

THE BUTTONWOOD



First Quarter 2007



On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street.

There they signed the *Buttonwood Agreement*, creating the first investment community, which later evolved into the New York Stock Exchange.

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Tandemonium, or the Anatomy of a Sell-Off

By Gail Gardner, CFP, ChFC

Market volatility and higher correlations are the wave of the future, it seems, a point that was punctuated by the Wall Street sell-off that occurred on February 27th, certainly the most notable event of the first quarter. In an unusual confluence of events, the Dow Jones Industrial Average Index (DJIA, or Dow) dropped 546.02, a decrease of 4.3%, recovering somewhat from the day's low, to close down 3.29%. This represented the worst one day drop since the decline that followed the events of September 11, 2001. It was led by an almost 9% drop in the Chinese stock market, its worst in ten years, brought on by fear of government controls over capital investing in China. The fears are not unfounded, as Malaysia, for one, switched from an open monetary policy to capital controls in the late 1990s. The reaction in the US markets was underscored by a glitch in the computer that keeps track of the Dow. To make matters worse, the same day a suicide bomber attacked an airbase in Afghanistan where Vice President Cheney was visiting, and the day before former Federal Reserve Chairman Alan Greenspan expressed concern that the US economy was headed for a recession. That's a lot of events in a two day span, some of which warrant a closer look.

The Shanghai Stock Exchange, the larger of two exchanges in China, is represented by the Shanghai Composite Index (SSE). As of the end of 2006, the SSE, consisting of 842 companies, had a market capitalization the equivalent of \$915 billion US. That's certainly small by domestic standards; the New York Stock Exchange handles close to \$16 trillion US, meaning the size of the Chinese market overall is equivalent to just under 6% of the US market. So how does the impact of the event in China compare to its aftershock here?

To compare, we need to put the two in equivalent terms. The most appropriate index for comparison is the Wilshire 5000 (DWC), a market-weighted total stock market index. On February 27th, the DWC dropped approximately 3.4%, the equivalent of approximately \$5 billion US. Compare that drop, in dollars, to the 8.8% drop in the Chinese markets, equating to roughly \$80 million US. The incongruity of the US aftershock left many investors scratching their heads in the immediate aftermath: how could an 80 million dollar drop in China result in a 5 billion dollar reaction in the US? The original event in China represented only 1.6% of the US reaction in dollar terms.

Tandemonium, or the Anatomy of a Sell-Off (Cont)

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Have you been in recently to review your portfolio? If not, please contact us to schedule a meeting.

The answer, at least in part, must be attributed to the pitfalls of electronic trading. The drop in the Chinese market led to unusually high domestic trading volumes, especially after the downslide triggered computer-driven sell programs. The computer that keeps track of the Dow couldn't keep up, resulting in approximately 70 minutes of trading with slightly outdated data feeds. When the error was identified, a backup computer was brought online and the data was instantly brought to realtime, giving the illusion of a 178 point free fall in the Dow. Traders panicked, and the sell-off intensified. Placed in context of Greenspan's comments of the previous day and the attack targeted at Vice President Cheney, it's easy to see how things could have gotten out of hand.

Of course, after the dust settles, things always look a little different. Pundits claimed that the market was due for a pullback, and the events of February 27th merely accelerated, and perhaps intensified, what was already poised to happen. If that's the case, the magnitude of that pullback may be illuminated by looking at some more recent numbers. The Dow closed on April 5th at 14,640.40, 63.30 points, or 0.43%, below the February 27th open, a figure that represents a "mere" \$63.3 million in stock market capitalization.

The Dow closed on April 5th at 12,560.8301, 68 points, or 0.54% below the February 27th open. The SSE, as of April 9th, has experienced 6 straight trading sessions that have closed at record highs. If the Chinese market has recovered, then it stands to reason that the recovery has already been assimilated into the US markets. So it appears that the remaining unrecovered 0.5% stands as the market's answer to the pundits.

So what can we take away from the events of February 27th? Market volatility is here to stay. It's getting harder to reduce systematic risk by investing in multiple asset classes, as they increasingly move in tandem. The proliferation of electronic trading has amplified market swings, and the distinction between political and economic events is more blurry than ever. The utterances of, not just the current, but even the former Federal Reserve Chairman, can lead to reactions in the markets, both at home and abroad. With more open monetary policy around the globe, international economies are becoming increasingly integrated. Political events are no longer just a risk associated with international investing. With domestic companies penetrating markets all over the world, a shock wave overseas can now be felt just as acutely at home as abroad, and like the butterfly that flaps its wings in China, a drop in the Shanghai Composite Index can create a storm on the other side of the globe.