

July 1st, 2013

# Orders and Exchanges

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**President** 

Economic — Summary	3
Strategic Allocation —	6
Tactical Allocation —	7

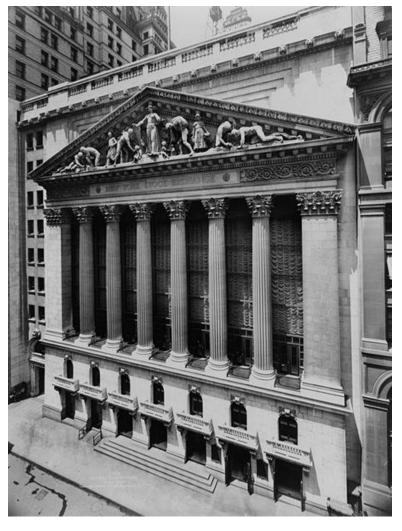
Last week the markets recovered some of the previous week's steep declines. Interest rates moved slightly lower, but remained much higher overall. Central bankers from around the world and members of the United States Federal Reserve made statements that markets were misinterpreting the speed, scale and likelihood of tapering. Strong economic data helped assuage some fears caused by the possibility of tapering as well. Home prices and pending sales were also higher. However, first quarter GDP was revised significantly lower to 1.8% annualized growth from previous estimates of 2.4%. Precious metals continued to fall dramatically until the end of the week with the price of gold now back to 2010 levels.

In this week's newsletter we will review the basics of how stocks are priced and traded. We will look at how the stock market operates and then see how new technology is changing the trading landscape.

### The Exchanges

A stock exchange is a centralized location where stocks and bonds can be bought and sold. The largest and most famous stock exchange in the United States is the New York Stock Exchange (NYSE). It was founded in 1792 when a group of traders met outside 68 Wall Street to establish rules for buying and selling stocks and bonds. Overtime the NYSE shifted from traders yelling buy and sell orders for their clients in a crowded pit to a few quiet traders in New York and a 400,000 square foot server farm in New Jersey. This reflects the switch to electronic trading that has come to dominate the marketplace. To understand why electronic trading has become so popular, let's first go over the basics of placing an order to buy or sell a stock.





# **Trading**

When an investor decides to purchase a stock the order must be communicated to a broker who can then execute the order. There are numerous types of orders that one can place, but the most simple type of order is a market order. A market order is simply an order to buy or sell a stock at the best price available as soon as pos-

Ible. Market orders can be problematic if the purchase price rises dramatically before the order is executed. Therefore it is common for investors to use limit orders. A limit order will only be executed at a specified price or better.

For example, assume that you want to purchase 100 shares of IBM for 191.11. You check the quote online and see that it last traded at 191.11 so you decide to place a market order. However, much to your dismay you end up paying 191.25 instead. This is because the market price can change rapidly. To avoid this problem, you can simply place a limit order for 191.11. Your order will not be executed until the price drops to 191.11 or lower. There are numerous other types of orders that are available to traders, the list on the right shows some of the more common order types (Here is a full list of all order types available to Financial Tailor through our broker).

#### Bid-Ask

The bid-ask spread is the primary way that an exchange makes money. The bid is the price that an investor can sell a stock for and the ask is the price that an investor can purchase a stock at. The spread is the difference between the bid and the ask.

For example, IBM may have a bid at 191.11 and an ask of 191.15. Investor A sells 100 shares at 191.11 and investor B buys 100 shares at 191.15. In this situation, the exchange makes 4 cents per share x 100 shares for a total of \$4.00. This may not seem like a lot, but keep in mind that the average daily volume of IBM is 4.3M shares.

# Competition

Since running an exchange is a highly profitable low risk business, it makes sense that it has become a competitive field. There are many competitors to the NYSE such as NASDAQ. The original distinctions between the two exchanges have been blurred to the point where they are now very similar in nature. Most trades are conducted through the internet matching buyers with sellers. This com-

## **Common Order Types**

**Market**—executed at the best price available at the time of the order.

**Buy Limit**—An order to buy at a specified price or lower.

**Sell Limit**—An order to sell at a specified price or higher.

**Buy Stop**—A market order that is not triggered until a stock rises to a specified price.

**Sell Stop**—A market order that is not triggered until a stock falls to a specified price.

**Stop-Limit**—A combination of a stop and a limit order; it allows the investor to create a limit order upon reaching a specified trigger price.

**Market-if-touched buy**—becomes a market order to buy if the market falls to a given price.

**Fill-or-kill**—This order must be executed as soon as it reaches the floor or else it is cancelled.

**All-or-none**—This order must be executed in full or not at all.

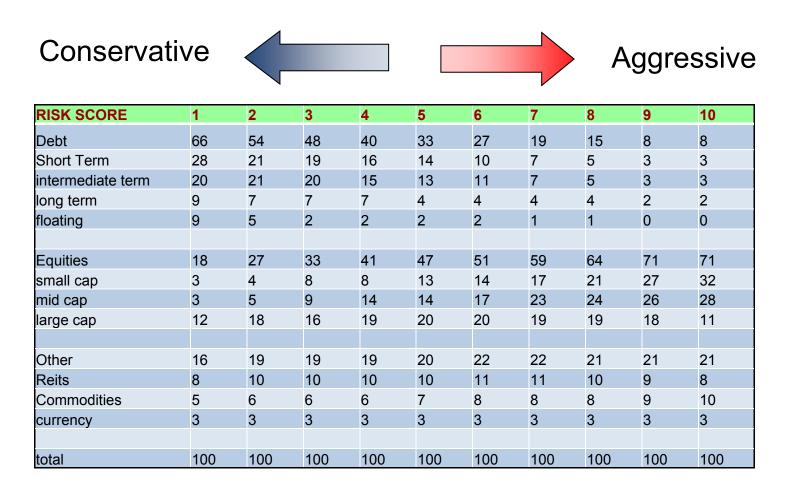
**VWAP order**—An order to buy or sell at the volume weighted average price from the time the order is place until the close of the market. This is an algorithmic trade that allows the investor to avoid buying at the days high or selling at the low.

petition has helped lower the spread that an investor has to pay to purchase a stock. Newer technologies called crossing networks have also provided benefits to investors by matching buyers directly with sellers and thus eliminating the exchange. Private crossing networks called dark pools are drawing criticism because of their anonymity and lack of price discovery. Dark pools allow investors to cut out the exchange and swap stocks at a price that is determined away from the exchange such as the midpoint of the national best bit and offer (NBBO). Critics of dark pools criticize their lack of transparency and the fact that there is no price discovery.

#### Conclusion

Unless new regulations change the outcome, markets will continue to become more automated relying on complex algorithms and faster speeds to bring down the NBBO. However, as was witnessed during the flash crash and on a regular basis in individual markets, these techniques are open to manipulation and small mistakes can have enormous impacts on the market.

# Strategic Allocation



The Strategic allocation represents what should be the long term average of a portfolio. That is, the average allocation of the portfolio should adhere to these risk allocations. Different asset classes will outperform during different market conditions. This allocation will change slowly as new information comes to light that will affect the long term performance of certain asset classes. We expect that portfolios that are more aggressive will outperform conservative portfolios over a longer period of time, but will experience a greater amount of volatility.

**Neutral short term debt,** particularly for more conservative clients. This sector should reduce interest rate risk as well as market risk in the portfolio.

#### Neutral intermediate term debt

**Overweight Long Term Debt**, this asset class has been oversold as a result of market expectations of Fed tightening, we are slowly purchasing more long dated treasuries and TIPS at the higher yields.

Overweight on floating rate debt, we are expecting slow and steady appreciation on floating rate notes.

**Neutral Small Capitalization Stocks,** we are recommending a neutral holding of smaller companies with strong balance sheets and little need for short term debt financing.

**Neutral Mid-Cap Stocks**, we apply the same logic to this asset class as to small cap stocks.

**Underweight Large Cap Stocks,** We are more selective with large cap stocks, and will try to avoid those companies with a larger exposure to the Chinese economy.

Neutral REITs, we will start looking to slowly increase REIT holdings now that selling has begun.

**Overweight Commodities**, we believe that we are now in a period of deflation, and that the selloff in commodities is largely tied to China. This selloff is likely overdone especially with respect to precious metals.

**Currency** - We are underweight the Euro. We continue to recommend protecting any exposure to the yen. We are currently holding higher levels of U.S. dollars, but will begin reinvesting those dollars on continued weakness.