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In Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

There Is a Big Difference Between the Economy and the Stock Market

For the past couple years, investors have been bombarded with bad news about the economy. Investors may feel like they should be selling, assuming that with all the bad news, stocks just have to go lower. The flaw in this thinking: There is a major difference between the economy and the market.

Nightly stock market recaps of the Dow Jones industrial average often follow reports about economic activity, but that does not mean the two go together. Academics have studied the behavioral tendency to draw connections between unrelated events or associate disparate data, known as an illusory correlation effect.

Researchers have found that once people draw a connection between non-related events, it becomes difficult to accept contradictory information. Whether it is the non-relationship between the latest U.S. Farm Report statistics and the market's movements, or the lack of connection between the last 10 spins of the roulette wheel and the next one, this behavioral effect can result in accepting a false opinion about a situation.

What's the Difference?

The big difference between the economic news and market activity is that the economic news relates what has already happened while the market is forward looking. Unexpected events, which by definition are unpredictable, are the major factor driving future stock prices. It doesn't even matter whether future news is good or bad. What matters is whether it is better or worse than *already expected*. This is exactly the scenario that has occurred since March 2009.

Lately, unemployment, possible changes in tax law and low residential real estate prices have haunted the headlines. Yet, the S&P 500 Index rose from its March 9 low of 677 to 1141, a gain of 68 percent, as of September 30, 2010. The reason for the strong performance is that the market **expected the economy to do even worse**. The fact that economic news has been better than expected fueled the rally. However, only investors who had the discipline to stay the course benefited from that rally.

A Real Correlation

Educated investors understand that risk and expected return are positively correlated. The greater the perceived risk, the higher the expected return must be. Increased perception of risk is what causes bear markets, but the lower prices that result also mean that expected returns are higher.

However, when investors falsely perceive risk by attempting to interpret and connect non-related information, they create unnecessary anxiety and risk derailing their plans. That is why having a well-designed plan that does not exceed your tolerance for taking risk is essential to a solid investment strategy. The reason for the recurring sentiment: Risk inevitably shows up. When it does, it helps to know you have the discipline needed to adhere to your plan.

The Recession Is Over

It may have come as a surprise when the National Bureau of Economic Research (NBER) announced late last month that the recession ended in June 2009.

According to NBER, "In determining that a trough occurred in June 2009, the committee did not conclude that economic conditions since that month have been favorable or that the economy has returned to operating at normal capacity. Rather, the committee determined only that the recession ended and a recovery began in that month."

The recession lasted 18 months.

Further, the committee noted that, according to its data regarding the strength and period of recovery to date, "any future downturn of the economy would be a new recession and not a continuation of the recession that began in December 2007."

The news media have been quick to point out that while several economic indicators are showing signs of recovery, unemployment numbers remain relatively high. This is not unusual for periods of recovery, as unemployment is a lagging indicator rather than a leading indicator of economic activity.

Faced with frequent bad news on the economic front, it may be difficult for some to accept this is what recovery looks like. As we have learned from previous recessions, recovery feels different each time. That said, it is easier to look back and make an assessment with raw data than to experience a downturn and then wait for recovery to make a lasting impression.

High Frequency Trading and the "Flash Crash"

By Kenneth R. French and Eugene F. Fama

Q: The "Flash Crash" on May 6, 2010, is generally attributed to the growth of automated or "high frequency" trading programs. How have they affected market volatility and security valuation and what, if anything, should investors do differently?

EFF/KRF: We know of no evidence on how high frequency trading has affected volatility. High frequency trading could affect valuations by changing transaction costs. The interesting question is whether high frequency traders push transaction costs up or down. Assume that, as a group, high frequency traders are profitable. Then the key is whether their gains come at the expense of investors or other liquidity providers. For example, if they are just anticipating what investors are about to do and stepping in front of them, high frequency traders' profits add to investors' trading costs and valuations should fall. If high frequency traders are better liquidity providers, they reduce transaction costs and valuations should rise.

By the way, we have yet to see evidence demonstrating that high frequency trading caused the Flash Crash. Apparently, many high frequency traders stopped trading when prices became erratic. To the extent that these traders are important liquidity providers, their withdrawal would have amplified the effect of unbalanced buy and sell orders. To go further and say they "caused" the Flash Crash, one would have to argue that other liquidity providers were no longer around to offset unusual price pressure because they had been displaced by high frequency traders.

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PERSPECTIVES

Perspectives represents a departure from economic and market-related updates and investing commentary. This new section will feature different topics of interest that offer perspectives on improving quality of life.

This quarter, we focus on a topic that affects everyone: interpersonal conflict. The following article discusses the nature of conflict and why understanding more about conflict resolution can bring positive change in everyday life.

Resolving Conflict

Conflict is more than a heated discussion. When it occurs in the workplace, conflict can lead to absenteeism, presenteeism, mental stress and loss of productivity. Conflict also affects the quality of personal relationships.

"Even people who vastly prefer peace, harmony and calm interaction find themselves involved in situations that are tense, escalating and uncomfortable. Truly, we do not have the option of staying out of conflict unless we stay out of relationships, families, work and community. Conflict happens — so we had best be prepared for it."[1]

Understanding the nature of conflict and following a process can help individuals more effectively resolve issues when they arise.

Emotion Is Better Left in the Background

It is not easy to put aside feelings and focus on facts, but doing so is essential to reaching consensus. There are benefits in reaching out to trusted counsel or a trusted confidant for support as you attempt to resolve a conflict.

Moving toward resolution: Concentrate on one objective: Getting back to the table. This requires moving past emotions and working toward a common goal.

Objective Thinking Can Lead to the Unexpected

When individuals take an observer's view of the situation, they can change the direction of the conflict, making it easier to present new ideas for resolution.

Moving toward resolution: Find a benefit that appeals to the other parties involved. This increases the chance they will listen and be willing to seek a solution.

Preparation Is Essential

Individuals who keep a positive outlook and try to find common ground set the stage and tone for a successful outcome. The focus should be on the future, not past disagreements.

Moving toward resolution: Take time to practice. Choose a neutral, comfortable location to meet, write questions and observations before the meeting, and allow ample time for the conversation to take place.

Even if some differences remain unresolved, it is still worthwhile to take time to reach out to the other parties involved. Doing so can help ease pressure and begin to build a bridge toward more productive interactions.

[1] William Wilmot and Joyce Hocker, Interpersonal Conflict (6th edition). McGraw-Hill, 2001.

Source: Psychological Associates, St. Louis.

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