The Rollercoaster Effect

June 25, 2013

For discussion purposes, let's say there are two kinds of investors in this world (which is pretty close anyway). One type pays close attention to the daily (and sometimes hourly) flood of information, looking for a reason (any reason) to jump in or out of the markets. (If you're reading this, you know who you are.) The other kind of investor is in for the long haul, has identified their short and long term goals and is invested accordingly, and recognizes that the markets are going to experience dips and turns, sometimes severe ones. If these people are particularly wise, they know that the dips and turns are the best friend of the steady, long-term investor, because as you put money into the markets, as you rebalance your portfolio, you gain a little extra return from the occasional opportunities to buy at bargain prices.

This past week, the investment markets have made an unusually sharp turn on the roller coaster, and showed us once again the sometimes-comical fallacy of quick trading. See if you can follow the logic of the events that led to last week's selloff. Federal Reserve Board Chairman Ben Bernanke and the Federal Open Market Committee issued a statement saying that the U.S. economy is improving faster than the Fed's economists expected. Therefore (the statement went on to say) if there was continued improvement, particularly in the labor markets, the Fed would scale back its QE3 program of buying Treasury and mortgage-backed securities on the open market, and ease back on stimulating the economy and keeping interest rates low.

Everybody already knows that the Fed will eventually have to phase out its QE3 market interventions, and that this would be based on the strength of the economy, so this announcement should not have stunned the investing public. Nothing in the statement suggested that the Fed had any *immediate* plans to stop buying altogether; only to ease it back as it became less necessary. The statement said that this hypothetical easing might possibly take place as early as this Fall, and only if the unemployment rate falls faster than expected. At the same time, the Fed's economists issued an economic forecast that was more optimistic than the previous one.

The result? There was panic in the streets--or, at least, on Wall Street, where this bullish economic report seems to have caused the S&P 500 to lose 1.4% of its value on Thursday, another 2.5% on Friday, and then another 1.2% yesterday.

In addition--and here's where it gets a little weird--stocks also fell sharply in Shanghai and across Europe, and oil futures fell dramatically. How, exactly, are these investments impacted by QE3? The only explanation for last week's and yesterday's panic selloff is that thousands of media junkie investors must have listened to *"we plan to ease back on QE3 when we believe the economy is back on its feet again,"* and heard: *"the Fed is about to end its QE3 stimulus!"* (Obviously another explanation is that they are not so much impacted by QE3 as they are by their own economic slowdown, which are progressing at varying rates of speed, but that is an entirely different discussion. We do know that there hundreds, if not thousands of "things" that move markets on a daily basis.)

It's possible that the investors who sold everything they owned on Thursday and Friday and again yesterday will pile back in this week (and so far today this looks to be the case, with the market up a bit less than 1% at around 1.30 pm), but it's also just as possible that the panic will return tomorrow and feed on itself for a while until sanity is restored. *If stocks were valued daily based on pure logic, on the real underlying value of the enterprises they represent, then the trajectory of the markets would be a long smooth upward slope for decades, as businesses, in aggregate, expanded, moved into new markets, and slowly, over time, boosted sales and profits.* The rollercoaster effect that we actually experience is created by the *emotions* of the market participants, who value their stocks at one price on Wednesday, and very different prices on Thursday and Friday.

The long-term investor has to ask: did any individual company in my investment portfolio (or in the funds that my portfolio holds) become suddenly less valuable in three days? Did ALL of their enterprise values in aggregate become less valuable within 72 hours--and at the same time, did Chinese and European stocks and oil also suddenly become less valuable? Phrased this way, the only possible answer is: no. And if that's your answer, then you have to assume that eventually, people will be willing to pay the real underlying value of the stocks in the market, and the last couple of days will be just one more exciting example of meaningless white noise.

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