WHAT IS THE MARKET AND WHY DOES IT MOVE?

"I can calculate the movement of the stars, but not the madness of men."

Sir Isaac Newton after losing a fortune in the South Seas investment market.

SO WHAT IS "THE MARKET"? First, there is not a single market. Most often what is referred to as "The Market" is the Dow Jones Industrials, a composite of 30 of the largest stocks in the country, like Disney and General Electric. There are better proxies for the market, though, like the S&P 500, composed of 500 large capitalization stocks selected as representative of the economy by a committee, and the Wilshire 5000, which includes nearly all the listed stocks in the country. There are 36 approved exchanges in the US, and more than half trade stocks. The best known is the New York Stock Exchange (NYSE) which lists 2800 of the largest companies in the country, and trades $1.46 Billion shares daily. Some of the NYSE trades occur on the floor, executed by specialists in booths surrounded by the frenzy you see on TV, though a larger portion is done electronically upstairs. However, more trades occur on the National Association of Securities Dealers Automated Quotations (NASDAQ) which lists over 3100 companies, many generally smaller that those on the NYSE. NASDAQ trades on highly sophisticated computerized trading programs to the tune of $2 Billion shares daily. Then, there are markets for bonds, futures and options, but they're for another day. Let's talk about the stock markets.

Stock exchanges are auction marts, kind of like a cattle auction, except that the floor of the NYSE is generally only covered with paper. There is a bid and ask and there are buyers and sellers for each transaction. Supply and demand dictate prices in all the markets. So, in a way, each time a stock is bought or sold, somebody was wrong. Stocks, like cattle are analyzed based on history/heritage, potential, past performance, fundamentals and appearance. When markets move, it is usually the result of factors like:

- Emotion. Markets respond to the difference between what the participants in the financial business expect to happen and what actually happens. Even if a company has good earnings but a lower-than-expected near-term performance ahead of it, the stock can head south regardless of strong current results. (See Apple). Note that the biggest movers of the stock markets are institutions: mutual funds, large commission funds

1. Greed. As stocks go up some investors jump in because they want to participate NOW. The desire to make a 'quick killing' destroys any sense of responsibility. Investing becomes a gamble.

2. Fear. Fear also moves the stock market, but in a different direction. Sometimes, investors become so afraid of losing more money that they will sell holdings at almost any price in order to get out... NOW.

3. Herd mentality. The possibility of being left at the gate causes knee-jerk reactions, which are generally unsound reason to invest.

4. The opinions of experts you haven't met. Influential analysts and money managers examine fundamentals like earnings, inflation, interest rates and oil and energy prices; creating those expectations that move stocks, sectors, and the markets. There is no 100% agreement among them. For every one that's right, there's one that's wrong. Take Apple (AAPL) for instance. Last year the company predicted first quarter earnings of $3.36 per share, solid, and more than many analysts' expectations of about $3.21. Plus, it declared a dividend of $.57 Apple's price up $5.88 and closed up $7.40. Justified? No one knows.

- But the principal force that moves markets and its experts is **uncertainty.** It drives analysts absolutely crazy**.** They cannot stand surprises and when there is the chance that something may change, it makes short-term stock prices volatile, erratic and unpredictable.

When you buy the stock of a corporation, you have an ownership share and are entitled to part of that corporation's earnings and assets. Stockholders make money when the stock increases in value or when the company pays a portion of its profits, called dividends, back to its shareholders. Most equity ownership in this country is in large mutual funds.

Investors, mom, pop and institutions, <u>react</u> to the Market, they do not <u>cause</u> movement, at least not directly. When emotions take over and there are a disproportionate number of sellers than buyers of these large mutual funds, funds must sell shares to pay their exiting investors, not because of any investment decision made by the professionals who manage the assets. Sometimes, though, the investment professional that manages fund assets must follow the herd in case <u>they're</u> right and he/she's wrong.

So when you see any week that is an especially volatile one in the US stock markets, economists and analysts may describe it as follows: "An early global sell-off amid growing fears that a U.S. recession triggered by huge losses to financial firms due to the XXXX crisis could send economies around the world into a downturn. Weak economic data and the anticipation for more disappointing economic news contributed. In response, the Federal Reserve cut (or raised) or may cut or raise interest rates by 0.25% in an attempt to restore stability to the faltering U.S. economy. As investors digested the Fed's move, bargain-hunters entered the market, creating volatile trading, and market charts were craggier than the Tetons".   Or something like that.

Believe it or not institutional money managers generally try to buy at lows in the markets, so when there is a huge drop in the indices like last week, you can bet today that there will be upticks that spell r-e-c-o-v-e-r-y. Until the next time.

Market movements in this digital age are heightened in volatility by algorithmic trading, Traders establish a set of instructions to place trades faster than any human element can. Basically a mathematic model, a computerized system executes orders at the speed of… well computers. No decision making is involved, so they are essentially market followers. They do not create efficient markets; instead, they exacerbate inefficiencies and create chaos and volatility at times. (ie; witness last week). A common method for high frequency- traders set parameters based on price trends or to take advantage of pricing differentials on different exchanges (arbitrage).

So what should <u>we</u> do in Volatile markets?

Wait.

Do not overreact. Some days the S&P 500 may range from down 2.75% during the day to up 2.13% at the end of the day.
Don't listen to the talking heads on <u>any</u> financial channel.
Don't read any investment advice magazine.
Don't ever read the back page of the Business Section of *USA Today*.

If you dutifully followed the advice of all the pundits you would be so confused you could lose all your cash quicker than a blue light special at Vegas. But, if you MUST do something with your money NOW because you can't stand it, they do have these little machines over in Deadwood that have spinning wheels, flashing lights and bells and everything.