



Weekly Commentary September 19, 2011

The Markets

Are the world's economic leaders focused on solving the wrong problem related to Europe's sovereign debt woes?

As you may know, Greece and several other European countries are in debt up to their eyeballs. Much of their debt is held by European banks and there's a big worry that if Greece or some other countries default, then some European banks may face major write-offs that could severely jeopardize their viability.

Unfortunately, what the powers that be in Europe are doing is akin to you going to the doctor and being treated for severe back pain with a heavy dose of pain medication. Rather than "heal" your back, the pain killer simply "masks" the pain.

Last week, five of the world's leading central banks announced a coordinated action that made it easier for European banks to borrow U.S. dollars to help fund their loan needs, according to *The Wall Street Journal*. This move addresses the "liquidity" of European banks, but not the "solvency" of them. In other words, it helps ease the symptom of the problem without actually solving the problem.

Simply put, a liquidity problem means you are short on cash and unable to meet current payments due. Typically, it's a temporary situation that's resolved by a loan or selling an asset to raise cash. By contrast, a solvency problem is much different. It means you have a structural defect and your revenue/assets are not high enough to support your expenses/liabilities. In effect, your business model is unsustainable. Frequently, it leads to a restructuring or bankruptcy.

In Europe, Greece has both a liquidity problem and a solvency problem. And, by extension, the banks heavily exposed to Greece and some of the other weak euro zone countries may be facing a solvency issue if they don't raise additional capital.

So far, European leaders have been unable to agree on a once and for all solution to solve the liquidity and solvency problems facing the euro zone. Until they make the tough decisions, we may be stuck in this volatile market environment.

Data as of 9/16/11	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Standard & Poor's 500 (Domestic Stocks)	5.4%	-3.3%	8.0%	0.1%	-1.6%	1.6%
DJ Global ex US (Foreign Stocks)	1.0	-13.1	-4.1	0.1	-2.2	5.7
10-year Treasury Note (Yield Only)	2.1	N/A	2.8	3.5	4.8	4.6
Gold (per ounce)	-3.1	27.2	41.0	32.0	25.3	19.9
DJ-UBS Commodity Index	-1.9	-3.0	14.6	-2.0	-0.2	4.3

DJ Equity All REIT TR Index	4.1	4.0	10.6	1.6	-0.3	10.6
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Notes: S&P 500, DJ Global ex US, Gold, DJ-UBS Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT TR Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods.

Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association.

Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable or not available.

“BEWARE OF GEEKS BEARING FORMULAS.” --Warren Buffett

On October 19, 1987, the Dow Jones Industrial Average went into a free-fall that was exacerbated by computerized “portfolio insurance” trading strategies. By the end of the day, about \$1 trillion of market value evaporated, according to CNBC.

In the fall of 1998, hedge fund Long-Term Capital Management imploded and had to be bailed out by a consortium of investors orchestrated by the Federal Reserve, according to Investopedia. The fund was led by Nobel-Prize winning economists and employed sophisticated computerized trading strategies that eventually ran amuck.

During the week of August 6, 2007, as the subprime mortgage crisis was gathering speed, several large hedge funds employing quantitative investment strategies “blew up” and lost billions of dollars in just a few days, according to Scott Patterson, author of the book, *The Quants*.

A “Flash Crash” on May 6, 2010 wiped out \$862 billion in market value in a matter of minutes and was triggered by a computer-driven sale, according to Reuters and Bloomberg. Within four days, the entire loss was recouped, according to data from Yahoo! Finance.

Last week, Goldman Sachs announced that it was closing one of its well-known hedge funds that relied on computer-driven trading strategies after it racked up substantial losses this year. At its peak, the fund had \$12 billion in assets, according to CNBC.

Despite the occasional headline-grabbing failure of computerized high-frequency trading, it still accounts for roughly 50 percent of all trading volume in the United States, according to Bloomberg. Based on complex mathematics, computer-driven trading is defined as, “A technique that relies on the rapid and automated placement of orders, many of which are immediately updated or canceled, as part of strategies such as market making and statistical arbitrage and tactics based on momentum,” according to Bloomberg.

With this technology takeover of Wall Street, a new element of unpredictability has entered the financial markets. The above examples show how volatile things can get when computer models go haywire.

So, some of the volatility we see in the markets these days may be exaggerated by computerized trading—both on the upside and downside. While we may not like it, we need to get used to it.

Weekly Focus – Think About It

“Interest on debts grow without rain.” --*Yiddish Proverb*

Best regards,



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P.S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.

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* This newsletter was prepared by Peak Advisor Alliance.

* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

* The DJ Global ex US is an unmanaged group of non-U.S. securities designed to reflect the performance of the global equity securities that have readily available prices.

* The 10-year Treasury Note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury Note as a benchmark for the long-term bond market.

* Gold represents the London afternoon gold price fix as reported by the London Bullion Market Association.

* The DJ Commodity Index is designed to be a highly liquid and diversified benchmark for the commodity futures market. The Index is composed of futures contracts on 19 physical commodities and was launched on July 14, 1998.

* The DJ Equity All REIT TR Index measures the total return performance of the equity subcategory of the Real Estate Investment Trust (REIT) industry as calculated by Dow Jones.

* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.

* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

* Past performance does not guarantee future results.

* You cannot invest directly in an index.

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