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## The Trading Vs. Investing Phenomenon

And the benefits to the long-term investor

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As we all know, the summer of 2011 brought another period of increased market volatility. Nearly half of the trading days since late July have finished with losses or gains in excess of 2% and intra-day swings of 3%-4% have been common.

This has been a period where broad economic concerns and short-term trading strategies have influenced market direction much more than individual company fundamentals. One aspect of this 'trading versus investing' phenomenon that is worth examining is the rise in popularity of **Exchange Traded Funds**, more commonly known as ETFs, which have accounted for a reported 35%-40% of recent market activity.

ETFs are designed to deliver the return of an overall market segment in a "passive" manner, without input from an "active" manager to choose the individual securities. They have lower management fees and offer the relative predictability of traditional index funds with the added feature that they are priced and traded throughout the day. ETFs now represent a \$1.2 trillion market, having doubled in size the past five years.

### The use and design of many ETFs have evolved over the years

Originally, ETFs were viewed as a simple, convenient and low-cost approach to investing in the capital markets, much like their index mutual fund predecessors. An ETF is an investment fund that holds assets such as stocks, commodities or bonds that track an index.

These derivatives, if used properly, do offer benefits to investors, and Federal Street has recommended them on a selective basis in the past. However, many investors use ETFs as short-term trading instruments. In addition, day traders have embraced more complex versions of ETFs in recent years, such as leveraged ETFs that allow investors to bet on a market move with borrowed money. Leveraged ETFs are rebalanced each day to provide a return that is two or three times as great as the movement of a targeted market segment; thus their appeal for a short-term investment horizon.



### **Basket trading ignores the fundamental differences between companies**

What is the impact on long-term investors of the explosive growth in ETFs and other strategies trading baskets of stocks? In the short run, it's not necessarily benign. Market volatility increases (which is unsettling for investors) and good stocks go down with bad. Basket trading ignores the fundamental differences among companies, making it harder for investors who do care, and stock picking becomes more difficult. We saw this during the liquidity crisis in 2008 and we are seeing that now.

Jack Bogle, pioneer of indexing and founder of The Vanguard Group, "has warned for years that ETFs are so easy to buy and sell that they could lead to excessive speculation," writes Mike Forster of the Dow Jones *Financial News*.

### **We think rapid trading presents a growing opportunity for active managers**

Indexing was founded on the premise of efficient markets, so it is ironic that the increased use of ETFs can lead to a greater disconnect between price and value. As played out during the market rebound across 2009-2010, rapid trading activity rooted in ETFs and computer-based models presents an opportunity for firms like Federal Street Advisors. We have always emphasized exceptional investment managers that actively research individual companies, identify the weak and the strong, and establish positions that benefit from mispricing.

With more market participants ignoring business fundamentals and fewer taking a long term perspective, **investors that do focus on business fundamentals should have a greater advantage as the valuation gap widens.**

One could argue that markets cycle between periods of "trading" and "investing." At Federal Street, we continue to believe that the long-term benefits of fundamental investing outweigh the short-term risks of trading.

We see the best opportunities in managers who invest with a longer time horizon, continually review the relative attractiveness of securities, and maintain or increase their portfolio's exposure to securities that are fundamentally sound and attractively priced. Experience has shown this approach can help clients grow their wealth and achieve their long-term financial goals.

*For more information about our investment strategy and manager selection process, please visit [www.federalstreet.com](http://www.federalstreet.com)*

*Indexing was founded on the premise of efficient markets, so it is ironic that the increased use of ETFs can lead to a greater disconnect between price and value in many areas.*

*Those who choose not to rely on ETF's should have a greater advantage as the valuation gap widens.*