



THOUGHT FOR THE WEEK

Three Companies Tell A Cautionary Tale

SYNOPSIS

- Three firms have consistently made headlines over the past few years who are changing the landscape of global financial markets.
- Their successes combine to tell a cautionary tale to those who want to day trade stocks.
- Getting in the middle of professional traders competing against each other presents next to no upside for individual investors.

IT'S A NEW WORLD

I spend a lot of time following the progress of both innovative companies that serve the finance industry and asset managers who approach investing from unique perspectives.

In particular, three firms have consistently made headlines over the past few years whose combined successes could very likely change the landscape of global financial markets.

The first is a company called Planet Labs Inc., which has launched several small satellites that are the size of a shoebox but can deliver much more frequent imagery of economically sensitive spots than traditional satellites.

Their satellites capture high-resolution pictures of parking lots, shipyards, farmland, etc. Computers then analyze these images to count the number of cars in each parking lot, ships in port, and corn stalks being harvested to look for trends in economic data. Traders then pay huge sums of

money for this information to incorporate it into their buy/sell decisions.

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For example, if a trading firm determined that the number of cars in a parking lot for a big retailer are higher than in prior years, they may conclude that a recent promotion attracted more shoppers. The fund could then buy the stock the day before the company reported quarterly earnings and sell it shortly thereafter for a quick profit if their thesis was, in fact, correct.

The second company is a firm based out of Mississippi called Spread Networks, and they own a quasi-monopoly on speed in the world of High Frequency Trading (HFT), which uses complex software algorithms and technological tools to trade in and out of stocks in fractions of a second.

The focus of an HFT strategy is to book small profits daily, and these traders rarely hold positions overnight. Due to the short-term nature of these strategies, speed is the name of the game. Those traders who can execute the buys and sells the fastest should win over time.

Speed is so critical that it motivated this company to lay 825 miles of straight-line optical fiber to



shave off three microseconds of communication time between the futures markets in Chicago to the stock markets in New York.

The initial investment for this project exceeded \$300 million and even involved building a tunnel underneath the Allegheny Mountains. However, the project has more than paid off thanks to the willingness of HFT firms to pay \$10 million each for the resulting data feeds. In fact, it has practically become mandatory to use them because those three-thousandths of a second create an insurmountable advantage over those firms who do not pay for access.

The third company is Two Sigma, which is a very well-respected money manager that oversees around \$35 billion in assets. They are one of several firms who now utilize Natural Language Processing (NLP) in their trading strategies by completing tasks no human could ever tackle.

NLP is a sophisticated technology that trains computers to analyze and derive meaning from human language in a smart and useful way. It is based on machine learning, which is a type of artificial intelligence that examines patterns in data to improve a program's own understanding.

NLP is what makes it possible for Google to magically know exactly what a visitor to their website hopes to find on the internet. When I say the words, "set an alarm for 5 AM" into my iPhone, NLP is the engine behind Siri that ensures I wake up on time.

The advances in NLP over the last decade are changing the world, and its application extends much further than searching the internet. Two

Sigma uses it to read through scheduled press releases on economic data and then trade millions of dollars based on the placement of specific adverbs, semicolons, or anything else that informs them on the direction of a trend.

Although these companies are reshaping the investment industry in their own unique way, three commonalities across each combine to form a cautionary tale:

1. **Geniuses:** The PhDs, mathematicians, and physicists who conceived and implemented these strategies are some of the smartest minds in the world.
2. **Deep Pockets:** Their expertise and success have attracted billions of dollars into their funds. Such huge sums of money give them access to very expensive advantages.
3. **Technology:** Most of the technology that underpins these strategies is proprietary, expensive to replicate, and took years to develop.

Add it all up, and the business of trading stocks is overwhelmingly dominated by highly-trained professionals who use increasingly complex tools to compete against each other.

IMPLICATIONS FOR INVESTORS

I recently attended a group dinner where I was fortunate enough to sit next to two former NASA engineers who were debating if it was possible to send astronauts to Mars and return safely.

Being an astronomy nut, I was not only fascinated but also anxious to contribute to the discussion. The problem is that I possess neither the experience nor the intellect to do so. Had I even whispered for or



against either side, one or both could have easily destroyed me. Hence, I just sat there quietly while I listened, learned, and kept my ego intact.

Try to remember this story the next time you get the temptation to day trade stocks because, much like my desire to dispute the merits of life on another planet with two subject matter experts, you will be bringing a knife to a gun fight. Getting in the middle of professional traders competing against each other presents next to no upside for individual investors.

Sure, you could get lucky and make a quick buck every now and then. Michael Jordan may have even lost a few rounds of H.O.R.S.E. back in his prime, but being able to go up against the best of the best and consistently win is simply not going to happen.

NOTE: *The only sure winners from day trading are brokers because they charge a commission on every order, irrespective of whether their clients make or lose money.*

Since individual investors cannot win trading stocks, they should stick to owning them in a diversified portfolio long enough for the fundamentals to drive their price. Traders almost never own stocks for more than a few months, so longer holding periods tends to shake out those who buy and sell for reasons that are unrelated to the health of the underlying company.

The bottom line is that the next time you get the urge to trade stocks, ask yourself if you are smarter, faster, and better funded than the person on the other side of the trade. I know I am not, so I will continue to invest for the long run.

Sincerely,



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