



PLIMSOLL MARK CAPITAL

The Collapse of Complexity

At first glance, the Gulf oil spill and the recent Wall Street stock market spill seem to have little in common. Both appear to be random events triggered by unusual circumstances. However, both occurred when supposedly fail safe mechanisms failed to do their job – the oil industry’s blowout preventer on one hand and the NYSE’s circuit breaker on the other. They were both designed to bring systems back under control when threatened with imminent failure. They both failed when stressed – something that was not supposed to happen. Could it be that our advanced systems, whether mechanical or electronic, have become so complex that human intervention is becoming increasingly problematic?

In the case of Wall Street, the humanly activated circuit breaker, designed to slow electronic trading on the NYSE, actually made the problem worse by diverting trades to less liquid fully automated trading systems. When humans made the decision to slow NYSE trading, computers literally took over to compensate, instantaneously routing orders to those trading systems that were still operating in real time. It is becoming increasingly difficult to manage the complexity that we have created. Growing complexity can result in system instability.

With Congress stepping-in and launching an investigation into the causes of the market’s spill, (and the causes of the oil spill), we will surely see legislation that promises to prevent a recurrence. Unfortunately, it’s not that easy. It is just not possible to legislate away complexity. Trading is integrated globally, and there is no single regulatory body that has jurisdiction. Moreover, it is impossible to pull the plug on the trading systems that have been so actively promoted by Wall Street as a means to reduce trading costs and increase market efficiency, as well as to capture the fractional trading spreads that high speed computers can identify.

What we will likely see is a patchwork response, most focusing on trading halts when any stock falls by more than a certain percentage. (Could this be self defeating, as maximizing market liquidity requires continual price discovery?) Unfortunately, any response will focus on controlling the effect, rather than the cause, of financial market instability.

As a result, investors must become accustomed to increased, random volatility. Even during more “normal” periods it has become difficult for individual investors to successfully compete against the complex trading systems of Wall Street. The real question is how is the investor to cope in this environment?

Investors must recognize that short-term volatility has little impact on long-term returns, though we appreciate that random volatility can be extremely disconcerting. To better live with this volatility, it is important to pay close attention to both asset allocation and equity investment fundamentals. Fundamentals, driven by earnings, cash flow, dividends, and, of course, valuations, are not affected by price volatility. By focusing on fundamentals, volatility can even be your friend - permitting timely purchases at depressed prices and sales at inflated levels.

The reality of short-term uncertainty reminds us of the importance of a fundamental approach to investing, a hallmark of the Plimsoll approach. We construct portfolios using a five year forecasting period - viewing each five year segment as a building block in constructing a longer term financial plan. Keeping our focus on your long-term objectives reduces the relevance of short-term volatility and allows us to use the irrational behavior of the markets for your benefit.

At Plimsoll, we expect financial market volatility to increase as a result of too much debt in the developed world as well as the intricate systems now in place to execute complex global trading activities. Events such as the recent 1,000 point intra-day swing in the Dow Jones Industrial Average can cause a great deal of anxiety when they occur. But we view these as opportunities to implement the long-term financial plans we have previously established with our clients. Plimsoll clients can rest assured that they have experienced professionals looking out for their best interests, ready to seize opportunities when they present themselves.

The combination of a balanced asset allocation, a rigorous fundamental perspective, access to some of the finest money management capabilities, and the judgment to act decisively when the time is right will be the elements required for growth and safe passage of your assets in an increasingly uncertain world. Plimsoll is here to help.