

Coping with an Indexed Market



Clients,

I continue to be preoccupied if not obsessed with the impact indexed products have on stock prices. As an investor, the immediate concern is what to do about the effect of all stocks in an index being purchased or sold by index products regardless of their merits, which I'm convinced increases the correlation between stocks and makes markets more vulnerable to wider swings.

One response is to try to buy stocks not in an index, or stocks in fewer indexes. Ranked by the number of dollars of a stock's total value, numbers 1-500 are most heavily indexed, followed by numbers 1000-3000 (The Russell 2000). To try to pick stocks with market capitalization ranks between 500 and 1000 would be one approach, but doesn't really avoid the issue. To buy stocks smaller than rank 3000 is only 2% or so of the market. They are also affected by microcap indexes, and there often aren't enough buyers and sellers to buy and sell a stock prudently.

The more viable alternatives are:

1. To buy stocks with a lot of buyers or sellers beyond what the indexes and benchmarked managers are buying or selling. While it is not easy to identify these stocks directly, stocks that go up or down much more than the market or do not correlate with the market would presumably qualify. Within these stocks, some will do better than the market and some not so well. Volatility is usually persistent, so one would expect stocks to continue to have extra buying or selling pressure.

What do we know about auctions that might be relevant for the stock market? If you go to an auction and 99 bidders know the true or intrinsic value of the item, while one bidder will pay any price to buy it, it will sell for a notch above the intrinsic value. If two buyers are committed to buy it at any price, such as is the case with index

buying, the price will be run up. In the stock market, presumably a market specialist or index representative will wait a few seconds or minutes to better expedite the transaction. If instead of the auction having one item, we have thousands of shares, the auction is shaped by the relative volumes of buyers and sellers. So the buying and selling pressure is shaped by money entering or leaving the index funds. It is also shaped significantly by corporations buying their own stock, thus reducing the float. Executives are accused of affecting their stock prices more by such financial engineering than by increases in operations and productivity.

So this is not so simple. When I have year-end data, I plan to add correlation and volatility variables to my research database that now includes a fractal dimension. I'm particularly interested in learning if there is a clear boundary between stocks that correlate with the market and stocks that do not. In other words, do 80% of stocks clearly move lock step with the market while 20% move on their own?

I anticipate combining the results of this research with credible newsletters or statistical screens that I have used in the past. A new source that I'm considering that I haven't used in many years is the Shadow Stock portfolio from AAIL. It is primarily low-liquidity micro-cap stocks that has historically done very well, although one has to buy many stocks as the gains are only from a few.

2. Buy securities which are not stocks, such as gold, real estate (REITS), limited partnerships or preferred stocks. I'm particularly interested in gold and silver, since I believe the downside threat is minimal and that within a year or two we will see significant appreciation. Preferred stocks pay dividends of about 6.5% and are less volatile because they are callable at \$25.

An alternative to mutual funds.

Lee Wenzel
(952) 944-2699
Lee@WenzelAnalytics.com
www.WenzelAnalytics.com

Wenzel Analytics, Inc.
Registered Investment Advisor
8666 Westwind Circle
Eden Prairie, MN 55344

3. To attempt to do better than the market by judicious moving between securities and cash (market timing). This is not easy to accomplish. Things look bad when one trails the market and are taken as gravy and obvious after the fact when successful. I know of only three experts whom I would give credibility in this endeavor.

David Nichols with FractalMarketReport.com uses mostly fractals in his analysis. My going mostly to cash is largely based on his analysis. He has been right on most economic indicators, but so far the market has continued to climb contrary to his predictions. This is a market that is not following the normal patterns. Is it perhaps because of the increasing index effect, reducing stock movements to the overall impact of money flowing in or out of the market?

Jason Goepfert with SentimenTrader.com has daily analyses of what has happened following many different similarities to each current market. For example, he reports that at the present time 33% of “smart money” (institutional, large managers) is bullish, while 75% of “dumb money” (retail and smaller investors) is bullish. He reports that spreads like this of more than 40% are prone to precipitous market declines. On his extensive website, he reports the implications of active studies. Currently three are bullish and nineteen are bearish. He also reports on indicators. Of indicators at extremes, none are bullish and 26 are bearish.

The third expert is Len Fox who in a manner somewhat similar to Jason Goepfert takes data from multiple studies but then combines the implications into a management service for advisors. His validated returns are strong. While I generally prefer to do my own research, I intend to look into his service.

4. Buy and hold the ETFs and forget about doing better than the market. Most advisors do not set expectations of doing better than the market. Their service is in financial planning and giving clients faith to stick with the market during its ups and downs (and with the advisor). One could try to beat the overall market by selecting specific indexed ETFs, such as a sector rotation, but this needs to be dynamic and is essentially a

variation of market timing and what Len Fox does.

Beyond the immediate investment concerns, I see the indexes as having significant macro-economic impacts. For example, if stock prices for most companies are determined most of the time by indexed buying and selling, does it make any sense to compensate executives with company stocks and options?

Capitalism relies primarily on markets for the efficient allocation of capital to the most productive corporations. What if capital is distributed by index funds to every corporation indiscriminately? While we may not like the idea of state run enterprises such as in China or Russia, at least someone or some group is trying to rationally allocate capital. How does and will indexed buying and selling affect our overall economic productivity?

A couple of things I find very interesting about this phenomenon is that it is not a result of corruption, malfeasance or power exploits. It is a case of the tragedy of the commons, where when everyone does what appears to be in their individual self-interest, the aggregate effect is destructive. Additionally, so many of us have believed in the sacrosanct markets - or have strong economic incentives to do so - that no one or no institution wants to hear it challenged. We denigrate the aberrations, such as the Madoffs or even the credit default swaps of the banks-too-large-to-fail, but not the market itself.

So I'm going through a time of questioning the premises of how I manage money. I'm becoming more skeptical. There are many variables other than buying stocks representing good or innovative companies. For something as important as financial security, there are a lot of vulnerabilities and very little that we know for sure. Not all of you have or will continue to want to ride with me on this journey, which is fine. I'm at a place where the size of this business is optional; the prudent investment of our family's personal assets is not. My approach to you is that I wouldn't want to invest your money in ways that I wouldn't do with our own.