

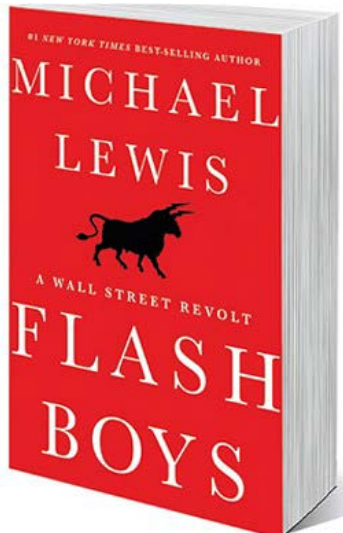


April 2014

## Evolution of High Speed Trading, Market Bubbles Brewing & How to Invest

*Build a better mousetrap, and the world will beat a path to your door. --Ralph Waldo Emerson*

The stock market is rigged! Or at least Michael Lewis would have you believe it is in his new book *Flash Boys*, released just two weeks ago. In the book, Lewis argues that high-frequency traders game the market by using faster computers, better cable lines, and closer proximity to exchanges to jump in front of other stock trade orders, creating a near riskless basket of profits for themselves at the expense of other investors.<sup>1</sup> While the net effect may only increase the cost of execution on stock trades by less than a penny per transaction, high-frequency trading gives the investing public just one more reason not to trust Wall Street.



### Need for Speed: Same-old, Same-new

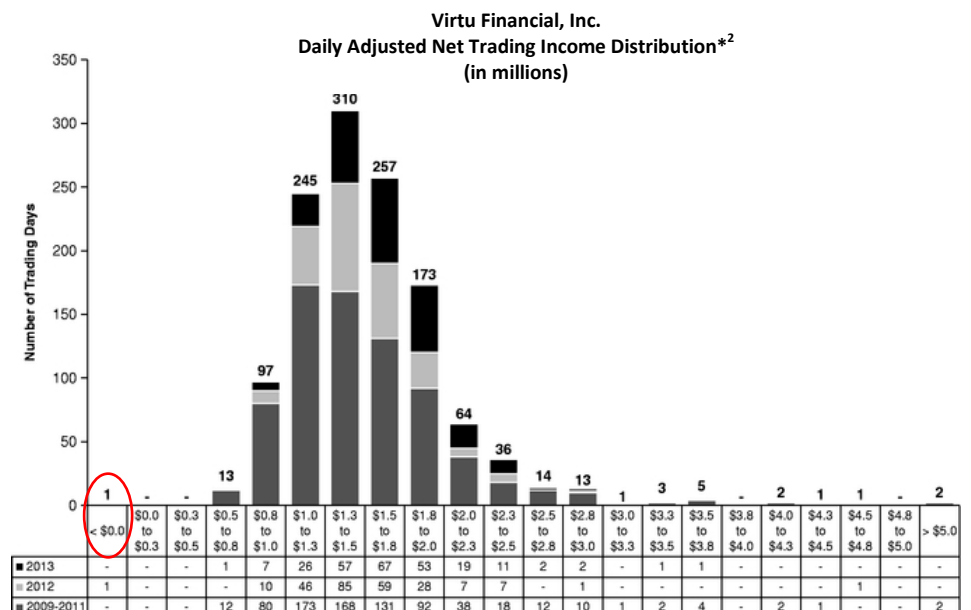
To be certain, 'high-speed trading' is a relative term and perhaps has taken on different meanings over the years. For instance, in 1790, Secretary of the Treasury, Alexander Hamilton, helped write into law the *Funding Act of 1790* where various near-worthless Continental loans would be redeemed at full face value. Word travelled as swiftly as a horse could run as speculators left New York City for Southern states to buy the Continental debt for pennies on the dollar and profit wildly from its ultimate retirement at par.

Communication speed increased further. The famous French bank, Rothschild, used carrier pigeons from the front lines at Waterloo to relay news of Napoleon's defeat in 1815. They used the information to buy British bonds at a large discount before word of Wellington's victory reached the streets of London and drove prices up. The next half century would see quantum leaps in communication speed with the commercial use of the electric telegraph in the mid-1840s, the advent of the stock ticker in 1867, and the first telephone installed on the

NYSE floor in 1878. Each of these advances helped create outsized arbitrage profits for those early adopters of the new technologies at the time. So, the notion of a select few possessing a superior technology to gain a leg up on the rest of us is nothing new. In fact, it is the same-old, same-new.

### Patience is not a Virtu

Despite the fact that gaming the market with speed is nothing new, *Flash Boys* has garnered a tremendous amount of attention and has outraged both the investment community and the general public alike. Maybe this has something to do with the fact that, unlike most market-moving headlines, this one has a publicist behind it, but that is an aside. In reality, the attention and outrage probably have a lot to do with the sheer scale of it. Virtu Financial, a large and profitable high-frequency trading firm mentioned in Lewis's book, created a maelstrom when

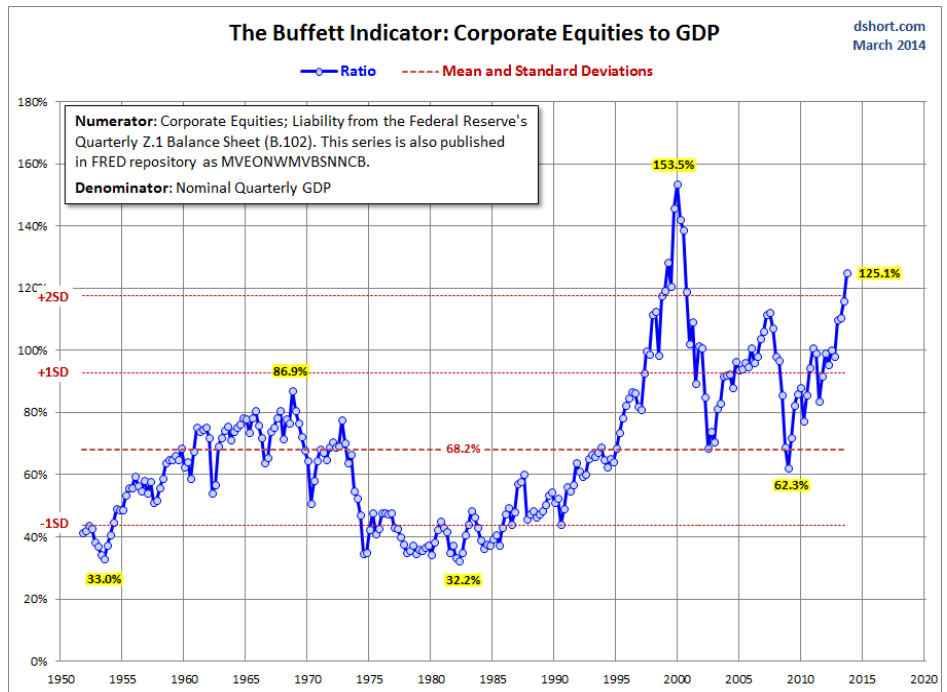


it stated in a recent S-1 filing that they suffered but a single losing trading day over the course of a remarkable 1,278 sessions, covering a period from January 1, 2009 through February 28, 2014!<sup>2</sup> Virtu's holy grail of money-making machines has created far more profits than would ever fit on a horse's back or carrier pigeon's leg and makes it seem as though exploitation and unfairness are the norms of today's markets, rather than the exceptions.

None of this should be terribly surprising, though, as the Fed has been rigging the market for years by pumping money into the economy and artificially suppressing interest rates on a scale that makes Virtu look like a two-bit hustler. So, the notion that the market is rigged because of high-frequency trading is overblown, at best. Firms like Virtu did not rig it; they simply joined the party. However, what they have done is made markets more vulnerable. Much like leverage, high-frequency trading amplifies market momentum. This is all fine and good when the market is going up, but at some point in the future, the Fed will abandon its easy money policies, and market sentiment will likely turn negative. When it does, high-frequency trading will help accentuate negative momentum much like it did during the 'flash crash' in the spring of 2010.

**Senti-mental Breakdown**

All of the recent fuss about *Flash Boys* and high-frequency trading has only intermittently been interrupted by talk of machinations of the Fed. As with a slight of hand, it has given market pundits yet another distraction from addressing the suggestion that markets are overvalued and have reached a critical inflection point. Much of our 1<sup>st</sup> quarter newsletter ([http://www.doucetcapital.com/pdfs/Doucet\\_Newsletter\\_2014\\_Q1.pdf](http://www.doucetcapital.com/pdfs/Doucet_Newsletter_2014_Q1.pdf)) was dedicated to explaining how we are at a point of inflection by showing that many traditional market indicators (Shiller CAPE, earnings growth, and corporate margins, to name a few) are signaling an overvalued market.



S&P 500: Estimated Earnings Growth at Quarter-End vs. Actual Earnings Growth



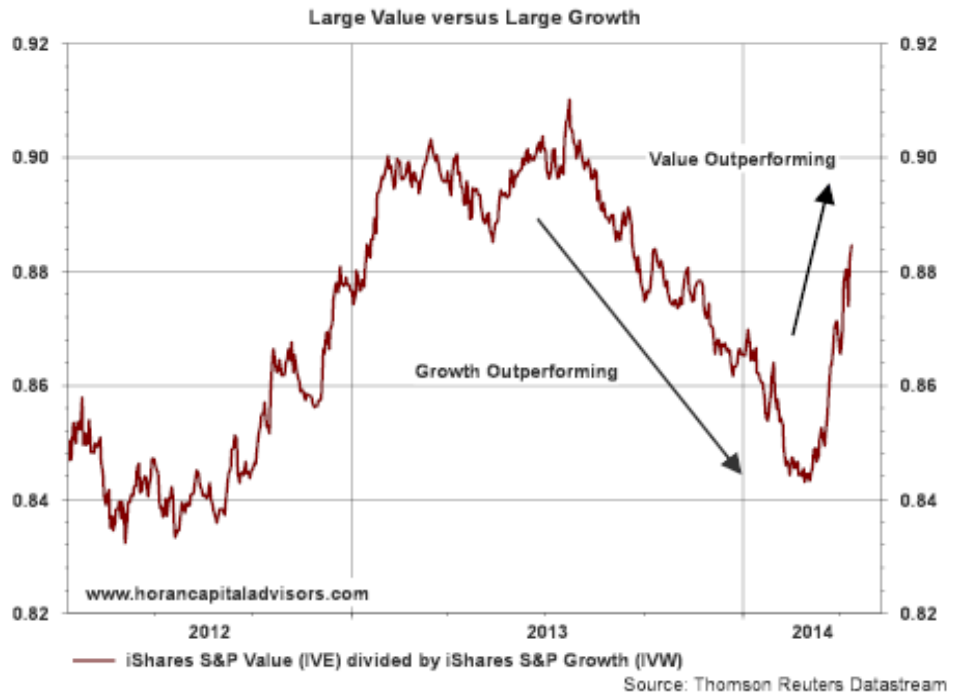
FactSet Research Systems Inc.

Perhaps the Buffett Indicator, named after famed investor, Warren Buffett, does an even better job of illustrating this inflection point. It measures the total value of the equity markets against the gross domestic product (GDP) or the monetary value of all the finished goods and services produced within the U.S. each year. Based on this metric, the indicator is very near its all-time high set in 2000 (see chart above).<sup>3</sup>

While many market indicators are signaling an overvalued market, sentiment is starting to turn. An expected 1<sup>st</sup> quarter drop in S&P 500 earnings of 1.3% year-over-year would be the first quarterly earnings decline since 2012 and is partly to blame.<sup>4</sup> History would suggest that as

earnings soften, growth-oriented and higher multiple stocks would be expected to ‘roll over’ or decline more than their traditional value counterparts. This is exactly what has been happening. Investors have been rotating out of growth-oriented stocks, like biotechs and social media companies, and into perceived safer value-oriented stocks, like utilities and consumer staples. Another telling sign of a shifting sentiment is the recent pick-up in volatility. So far, investors have witnessed the Dow Jones Industrial Average fluctuating more than 100 points from its high to its low every trading day but one so far in the 2<sup>nd</sup> quarter.<sup>5</sup>

Together, high-frequency trading and Fed policy go a long way towards explaining why fundamentals-based investing has not mattered much in recent years as markets continued their climb. As sentiment has begun to turn, however, this too is changing and fundamental analysis is becoming en vogue again.

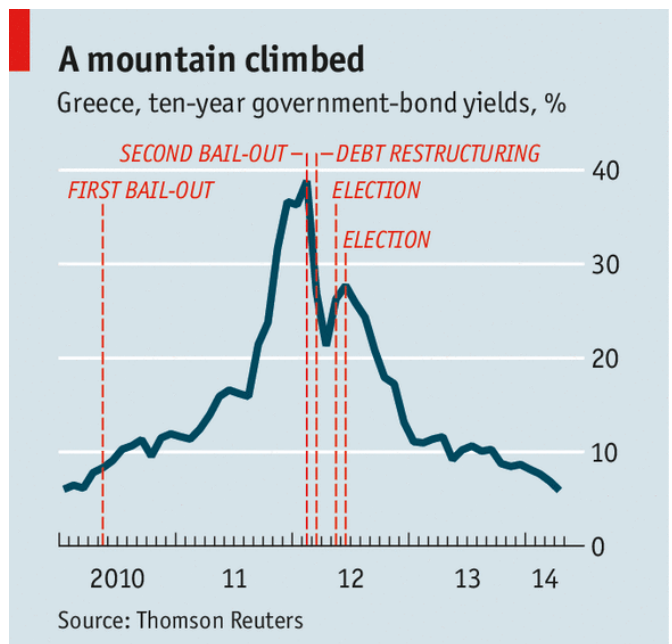


### Preparing for Low Tide

Michael Lewis and high-frequency trading have managed to dominate the financial headlines so far in the 2<sup>nd</sup> quarter. The bigger issue, however, is not whether or not the market is rigged, but rather what sort of impact might such a momentum amplifying strategy have if sentiment were to go strongly negative. That’s the part that should be attention-grabbing and cause outrage. Sentiment has only started to show cracks, but the quiet fact that it has is having a significant influence on how we are allocating assets internally.

From an equity standpoint, we have increased our cash position by significantly reduced our holdings in a number of small-cap and growth-oriented companies. As our equity positions have continued to hit their price targets, we feel that it is more imperative than ever to not be greedy and adhere to our discipline of taking money off the table when it becomes difficult to rationalize holding any longer. The stocks remaining in the portfolio meet one of two basic themes: 1) The company is trading at a deep discount to replacement value, which we believe will provide an ample amount of downside protection in a soft market or 2) the stock is fairly priced based on other traditional metrics and represents a strong non-cyclical long-term positive trend in the market.

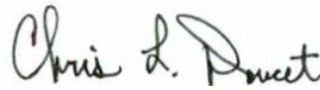
On the bond side, we think the new 5 year Greek bond issue which came to the market April 10th says it all. Greece quietly issued its first longer-term debt deal in over four years, and it sold at less than a 5% yield compared to more than a 30% yield just a few short years ago! It isn’t like that much has changed; public debt-to-GDP is still a whopping 175%, and the IMF expects the country to grow a meager 0.6% in 2014. And even more, the deal was a \$4.1 billion issue and was nearly 5x over-subscribed!<sup>6</sup> If this doesn’t tell you how complacent investors’ view of risk is, I don’t know what will. Things are little different in domestic fixed income markets, where investors continue to accept significantly heightened risk of principal for very little extra modicum of return. However, we do continue to



be surprised by how much value we see in some parts of the municipal bond market, especially in ‘short kickers’ or callable bonds with short final maturities. In our opinion, this is a great place for investors to hide while waiting for markets to revert back to levels more in line with historical norms.

It remains difficult this year to swim against the stream and adhere to a more conservative stance on the markets. Our counterintuitive positioning of assets makes us look early (best case) and just dead wrong (worst case). But fundamentals are telling us that both stocks and bonds are simply very overvalued, and now is a time for caution and not risk taking. So while the markets will always be rigged, whether it be through tiny bits of arbitrage gained by high-frequency traders or Fed shenanigans, we at Doucet Asset Management believe there will always be pockets of value in the market, and, often, the ‘rigged’ marketplace creates or amplifies the value that we seek to exploit. As Warren Buffett is fond of saying, “Only when the tide goes out do you discover who’s been swimming naked.”

Sincerely,



Chris L. Doucet  
Chief Executive Officer

### Firm News

We are pleased to announce that 2014 has seen the firm grow in multiple ways. First and foremost, we were excited to welcome baby Grace Vaughn into the Doucet Asset Management extended family. And, thanks to your referrals, the first quarter saw assets under management of the firm grow. We sincerely appreciate your continued support and referrals and are more than happy to assist any friends or family members that might benefit from our services. Thank you again.

### Footnotes

- <sup>1</sup> Michael Lewis, *Flash Boys: A Wall Street Revolt* (W.W. Norton & Company, 2014)
- <sup>2</sup> Virtu Financial, Inc. SEC S-1 Filing (<https://www.sec.gov/Archives/edgar/data/1592386/000104746914002070/a2218589zs-1.htm>)
- <sup>3</sup> Doug Short, “Market Cap to GDP: The Buffett Valuation Indicator”, *dshort.com Advisor Perspectives*, Mar. 7, 2014 (<http://advisorperspectives.com/dshort/updates/Market-Cap-to-GDP.php>)
- <sup>4</sup> “FactSet Earnings Insight”, *FactSet Research Systems Inc.*, Apr. 11, 2014 ([http://www.factset.com/websitefiles/PDFs/earningsinsight/earningsinsight\\_4.11.14](http://www.factset.com/websitefiles/PDFs/earningsinsight/earningsinsight_4.11.14))
- <sup>5</sup> David Templeton, “The Market Beyond First Quarter 2014”, *Seeking Alpha*, Apr. 13, 2014 (<http://seekingalpha.com/article/2139023-the-market-beyond-first-quarter-2014>)
- <sup>6</sup> “Greece’s Return to the Markets; The Prodigal Son”, *The Economist* (<http://www.economist.com/news/finance-and-economics/21600727-bond-issue-milestone-there-still-long-way-go-prodigal-son>)

### Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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