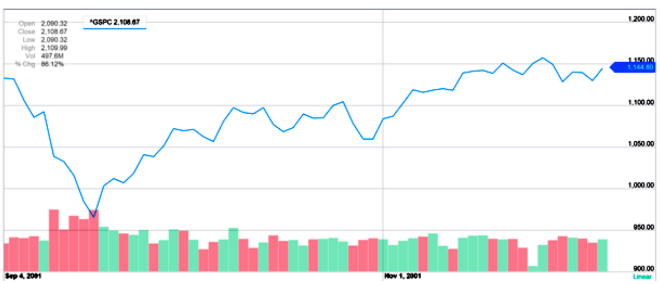
***NOTE**: I'd even argue that most investors who had been waiting for this pullback never ended up buying last week anyway. Knowing how this cohort thinks, they either got spooked or waited for a better price that didn't come and missed the window.*

5. PANIC SELLING ALWAYS LOSES MONEY

In the long run, fundamentals determine the prices of stocks. If Apple sells more iPhones, their stock will most likely rise over the span of one or more years to reflect the higher sales and profits for the company.

In the short run, markets are dominated by fear, panic, and greed. For example, Apple dropped 15% in a matter of seconds last week. Are we to believe that the largest company in the world magically lost tens of billions of its future profitability, only to recover it minutes later? Not a chance.

Last week was not the first time we have witnessed broad-based panic selling. The chart below shows the S&P 500 during the attacks on September 11, 2001.



This time period represents the worst attack on U.S. soil since Pearl Harbor, yet it was not enough to drive our economy into a recession. In fact, those who bought into the panic when the market was eventually opened, were able to participate in one of the best buying opportunities in the history of our equity market.

The fear of a slowdown in the Chinese economy was the primary catalyst for last week's selloff, but those who panicked were not paying attention to the fundamentals. For example, here's a fun fact, courtesy of Goldman Sachs: China accounts for 2% of S&P 500 company revenues and less than 1% of U.S. exports.

Also, a lot of attention has been given to slowing economic growth in China. However, while the percentage increases in the economy are indeed slowing down, the actual dollar amounts are going up. According to Templeton Investments, when China's economy was growing at 10% in 2010, about $844 billion was added to the economy, but with growth at 7.7% in 2013, $986 billion was added. Although it is slowing, it is still growing and adding to the overall size.

Yet, somehow investors were overcome with the urge to shoot first and ask questions later. Well, just as the market quickly recovered after the attacks on 9/11, equities recovered last week in a matter of days to end the week up one percent, once investors started to pay attention to the data.

The lesson learned here is to assess a situation from a fundamental perspective the next time emotions take the reins in the market. Determine if the reasons for the selloff are going to materially impact the largest economy in the world, and if not, have a plan to take advantage of those who are not willing to learn from past mistakes if the opportunity presents itself.

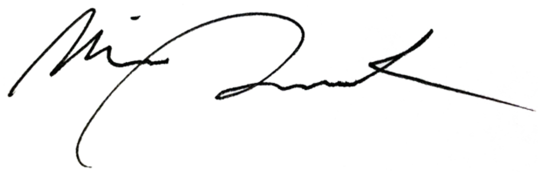
IMPLICATIONS FOR INVESTORS

Mistakes predicated on emotional responses during chaotic times are to be expected. There's simply no way of getting around the fact that we are all human, but how we reflect on times like last week can either make us better or worse investors.

Those who are able to look back and assess the situation from an objective point of view are in an advantaged position to determine what went wrong and why. We do this not to beat ourselves up, but rather to learn and apply these lessons to the future.

The bottom line is that experience can turn amateur investors into seasoned ones as long as we can view our mistakes as learning exercises rather than reasons to stay out of financial markets entirely.

Sincerely,



Mike Sorrentino, CFA
Chief Strategist,
Aviance Capital Management
mikeonmarkets.com

This commentary is not intended as investment advice or an investment recommendation. It is solely the opinion of our investment managers at the time of writing. Nothing in the commentary should be construed as a solicitation to buy or sell securities. Past performance is no indication of future performance. Liquid securities, such as those held within DIAS portfolios, can fall in value. Global Financial Private Capital is an SEC Registered Investment Adviser.