REGISTERED INVESTMENT ADVISOR

DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.757.4854 / 888.808.7475
Fax 303.832.7484
denewiler@msn.com
www.growmydollar.com

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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

The "race to zero", yes, there really is one. A few weeks ago the *Wall Street Journal* published an article describing trading firms who are trying to get the speed of their information they receive from the New York Stock Exchange and other market exchanges down to zero. For those of us who don't know what zero is, it is the speed of light in the world of communications. According to the *Wall Street Journal*, to these trading firms, billionths of a second can mean the difference between profit and loss. They are now investing hundreds of millions of dollars into new laser beam technology which promises to bring communication speeds down to zero, connecting Chicago, Washington D.C. and New York together as if you are right there in the room. Any place that provides market moving information is a candidate for zero speed. It was only a few years ago that three milliseconds was a big deal, but now, in three milliseconds you are a dinosaur. Why does any of this mean anything to you? Because it is estimated that half the trading volume on the exchanges is controlled by these trigger happy algorithm based computers.

You may remember that a few years ago the stock market declined by over 900 points in less than one hour. Thank you flash trading. The argument goes that these firms provide more liquidity to the market, thus bringing down the cost of buying a stock. They do, until they all decide to eat each other and sell at the same time resulting in very dramatic market moves. This volatility should be an investors' friend, but most investors don't like the uncertainty that large price swings create. If only investing was simple, you buy a stock, keep it for several years, and then sell it for a substantial gain. You don't even care if you paid an extra $.0001. This happens to be one of the points that Warren Buffett makes in this year's letter to shareholders.

"A "flash crash" or some other extreme market fluctuation can't hurt an investor any more than an erratic and mouthy neighbor can hurt my farm investment. Indeed, tumbling markets can be helpful to the true investor if he has cash available when prices get far out of line with values. A climate of fear is your friend when investing; a euphoric world is your enemy." This is an excerpt from the latest Berkshire Hathaway shareholder letter due out this weekend in the latest annual report.

New highs do not always translate into euphoric markets. Earnings are up 10% from the 3rd quarter, so even though the market has rebounded to the previous high of December 31st, valuations are 10% below the end of the year. In January, it appeared emerging markets where the virus that would infect the rest of the world. In February, we don't even need an aspirin. It would be much easier if prices were lower, but they're not. One of the few asset classes that is nowhere near its high is emerging markets.

Emerging markets continue to lag the S&P 500 by 40% in the last 12 months. Their valuations are about 30% cheaper. Everyday someone explains why they are no longer the growth story of the last decade. When something is 2/3rds the price, it can have a few flaws.

We are in a challenging investment climate. The investment climate seems to be disconnected from the real economy. The market appears to have shaken off the Fed's announcement of exiting their stimulus program, but there is no shortage of pundits that are predicting rough seas ahead. However, as Buffett states in his latest annual letter; ignore your neighbor unless he wants to buy your farm at a ridiculously high price, or sell you his farm at a real bargain. Otherwise, just go back to farming.