US & THEM

Richard Rooney, FCPA, FCA, CFA
President & Chief Investment Officer

Richard Rooney delivered the following speech on May 17, 2011 at the Burgundy Client Day

"At 2:32 p.m. a mutual fund complex initiated a sell program to sell a total of 75,000 E-mini contracts valued at approximately $4.1 billion as a hedge to an existing equity position…within minutes the high frequency trading firms started aggressively selling the long futures position they had first accumulated mainly from the mutual fund…high frequency traders then began to quickly buy and resell contracts to each other, generating a hot potato volume effect as the same positions were rapidly passed back and forth. The combined selling pressure drove prices down about 3% in four minutes….Between 2:45:13 and 2:45:27 [that's 14 seconds] high frequency traders traded over 27,000 contracts with a value of $1.8 billion…as prices in the futures market fell, there was a spill over into the equity markets…high frequency trading firms then decided to pause trading and withdrew from the markets altogether. The resulting lack of liquidity caused shares of some prominent companies, like Procter & Gamble and Accenture, to trade as low as a penny per share, and as high as $100,000 per share."

The above paragraph is based on a report by the regulators on the Flash Crash of May 6, 2010. The whole incident lasted a little longer than the time I am using to speak to you this morning. Roughly US$1 trillion in market value disappeared in the first 15 minutes. After a five-second trading halt, trading resumed and most of the losses were regained by 3:05 p.m.

If you didn't understand most of the opening paragraph, don't worry, I don't understand it either, on all kinds of levels. All we really have to realize is that some weird things are happening in the markets.

The Flash Crash has become a poster child for investor concerns about the irrationality and unreliability of the equity markets. I sympathize, as you shall see, but I have a different take on things that I want to share with you this morning.

As long-term investors in 2011, Burgundy faces a number of challenges. We have been talking for years about the increasing short-termism of the markets. That seems to be reaching an extreme when we look at the industry as it now stands. Last year, 60% of all the trading activity in North American stock markets, and almost 40% in Europe, was by high frequency traders, the kind of folks who brought you the Flash Crash. There are also lots of hedge funds and macro funds reacting to data releases and trying to arbitrage small anomalies. Then there are the people who are simply buying and selling "exposure" by playing exchange-traded funds and futures – essentially dealing in baskets of stocks rather than individual company shares. Probably less than one-third of trades in the U.S. markets are now people buying and selling stocks for fundamental reasons. And probably only 10% of that group are value investors with a time horizon of more than one year. So again, with Burgundy, you find yourself in a determined minority. And again, I'm going to try to show you that is a position of great advantage in the capital markets.

This morning I want to give you my description of how we have arrived at this pass. I will compare the high frequency traders' approach with Burgundy's, and I hope give you some comfort that a) you do not have to worry about these people, and b) long-term investing is probably looking particularly good right now.

Let me begin with a short 30-year history of equity trading. It is a little simplistic, but you'll get the general idea.

Until the 1980s, commissions on world stock exchanges were largely fixed. You paid so many cents per share for various prices of stocks, and there were really no volume discounts. That made sense in a time when trading was paper based and labour intensive. Various world stock exchanges moved to negotiated commissions by the 1980s, which greatly favoured big institutions and made their trading costs fall dramatically. At that time, stocks were still traded in eighths, meaning that the minimum spread between the bid side and the ask side of a trade was 12.5 cents. So while commission costs came down, there were still high costs to activity.

In the 1990s, the markets changed to decimalization, where the single cent became the minimum bid/ask spread. Computerization advanced further, and activity increased exponentially. Then came the Internet and the possibility that real-time trading could take place. Bid/ask spreads became completely negotiable, meaning that they could be fractions of a cent.

What was happening all along this time frame was that the frictional costs of trading were falling, while volumes were exploding. Then, in the early 2000s, another major chapter opened as the world's great stock exchanges moved from being essentially cooperatively owned utilities to profit-maximizing public corporations. And at that point, their mission became one of explicit volume maximization as well. They have become the willing accomplices of the high frequency traders.

It is pretty obvious that the major beneficiaries of all these reforms have been those who trade a lot. Consider that in the 1980s before the deregulation you would never have traded for a 25 cent profit. Your commissions and the bid/ask spread would have ensured that trading for such a small amount would almost guarantee that you would lose money. Today, that would be considered a fat profit incentive by most hedge funds and high frequency traders. They are usually trading for small fractions of 25 cents. What we see today is high frequency traders with their computers located within inches of the exchange computers, to reduce what they call "latency" – the few milliseconds it takes for their orders to go through the wire to the exchange computers, be processed and come back to them.

I have made up a schematic to show the two solitudes here, labelled "Us and Them." I have compared and contrasted Burgundy with the high frequency traders on a number of different categories.

Us and Them

	US	THEM
Activity	Minimize	Words fail me
Framework	Empirical realities	Statistical Models
Purpose	Participate in growth of an enterprise	Eliminate statistical "anomalies"
Time Horizon	Years – preferably forever	Nanoseconds – no overnight positions
Margin of Safety	Wide	Microscopic
Requirements for Success	Patience, knowledge, judgement	Other HFT's continuity

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First, and most obvious, is activity. At Burgundy, we are a lousy client for the brokers. Our trading is probably a third or a quarter of what would normally be expected from a firm our size. And a lot of that is frictional trades done due to cash flows rather than strategic trades made for fundamental reasons. We have always felt that activity in the capital markets is self-defeating. After all, even if trading costs have fallen dramatically, nobody has eliminated capital gains taxes, last time I checked. So we consciously minimize activity.

Each high frequency trading firm places tens of thousands of orders every single day. They often indulge in a practice called "quote stuffing," where they cancel orders after nanoseconds in hopes of seeing what direction the market is going. They are rumoured to be particularly adept at identifying naïve trading strategies, like market or limit orders, and leading the buyer or seller on for a few cents. The next time you get a fill at your discount broker, you have probably given a penny or two in profits to a high frequency trader. I mentioned above that a huge proportion of equity trading is done by high frequency traders. I failed to mention that they also account for 28% of futures trading (an enormous market) and a majority of trades involving exchange-traded funds. And all this from a relatively small number of firms, remember.

The second category is vitally important, in my opinion. Burgundy uses as its framework the value approach to investing, and observes the behaviour and results of real companies in the real economy to draw conclusions about its investments. We are foot-to-ground empiricists – we try never to pay for the future, and to buy the present at a steep discount. We have a thesis for every investment and a belief in how the fundamentals should play out – that we can test against reality on an ongoing basis.

High frequency traders trade stocks based on statistical models mainly driven by historical correlations. Let me give you an extremely simplified example. If Johnson & Johnson has shown a tendency to be up and down 80% of the market move over the past seven years, and on a given day the stock is only up or down 70% of the market move, they will go long or short the stock and long or short the index until this "anomaly" is eliminated. Since they are all doing the same things, and generally using the same data, they have a self-fulfilling prophecy in the short term and they can book a tiny profit. High frequency traders are the major reason that the stock market has shown the highest internal correlations in history, meaning that stocks are moving up and down in unison to a greater extent than ever before.

The lesson of the last decade is that investors should never forget that the stocks they invest in are fractions of living companies, not pieces of paper with their own properties. It sounds to me like the high frequency traders never learned that lesson. So, our purposes are very different. We want to participate in the growth of an enterprise; they want to maintain and enforce arbitrary relationships between stocks and baskets of stocks.

The fourth category I am looking at is time horizon. At Burgundy, we would prefer to hold our companies forever, providing the economics are sustainable, valuations are reasonable and management allocates capital appropriately. In practice, we have an average holding period of four to five years in most funds.

The high frequency traders have time horizons as close to zero as possible. They would view time as their enemy, since they are playing a relative game, and every second in the markets opens up new potential variables for them. They would never hold an overnight position, since that would involve taking perhaps 17 hours of risk – macro, micro, systemic and company-specific.

Which leads to my next point. Because they have no time horizon, high frequency traders can only play for extremely small stakes. They are trying to make 5,000 one cent profits rather than one $50 profit. We, by contrast, try to find businesses where time is on our side. We accept the risks of a long holding period, but we need a big margin of safety to compensate us for that risk.

Finally, I lay out the requirements for success in these two diametrically opposed visions of the capital markets. In Burgundy's case, we need patience, above all. We are trying to get rich slow. We also need knowledge of the important drivers of our investment, its industry, its business model and its management.

We have to be attuned to the risks facing the company. We need seasoned judgment that comes from experience and a proven investment discipline.

The high frequency traders need other traders – preferably high activity, naïve or incompetent ones. Your programmers have to be better than their programmers, and your hardware and software have to be state-of-the-art.

You also need continuity. The Flash Crash shows that in a discontinuous market, where prices gap in a directional way, high frequency traders get out of the market. That tends to be when we fundamental value players step in. There have been several such markets during my career, dating back to the Crash of 1987. The difference this time was that rather than having to live with those one cent per share and $100,000 per share trades, the exchanges cancelled the trades, giving these people a mulligan. So much for caveat emptor, caveat venditor. Only human error is irreversible these days, it seems.

I don't think you as Burgundy clients have to worry particularly about high frequency traders from a systemic point of view. They will occasionally roil the markets on an intraday basis, as they did with sugar prices in February, cocoa futures on March 1st, and the U.S. dollar against the yen on March 16th. In every case, prices returned to a normal trend within minutes.

On the other hand, you shouldn't feel that Burgundy does less than our very best in trading for your accounts. We have a highly professional and experienced trading desk, with three full-time people trading in all our different geographies. They are cost-conscious and value-oriented, just like our Portfolio Managers. Our trading costs have been falling every year without fail for the past decade, and the total cost of all transactions we do on your behalf in a year amount to only 11.24 basis points, or just over 11 cents per $100 traded. So you are well served here.

What I think is most interesting from our standpoint is the possibility that all this trading at the very short end of the market may be opening up longer-term opportunities for investors like us. Mark-to-model trading without reference to fundamentals has a tendency to do that. Remember all the sophisticated models that supported the mortgage-related securities in the U.S. housing boom? Well I don't think the high frequency traders represent a threat to the system like those things did, but I'm pretty sure that when their imaginary world of statistical relationships breaks down, the stock market will have some surprises in store for them.

Four years ago, you may remember I stole Michael Mauboussin's idea of the stock market as a Complex Adaptive System that thrives on diversity. At that time, I was interested in the possibility that the lack of opinion diversity displayed in bubble markets (when people all agree on what stocks they want to buy) could give opportunities for excess return to contrarian investors. I now feel that the lack of time horizon diversity may be opening up performance vistas to us as well. When the self-fulfilling prophecies of the statistical players begin to fail, as they always will, fundamentals will reassert themselves and patient, knowledgeable long-term investors like us will have a field day. As usual, we have no idea when this might happen, but stay tuned.

An additional consideration might be the usefulness of what high frequency traders do. From our standpoint, the functions of the equity markets are price discovery and provision of capital to business. Neither of these vital functions is served by high frequency traders. They are pure parasitic financial middlemen. They claim to provide liquidity, but based on the Flash Crash, they are only willing to do that when it isn't really needed.

High frequency traders and other short-term players are really the noise in the stock market. And never in history has it been so noisy! We, by contrast, are the quiet, patient money. We are the ones who most aid the market in its useful functions of price discovery and provision of capital to business for investment, two things these other players do not even pretend to do.

My goal this morning was to reassure you that, despite some crazy events in the equity markets, you as Burgundy clients don't have to worry about the high frequency traders and the occasional volatility they cause.

In fact, I feel the predominance of high frequency traders may be opening up opportunities for fundamental analysts like us. That tends to happen when market participants forget the linkage between stocks and companies.

And that is always good news for Burgundy clients – in the long run.