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Day-Trading? Day-Dreaming!

Although "day-trading" has excited the interest of the media and regulators, sketchy—sometimes horrific—tales that relate the experiences of a few winners or losers provide little useful information. We recommend you keep your day job.

The Securities and Exchange Commission places the number of individuals that own stock directly (not including mutual funds) at close to 80 million. How these individuals conduct their trading activities is as wide-ranging as the number of those involved. Of course, the majority of investors still rely on traditional full-service brokerages for advice and executing transactions. However, a growing rank of "do-it-yourselfers" now monitor, manage, and trade their own portfolios on-line—a trend made possible as a result of the increased access to information and markets spawned by new technologies in computer hardware and software. Although these five million or so investors may trade on-line, they are not to be confused with the estimated 5,000 so-called day-traders.

Day-traders are individuals who use sophisticated software directly linked to securities markets to buy and sell (mostly hi-tech) stocks for their own account on a very short-term basis—measured in seconds, minutes, or hours—in anticipation of quick profits. Whereas on-line trading can be thought of as merely using a "traditional" brokerage firm's internet website as a tool or electronic order entry service, day-trading uses the technology as an integral part of a trading strategy, and is carried out at roughly 60 specialized day-trading firms.

Day-trading firms are unique in that they actively promote and teach (for free or a fee) a particular type of trading based on hyper-trading (rapid-fire buying and selling) in order to exploit intra-day stock price movements. Many firms provide their customers with proprietary software and systems that complement the trading system. To facilitate the actual trading, customers are given the same direct "real time" links to the major stock markets and Nasdaq that not long ago were only available to brokerage firms. Being directly linked to the brokerage firms' order processing system allows a trader to send an order to a particular market or market maker and receive a trade execution within seconds. Commissions—2.5 cents to 3.5 cents per share—are less than those charged by traditional full-service brokers but more than discount brokers or on-line brokerages. Presumably, the transaction fees reflect the firms' high overhead and operating costs associated with this type of trading.

High Risk of Ruin

A 1999 study sponsored by the North American Securities Administrators Association (NASAA) concluded that 70 percent of public day-traders will not only lose, but will almost certainly lose everything they invest. Only 11.5 percent of the random sample of accounts in the study evidenced the ability to conduct profitable short-term trading. In a separate study, only one of sixty-eight accounts at a day-trading firm in Boston was profitable, according to investigators from the state of Massachusetts. Why are these results not surprising?

Profitable trading—put in the simplest of terms—involves finding a stable long-term balance between risk and return. Viable trading programs must consistently make money, without going broke trying to do so. Whether a program meets this criterion depends on a number of factors; namely, the expected return per trade, the probability of success, and the percentage of capital risked.

The restricted circumstances of day-trading dictate that the expected return per trade is relatively low. Most day-trading systems are based on some kind of momentum strategy—that is, "buying into strength" or "selling into weakness." However, a fundamental problem with any market timing approach—which is all day-trading is—is knowing when to get in and when to get out. Given that detecting patterns in stock price movements is a precarious business, day-traders are encouraged "to cut losses short and let profits run." Unfortunately, many inexperienced day-traders are observed doing just the opposite—that is, letting losses run and cutting profits short. The NASAA study revealed that the average intraday trade was a losing trade.

In addition, rapid-fire trading—averaging 30 to 40 trades per day or more—inevitably leads to substantial brokerage fees. Commissions truncate profits and exacerbate losses, thus reducing the expected return for each trade, which in turn leads to additional trading and even more fees. The NASAA study reported that the average trader turned over his portfolio 278 times a year and incurred annual fees amounting to 56 percent of starting capital. By comparison, state lotteries on average only nick players for 40 percent.

Burton Malkiel, a professor of economics at Princeton and author of the best seller *A Random Walk Down Wall Street* sums it up nicely:

> Momentum strategies are not altogether foolish. The market is not a perfect random walk, and there is some evidence of short-term momentum in the pattern of stock price movements. But it is not at all clear that such patterns as may exist represent true profit-making opportunities. No patterns are dependable all the time, and reversals in price trends occur with frightening speed. Moreover, whatever patterns exist are extremely small relative to the transaction costs that must be incurred to exploit them.

Whether a trading program is viable is also a function of the probability of success or the percentage of profitable trades. If the probability of success is low, the payoff ratio—the ratio of the average winning trade to the average losing trade—must be high, or the trader's capital will erode. For example, a trader that has a 50 percent chance of success on a trade, and whose average winner equals their average loser, will break even over the long run. To make money, the trader will either have to improve the probability of success, increase the margin on winners,

cut the average losers, or some combination of the three. Of the small number of accounts in the NASAA study that were profitable, a majority of these accounts' profits came from just one trade. In other words, counting on one big winner to offset a string of losers is a very high-risk trading strategy.

The final factor involves the percentage of capital risked per trade. Although a trader's average losing trade made be small, that figure may mask what the trader loses on any particular trade, which may be quite large relative to his or her bankroll. For example, traders that risk most or all of their entire capital regularly on individual trades are potentially one trade away from ruin.

Regulator Scrutiny

The seemingly explosive growth in day-trading and the concomitant ballyhoo accorded it by the media has not gone unnoticed by securities regulators. Securities cops claim they are not worried about systemic risk to markets or the economy (day-trading only accounts for about 15 percent of Nasdaq volume), nor do they view day-trading as illegal or immoral. Their primary concern is that day-trading firms may be skirting existing securities rules and regulations in an attempt to attract new customers with trading capital or keep existing customers afloat.

Some of the abuses and problems that regulators say plague the industry include:

- highly deceptive marketing practices, including inadequate disclosure of risks;
- violation of suitability requirements;
- questionable loan arrangements, including promotion of loans among firms' customers and loans to customers by brokers;
- abuse of discretionary accounts where brokers have traded customers' accounts;
- encouragement of unregistered investment activity (i.e., urging customers to trade the funds of third parties);
- failure to maintain proper books and records; and
- failure to supervise (make sure traders achieve compliance with applicable securities laws and regulations).

The Securities and Exchange Commission (SEC) is currently undertaking examinations of more than 40 day-trading firms. (State regulators have also launched a series of actions against firms they accuse of violating state securities laws.) Although the SEC found some instances of noncompliance, they did not find marked and widespread fraud. Responding to the intense regulator scrutiny, the Electronic Traders Association—an association of day-trading firms—laments, "There's an inordinate amount of resources being directed at our industry.… There's an investigation under way in search of a crime."

Don't Give Up Your Day Job

Day-trading—in its current form—has been around for about three years. And though some firms probably have failed to comply with the myriad of securities rules and regulations, given time, the likelihood is that guilty firms will run out of customers and/or their customers will run out of money. The larger problem—as we see it—is that for most individuals, adopting day-trading as an investment program is unwarranted. We recommend you keep your day job. ❑

WILL HIGHER RATES COOL THE HOUSING BOOM?

The housing market has been experiencing a remarkable boom. There are some signs, however, that activity is slowing in response to higher mortgage rates, and this may influence whether Fed officials raise interest rates at their next meeting.

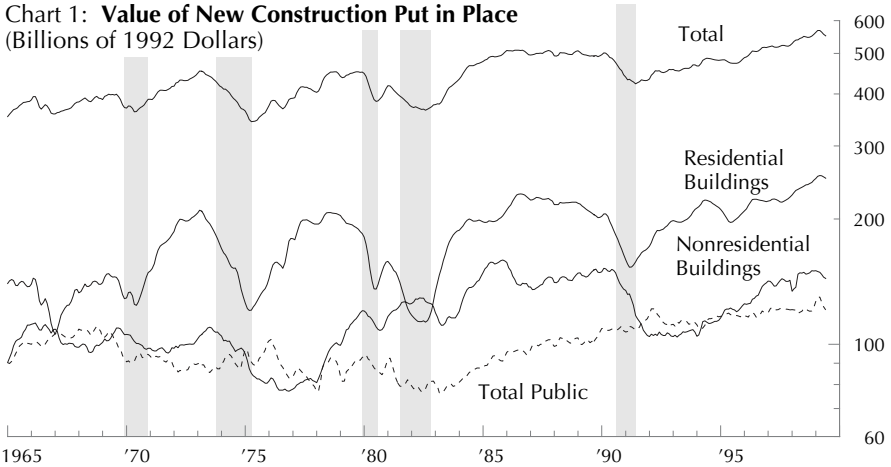
The construction industry has been a major factor behind the strong economy. For the past 2 years, it has been booming, and earlier this year the value of construction put in place, adjusted for price inflation, set a monthly record. Although the industry accounts for only about 7 percent of Gross Domestic Product, and construction workers for less than 5 percent of total employment, such activity has a large ripple effect. New buildings create demand for furniture, carpet, appliances, and fixtures. Thus, construction activity is more significant than its direct share of the economy might suggest.

All major categories of construction reached cyclical highs earlier this year, as can be seen in Chart 1. In the nonresidential sector, constant-dollar spending on office buildings, hotels, and motels increased last year and in the first quarter of 1999, offsetting a decline in outlays for factories and other industrial buildings, hospitals, and private schools. Construction activity in the public sector increased in real terms to a record high in the first quarter. Outlays for public buildings (schools, hospitals, public housing, etc.) were actually lower compared with a year earlier, but this was more than offset by a surge in spending on highways and streets. As anyone with a car is aware, there is an enormous amount of roadwork underway now.

The main source of the boom, however, is the housing sector. Residential buildings account for four out of every ten dollars spent on construction, and the level of spending reached a record high earlier this year. Activity is strong in every region in the country, but especially in the South, where almost half of all building permits for privately owned housing are issued. In contrast, the rate of permit issuance in the Northeast remains, despite recent increases, roughly half what it was in the 1980s. For every five housing permits issued in the South, only one is issued in the Northeast. This gap is likely to persist, given the continued flow of workers and retirees to the South.

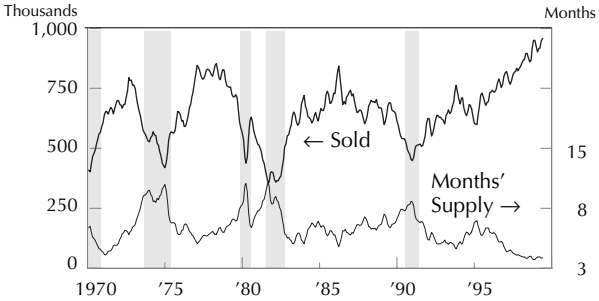
The national housing boom is reflected not only in record construction activity but in record sales. In 1998, over 900,000 new homes were sold, the highest annual total ever. Sales have been even stronger this year, as shown in Chart 2. In August,

Chart 1: **Value of New Construction Put in Place**
(Billions of 1992 Dollars)



Note: All series are 3-month moving averages of seasonally adjusted monthly data at annual rates.
Source of data for Charts 1 and 2: Commerce Department, *Current Construction Reports*.

Chart 2
New Single-Family Houses



sales approached an annual rate of one million units, just shy of last November's record monthly high.

The rate at which houses are being built has not kept pace with this extraordinary sales rate. In other words, demand is outstripping supply. The inventory of unsold new single-family homes has increased only slightly during the past year. At the recent sales rate, it would take just four months to sell off this stock. By this measure, the stock of unsold new homes is lower than at any time in the past 30 years, as can be seen in Chart 2.

Not surprisingly, house prices have increased sharply. As shown in Chart 3, in the second quarter the average purchase price of a new home was $209,000, up $16,000 from the same period a year earlier. The average price of a previously occupied home increased to $180,000, up $10,000. Since 1993, when house prices began to recover from the last recession, the average price for new homes has increased by $48,000, and for existing homes it has increased by $40,000.

Many factors of supply and demand influence house prices, but one reason they continue to increase, and new houses sell for more than older ones, is that new houses are larger and better equipped. In 1970 (when the average purchase price of a new house was $35,000), the average size of a new single-family house was 1,500 square feet. In 1997, it was 2,150 square feet, or 43 percent larger. New houses also have more amenities. One of every six houses built in 1970 had 2.5 or more bathrooms; by 1997, half of all new houses did. Homes built today are more likely to have garages and central air conditioning. The trend toward bigger and better-equipped homes is one of many that refute the conventional wisdom that American living standards have stagnated since 1973. (See *Myths of Rich and Poor—Why We're Better Off Than We Think*, by W. Michael Cox and Richard Alm.)

Home values have not appreciated as much as stock prices. Since the beginning of 1993, the Dow Jones Industrial Average and the S&P 500 have roughly tripled. But for most families, their home is their single largest asset and it accounts for a far bigger share of their total assets than do stocks or other financial assets. Thus, the appreciation in housing prices undoubtedly has had a large impact on household wealth.

In addition, the rate of return on a residential investment usually is enhanced by borrowing. Most people invest only a small percentage of the price of the property when they buy a house. The rate of return on this down payment may greatly exceed the percentage increase in the price of the house. For example, if an individual makes a $10,000 down payment to buy a house, and a year later he sells the house for $5,000 more than he paid for it, the return on his investment is 50 percent. This simplified example ignores other factors that affect the return, such as transactions costs and tax savings, but it makes the broader point: for many families the recent investment returns on housing have been substantially higher, due to the leverage provided by mortgages, than the increase in house prices suggests.

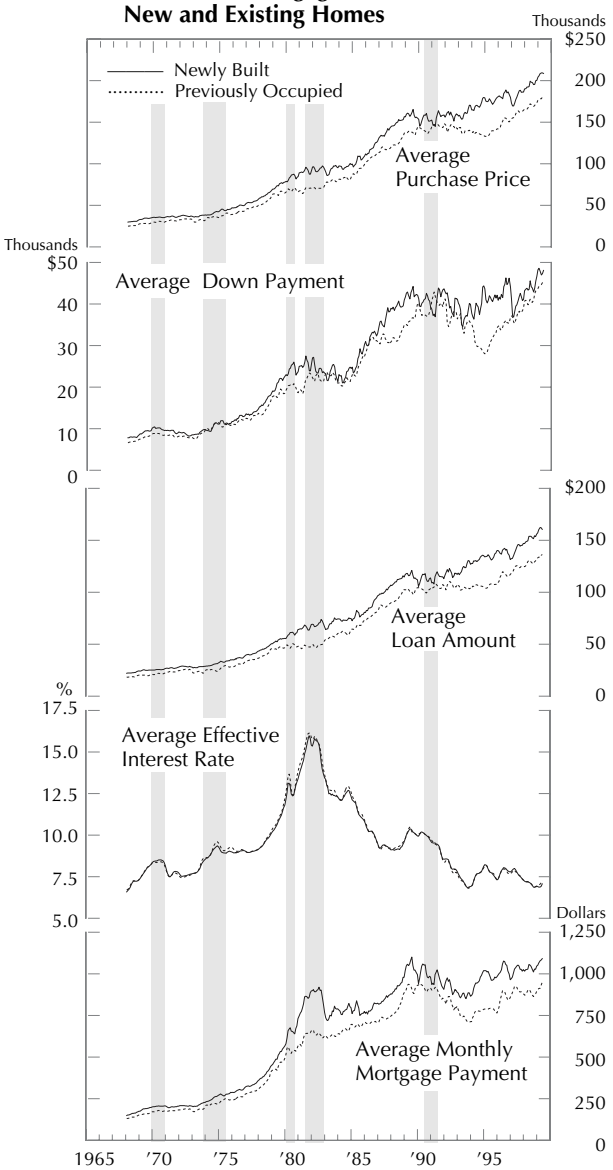
Interest Rates are the Key

Home buyers, on the other hand, have not been as financially squeezed by higher prices as the figures might indicate. The average monthly mortgage payment on a new home purchased this summer is $1,090 (see Chart 3). This is almost the same as the average mortgage payment was 10 years ago—even though homebuyers now pay $45,000 more, on average, for a new house than they did in 1989. The difference, of course, is lower interest rates. Mortgage rates were below 8 percent in July, compared with more than 10 percent in 1989. Lower rates have enabled buyers to take on much larger mortgages without paying comparably higher mortgage payments.

Similarly, lower interest rates have been the key to keeping previously occupied homes affordable. These homes now sell for $42,000 more, on average, than they did 10 years ago. However, the average monthly mortgage payment, $950, is only $25 higher now.

The biggest hurdle to buying a home is the down payment. The average down payment is $49,400 for a new house, and $42,700 for one that was previously occupied. Where do home buyers find this money? In addition to the income generated by the expanding economy, recent changes in the tax laws have provided them with extra funds. Many use the capital gain on the sale of a previous home to

Chart 3: **Prices and Mortgage Terms for New and Existing Homes**



Source: Federal Housing Finance Board, *News*.

finance the down payment, and the 1997 tax act greatly increased the amount of gain from a home sale that is exempt from capital gains tax. The new tax laws also allow individuals to take penalty-free early withdrawals from retirement accounts if the funds are used to buy a first home. The booming stock market, of course, has provided another source of down payments.

Despite rising house prices and larger down payments, the combination of income growth and relatively low mortgage rates has kept housing affordable. According to the National Association of Realtors, a family with the national median income, ($47,464) in July had 29 percent more income than the minimum required to qualify for an 80 percent loan on a median-priced ($135,400) existing home nationwide. However, this margin is lower than it was a year ago, indicating that affordability could soon become a problem if current trends persist. Some regions may already be feeling the pinch. In the West, where the median price of an existing house is $167,600, a family with median income has only 6 percent more than the minimum required to qualify for a standard loan. Housing is most affordable in the Midwest, where a typical family has 50 percent more income than needed to qualify for a loan and the median price of an existing house is just $122,900.

Outlook

In June, the Federal Reserve announced it was increasing the Federal Funds rate, a benchmark indicator of monetary policy, by 25 basis points (one quarter of one percentage point). In August, it raised the rate another quarter point. While the Fed does not control interest rates, it can heavily influence them, and in the wake of these rate hikes, it is not surprising that interest rates across the economy have increased.

Changing trends in interest rates have an enormous impact on housing and construction activity. Most home purchases are financed with mortgages. After the Fed increased rates in June, the housing market and overall construction activity cooled. Indeed, mortgage rates actually began to increase before the Fed's action, increasing from 6.8 percent last November to about 7.5 percent this summer. As a result, the average monthly mortgage payment on a new house is now about $80 higher than last fall. Building activity peaked in the first quarter, and since then the number of permits issued for new housing has decreased by 7 percent. The number of houses started and the number completed also have decreased.

In Memoriam
Roy Anderson Foulke, Jr., 1927-1999

With deep sadness we note the passing after a brief illness on September 24th of Roy A. Foulke, Jr., Chairman of the Board of Trustees of American Institute for Economic Research.

A graduate of Bowdoin College, he earned the M.B.A. degree from Stanford University, and following service in the United States Army (and later as a reserve officer in the Army Air Corps), he embarked on a successful career in finance and industry that spanned many years and involved a variety of enterprises. Most recently he was associated with the Wall Street firm R. F. Lafferty & Co.

Although he was active in a variety of civic, fraternal, and charitable affairs, Mr. Foulke's service to AIER was extensive. As a long-time Voting Member of the AIER Corporation, he was steadfast among those who "held the line" whenever the Institute's interests were in jeopardy. At a number of junctures his leadership proved crucial. But at all times he was an enthusiastic and tireless ambassador who introduced AIER's work to people from all walks of life throughout the Nation and around the world. He was a founding director in 1978 of AIER's wholly owned subsidiary American Investment Services, Inc., and served as Chairman of the AIS Board of Directors from 1979 to 1987. In 1987 he was elected to the Board of Trustees of AIER, and served as that Board's Chairman from 1994 until his death last month.

His service to AIER extended a family tradition that began with his father, who was a close friend of E.C. Harwood and who served as Chairman of the AIER Board of Trustees from 1966 to 1972. Mr. Foulke leaves his wife, Maureen, daughter, Sarah, and son, John—all Voting Members of the AIER Corporation—and granddaughter, Kirsten.

His philanthropy was dedicated to promoting civilization, and his time and counsel to the search for solutions to human problems. Brief notice cannot do justice to his character. But it can record that he was our dear friend, and will be sorely missed.

We extend our deepest sympathies to the members of his family, who have asked that he be remembered through charitable contributions to American Institute for Economic Research in behalf of the Roy A. Foulke Fellowship.

Presumably this downturn is just what Fed Chairman Alan Greenspan and other Fed officials expected. Their goal is to cool what they perceive to be an overheating economy, in hopes of dampening potential inflationary pressures. Home sales, however, have shown no sign of weakening, having continued to hit new highs through the summer. On October 5th, Fed officials announced that they would not increase rates but said they remain poised to do so. If houses continue to sell at a record pace and record prices, the Fed might interpret this as evidence that it has not raised rates enough. ❑

PRICE OF GOLD

	1997	*1998*	*—— 1999 ——*	
	Oct. 9	*Oct. 8*	*Sept. 30*	*Oct. 7*
Final fixing in London	$333.40	$300.25	$299.00	$323.50

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