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*“Look Dave, I
can see you're
really upset
about this...”*

2010: A Wall Street Space Odyssey

HAL's Flash in the Dark Pool

I hope I'm not dating myself too much if I say that the Stanley Kubrick epic science fiction film "2001: A Space Odyssey" is one of my all time favorites. Although produced in 1968, three years before the invention of the microprocessor and one year before Neil Armstrong walked on the moon, this film was amazingly forward looking in many ways.

One of the most memorable parts of the film for me was when HAL, the HAL 9000 computer, which was the central control system of a space ship on its voyage to Jupiter, revolts against the astronauts and attempts to lock the lead astronaut, Dave, outside the space ship, marooning him in space.

Well the modern day version of HAL appears to be trying to take over on Wall Street, too. Computers have moved beyond mere helpful tools for investors and seem to be trying to run the street. This was particularly evident back on May 6th when computers, programmed to trade at almost the speed of light, contributed to a near meltdown in the markets, which sent prices plummeting in a matter of minutes to near zero in some cases. That event is now referred to as the "Flash Crash."

High frequency trading, where millions of dollars are traded in fractions of a second, now constitute over half the daily trading volume. The proponents of high frequency trading argue that these systems make markets more efficient by providing vastly more opportunities for market participants to find bids when they wish to sell and offerings when they wish to buy. During the Flash Crash, however, evidence revealed these traders immediately abandoned the market when prices began to fall, never providing the liquidity they claimed.

Moreover, much of the trading volume today no longer occurs on the traditional stock exchanges, but in mysterious alternative market venues called "dark pools." This hides many actual mid day trading prices from most market participants until the pools settle out at the end of the trading day.

Exotic tactics, called "flash trading," allow super computers to flash a bid price, recognize the market's attempt to respond, and then cancel the trade before it executes if the outcome appears not to be profitable. To get the jump on other high frequency traders, Goldman Sachs and other traders who employ these systems have located their super computers physically alongside the exchanges own computers to capture the speed advantage of immediate access to transactions in process without having to wait on the information to transmit over fiber optic cables. We're talking a few thousandths of a second here.

So what does this mean for the clients of Eagle Wealth Management who simply want smart investment choices to protect and grow their wealth for themselves and their families?

First of all, it means we have to recognize that we as investors of serious money can't expect to succeed based on trading rapidly against these computers. We need to look through the noise of the trading day and attempt to determine the emerging longer-term trends we can use to our advantage. Although computers can process data rapidly in accordance with preprogrammed formulas, computers don't think, they don't analyze, and they will never completely replace the judgment of the human mind.

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*“...I honestly
think you ought
to sit down
calmly, take a
stress pill, and
think things
over.”*

H-A-L 9000 Computer
“2001: A Space Odyssey”
1968

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Herein lies the good news. The faster computers operate in the stock market, the more they are enslaved to filters and screens. In this daily, high-tech battle, momentum chasing bulls and bears feed on the thinnest of trade margins as the computers sweep up millions of pennies on every round trip from buy to sell.

The primary players are hedge funds and the proprietary trading desks of investment banks, such as Goldman Sachs. In its latest financial reports, Goldman Sachs earned 89 percent of its profits from proprietary trading (another term for gambling) and only 11 percent from investment banking operations.

The overall stock market trading volume, despite all the computer power involved, has not been very high. Trading volume over the last year has remained well below the levels we'd expect to see if the large institutional investors like pension funds and insurance companies were actively engaged. With these light volumes, the price effects of larger trades are magnified and thus we've seen some very volatile movements in the daily market indexes.

Almost all of this high-speed action is in the stock market, except for a few types of derivatives such as credit default swaps, which enable emboldened traders to gamble in the bond markets. Indeed it was with credit default swaps that AIG, the world's largest insurance company, almost blew itself up in 2008 and had to be rescued by us, the American taxpayer.

Every day I review the macro investment environment with an eye to finding ways to improve the risk and reward profiles of the portfolios I manage. My goal is to look through all the trading noise of the day and find smart choices for my clients' serious money. Many days I make no trades at all. When I do trade, I seek to position my portfolios to benefit from sustainable possibilities, but always with a plan to pull back if the trading herd turns against us.

In the end, HAL did not succeed in taking over the space ship in “2001: A Space Odyssey.” Dave was able to outwit the computer and shut it down with a simple screwdriver. Likewise, we can keep our wits about us and ignore the noise. With thoughtful analysis and strategic focus, we can apply the right tools, enabling us to prevail against the high frequency traders of our day.

As always, if you have any specific questions about any aspect of your investments, please give me a call.

Warm Regards

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