VAN LIEW TRUST COMPANY

as we see it

Holiday 2011

THOUGHTS FROM OUR CHAIRMAN

As we all know, confidence and fear are primary emotions. Armed with modern technology, "high-frequency traders" create market volatility by making short-term investments buying significant blocks of securities based on their perceptions as to which emotion is prevalent in the marketplace. Fundamental issues such as the health of the economy and corporate profitability are of little interest to them. In this Holiday installment Joe Healy tackles the issue of market volatility.

We wish you and your family a joyous holiday season.

*Alfred B. Van Liew*

# Is Volatility "The New Normal"?

*Joseph J. Healy, CFA*

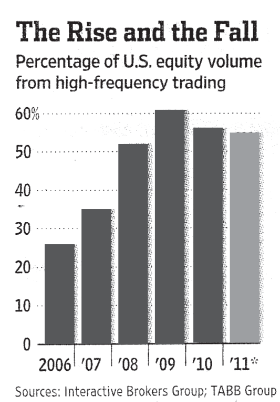
Bill Gross, investment guru and founder of mutual fund giant PIMCO is credited with coining the term "the new normal" to reflect his forward outlook for our economy. In a nutshell, "the new normal" thesis predicts the U.S. economy will grow at a below-average pace for the next several years as expansion in the developed markets slows, unemployment stays high and the "heavy hand of government" influences market activity. The uncertainty that "this time it's different" mixed with fear, emotion and the withdrawal to the sidelines of many investors has led to a current upswing in market volatility.

Whether up or down, volatility is the very nature of trading markets. Events like extreme weather patterns, Arab Spring political turmoil, a fractured EU and the U.S. struggling to stay on the road to recovery all influence volatility. Throughout history, dramatic events have shaped not only markets but also caused enormous swings in volatility.

In theory, technology and the effective transmission of information should make markets more transparent and efficient. It seems logical that more computer based systems would be an improvement over a seemingly chaotic room of shouting traders with pockets full of order tickets like a movie scene out of *Trading Places*. But is it?

Today, many large investors complain that the current lack of market liquidity is overwhelming an efficient market platform, creating less price certainty in the execution of large equity blocks, resulting in wider swings in prices. Big trades, that in the past would not have moved markets, now do. On a positive note, such circumstances may be one of the few advantages smaller investors hold over large investors. But why more volatility? Market liquidity has clearly suffered as many small individual investors were emotionally devastated by the crash and have withdrawn from the markets. Financial institutions have pulled back by reducing trading securities to boost their liquidity reserves.

In bond markets, uncertainty and a dearth of buyers have made financial-related bonds look cheap. But the after effects of the 2008 liquidity crisis have resulted in fewer active traders and more price volatility. A silver lining may be that this illiquid market makes it harder for high volume rapid trade strategies to profitably operate, thus, creating an opportunity for patient long-term investors.




In U.S. equity markets, computer driven high-frequency trading, a relatively new phenomenon, accounts today for more than 50% of all trading volume. While it is true, commission and transaction costs declined with the expansion of high-speed trading, what has been lost? Could the May 2010 "Flash Crash" have been exacerbated by high speed traders fleeing markets and dumping stocks? The SEC has started to question whether these market participants trading algorithms are "programmed to operate properly in stressed market conditions." Some form of greater regulation may be on the horizon to clip the wings of high frequency traders and pacify the public. In the meantime, high frequency traders continue to make money and earn huge bonuses. To them volatility means opportunity.

What can investors do in such a volatile trading environment? We believe they should, like we counsel at Van Liew, take a long-term view of the investment climate. Recognize markets can become volatile periodically and use the opportunity to purchase fundamentally attractive securities which they are confident will prosper over time.

For traditional investors conservative investment choices like CDs and high quality bonds aren't making it. Low risk means low return. Remember the old saying – "real estate never goes out of style"? Apparently it did in 2008 and it hasn't made its way back yet. Gold, an appropriate defensive tool, has gone more mainstream; however, it's also embraced by blogger conspiracy theorists – never a good sign. Market volatility has simply scared investors. As investment managers we worry some investors are retreating and concentrating their assets into defensive strategies that have no potential to get them where they need to be and virtually ensure a safe but less rosy outcome than might be gained from a long-term strategy in a broadly diversified portfolio.

Are we in a transition phase where market volatility is becoming "the new normal"? The Middle East has always been chaotic and uncertain. It doesn't mean that their investment markets suffer the perpetual rollercoaster of volatility. Investors have gradually become accustomed to the ever-present sense of insecurity. The Middle East is viewed predictable in its unpredictability. In our markets, heightened volatility is a new wrinkle and it may take time for investors to adjust.

For investment markets to stabilize, they need long-term investors. It's the pursuit of the quick buck that helped to get us in the predicament we're in today. As investment managers we strive to protect our clients from volatility rather than exploit the volatility. What can individual investors do to get by in this new environment? Here are a couple concepts and ideas:

1.) Have a formal strategy that addresses your time horizon, goals and tolerance for risk. Then stick to this strategy.
2.) Include defensive strategies like lower volatility asset classes and equity market sectors.
3.) Invest in ideas that can flourish regardless of uncertainty - ideas not dependent on EU deals or bank balance sheets.
4.) Diversification, diversification, diversification – add assets to your portfolio with low correlations to current assets.
5.) Avoid trying to time the market.

Bill Gross has backed off a bit from his new normal thesis since economic growth has actually lagged below anticipated levels. Perhaps volatility is "the new normal"? In October, the equity markets appeared to think all was right in the world and the problems of the EU were on the way to being solved. However, worldwide fundamental problems and upheaval have been building for years. Because of this environment, volatility may linger as these problems remain unsolved.

Fasten your seatbelt, drive safely and keep your eyes on the long view.

**Since 1926, it has paid off to stay invested in U.S stocks during troubled times.**

| Date | Subsequent 5-Year Return | Coincident Event |
|---|---|---|
| May-1932 | 367% | Great Depression |
| Jul-1982 | 267% | Worst recession in past 25 years |
| Dec-1994 | 251% | Most dramatic Fed tightening in past 20 years |

Three dates determined by best five-year market retun for the S&P 500 subsequent to the month shown. Source: FMRCo as of 9.30.2008. Past performance is no guarantee of future results.

*We would be delighted to meet with you to share comments about this article, or to review your portfolio in detail.*

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