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The Pretirement Press

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The economy is still struggling, unemployment is still high, and finding a new job may be tougher than ever. That's why this quarter's newsletter features a personal financial stress test to see if you can weather the storm in case it hits you. From job loss to disability to a stock market crash, take the test to see if you have what you need to make it though. Also in this issue, our recurring *By The Numbers* column featuring recent economic indicators and commentary, as well as our quarterly *Conversation With Joe* where we attempt to de-mystify bond investments. In *Quick Hits*, we feature bits of information on taxes, insurance, retirement, mortgages, and summer savings tips for kids. Finally, in the *Markets* column, we'll explain in simplified terms how the "Flash Crash" from early May probably happened and what actions we take to make sure our clients are never impacted by severe, temporary, mispricing of stocks. Enjoy the newsletter and have a great start to the summer season. ■

Personal Finance Stress Testing

During the peak of the financial crisis in early 2009, the Treasury and Federal Reserve worked together to create a "stress test" for the nation's largest banks whereby they would create an almost worst case scenario for the economy, foreclosures, other bad loans, etc. and see if each bank had enough capital to survive. If a bank didn't have the capital, the government would help them find it in the private markets, loan them money, or facilitate a merger with another bank. Basically, they were trying to find the problem banks and fix the issue before it got worse and they were out of business in order to avoid another Lehman Brothers scenario.

Drawing the parallel to personal finance, we've devised a stress test of sorts that will help families prepare for a worst-case scenario and make sure that they're fit to handle it. Those that aren't fit to handle it wind up having to resort to measures which have a large cost associated with them, like defaulting on a loan/mortgage and destroying credit, tapping into retirement savings and having to pay huge taxes and penalties for doing so, or having to stop funding their savings for their future goals.

So, let's take the stress test by walking through what would happen in each of five scenarios. For each question, give yourself the points associated with the answer the best meets your situation. Add up the points when you're done and compare your score to those in the Results section to see how prepared you are.

> *"...we've devised a stress test that will help families prepare for a worst-case scenario and make sure that they're fit to handle it"*

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Topic One: You Lose Your Job

1) How up to date is your resume?
< 6 months old: 3, 6-12 months old: 2, 1-2 years old: 1, > 2 years old: 0

2) Are you eligible for unemployment pay from your state?
Yes: 3 No Or Don't Know: 1

3) How many months of expenses would your savings / liquid investments cover?
> 12 months: 5, 6-12 Months: 3, 3-6 Months: 2, 1-2 Months: 1, 0 Months: 0

4) Are you married or living with a domestic partner who shares financial responsibility with you? Does that person work?
Yes and works: 4, Yes but doesn't work: 2, No: 0

5) Do you have anyone besides a spouse that you can rely on for financial support in an emergency?
Yes: 3 No: 0

Topic Two: Extended Illness Or Injury

6) How long will your employer pay you directly if you can't work?
>1 month: 3, >2 weeks: 2, up to 2 weeks: 1, 0 weeks: 0

7) Do you have short-term disability insurance? How much gross income does it replace?
80-100%: 4, 50-80%: 2, <50%: 0

8) Do you qualify for social security disability after 5 months of being out of work?
Yes: 3, No / Don't Know: 1

9) Do you have long-term disabitiliy insurance? How much gross income does it replace?
80-100%: 3, 50-80%: 2, <50%: 0

Topic Three: Flood

10) Do you have homeowners / renters insurance that covers flood (most policies don't unless you request it)?
Yes: 4, No: 0

11) Do you own or rent?
Rent: 3, Own: 1

12) Do you have an inventory of all your valuables?
Yes: 2, No: 0

13) What kind of personal property insurance do you have?
Replacement Cost: 2: Actual Cash Value: 1, None: 0.

Topic Four: The Stock Market Crashes

14) Add your age and the % of your portfolio that's in stocks together. What is the result?
<80: 4, 80-110: 3, 110-130: 0, >130: -2

15) What % of money you need over the next 5 years is in stocks?
<50%: 4, 50-75%: 1, >75%: -1

16) What % of your net worth is in your employer's stock?
0: 3, 1-10: 2, 10-20: 1, >0: -1

17) How much non-mortgage debt do you have?
$0-20k: 4, $20-50k: 3, 50-100k: 1, >100k: 0

Topic Five: You Have An At-Fault Auto Accident

18) What is the per incident limit on your auto liability coverage?
500k or greater: 4, 200-500K: 3, 100-200K: 1, <100k: 0

19) Do you have an umbrella liability policy of at least $1M?
Yes: 5, No: 0

20) Do you have an attorney?
Yes: 2, No: 0.

Score	What it means
0-20	Major changes needed. You're depending a lot on good luck
21-40	You could be in for some serious trouble if something goes wrong.
41-55	A good start, but still some risk in a bad scenario.
55-68	Minimal stress here, you're well prepared.

■

By The Numbers

Below is a conglomeration of recent economic statistics along with recent trend and commentary on its economic impact. This is the stuff you see on the front page of the paper or that you hear on the nightly news, but usually without a good explanation as to what it means. Updated information can be found on the economic indicator page of the PWA website. If you have any questions, as always, don't hesitate to contact your advisor. ■

Indicator	Description	Last Reading	Trend	vs. Last Month	vs. 3 Months ago	vs. Last year	What it means	Summary Effect on Economy
Gross Domestic Product (GDP)	Aggregate dollar value of all good and services produced by the country.	14.5924 Trillion	Improving	N/A	0.69%	2.42%	The economy is growing again at a fair pace of 0.69% in the last quarter (2.78% annualized) and 2.42% from the same quarter last year. More impressive is that consumer spending, the largest part of GDP was up an annualized 3.0% in Q1, showing this growth is not just in the form of an inventory rebuild. Q2 GDP could be weaker though (first read available in July).	Good
Productivity	Measure of the productivity of workers and the cost necessary for businesses to produce a unit of output.	153.169	Improving	N/A	0.70%	6.12%	As usually happens during an economic downturn, layoffs, and cost-cutting, output per unit of input increases. Continued increases are necessary as the economy recovers to sustain growth.	Good
Consumer Price Index (CPI)	Aggregate measure of the costs felt by consumers in purchasing a basket of goods.	218.178	Increasing slowly	0.08%	0.66%	2.02%	Key measure of overall inflation. Prices remain relatively stable, especially if excluding volatile food and energy prices	Good
ISM Index	Institute of Supply Management's reading on the manufacturing sector of the economy. A reading above 50 indicates expansion.	59.7	Improving	-1.16%	6.61%	39.49%	Indicates the manufacturing sector continues to grow from depressed levels caused by the recession. Significantly better than this time last year.	Good
ISM Services	Institute of Supply Management's reading of the non-manufacturing sector of the economy. A reading above 50 indicates expansion.	55.4	Steady	0.00%	4.53%	25.91%	Indicates the services sector has returned to growth and is a good sign for the recovery since much of the US production is services-oriented. Significantly better than this time last year.	Good
New Jobless Claims (4 wk average)	Seasonally adjusted number of people nationwide who filed new claims for unemployment in the previous week. This essentially represents new layoffs each week.	463,250	Steady	1.31%	1.93%	-25.04%	Number of new people filing for unemployment each week is much better than last year at this time but has stagnated for the past quarter. It is still exceptionally high.	Bad
Continuing Jobless Claims (4 wk average)	Seasonally adjusted number of people nationwide who continued to file for unemployment in the previous week.	4.59275 Million	Steady	-1.11%	-1.11%	-32.11%	Number of people continuing to file for unemployment each week has stabilized over the last quarter and is no longer falling. This number is still exceptionally high and needs to come down substantially for any recovery to hold	Bad
Non-farm Payrolls	Number of non-farming jobs available nationwide in the previous month.	130.57 Million	Improving Slowly	431,000	929,000	(571,000)	March and April combined to add over 500,000 jobs, the majority from the private sector, but May added only 41,000 after stripping out govt hired temporary census workers. Unemployment won't turn around for good until we're consistently gaining at least 100-200k jobs per month to keep up with population growth and re-entries into the workforce.	Poor
Unemployment Rate	The percentage of people who are looking for work that are currently unemployed.	9.7%	Steady	-0.20%	0.00%	0.30%	Unemployment is very high, but has stabilized in the 9.7-9.9% area recently after peaking at 10.2%	Very Bad
Retail Sales	Seasonally adjusted total monthly receipts at retail stores.	362.517 Billion	Improving Slowly	-1.20%	1.47%	6.86%	Up until May, retails sales have been increasing as the economy recovers, but are still down ~4% from the same time two years ago. May saw a 1.2% drop in retail sales, but it remains to be seen whether that's an data anomoly or a sign of another slowdow coming.	Fair
Consumer Confidence	An index created through a survey of consumers that gauges their feeling on the current economy and their expectations of the future.	52.9	Improving	-15.63%	1.15%	7.30%	Consumer confidence has bounced back significantly from it's lows in Februrary 2008, but still nowhere near it's highs in 2007 and June showed a sudden drop from May.	Poor
Consumer Credit	Measure of aggregate dollar amount of outstanding loans to individuals.	$2.44 Trillion	Steady	0.04%	-0.50%	-3.24%	Outstanding credit is showing signs of stabilization after a very sharp pull back as people paid down debt and saved more through the recession.	Poor
30-year fixed averge mortgage rate	Average rate on new mortgages in the previous week. Published by Freddie Mac	4.58%	Falling	-0.21%	-0.50%	-0.84%	Global economic and debt issues have caused US treasury rates to fall in recent weeks taking mortgages back to record lows.	Excellent
Median Home Prices	Median price of homes sold in the previous month.	$ 179,600	Increasing slowly	4.24%	9.11%	2.80%	Median price of homes sold (by NAR) has increased substantially in the past few months with the biggest spike in the most recent month. This is likely to be a temporary bump due to the Homebuyer Credit impact.	Poor
Existing Home Sales	Seasonally adjusted, annualized rate of existing home sales for the previous month.	5,660,000	Erratic	-2.25%	12.97%	19.92%	As expected, home sales picked up into the expiration of the Homebuyer Tax Credit but are now beginning to slump again. Prices will likely follow.	Poor
Existing Home Inventory	Number of homes currently on-the-market	3,892,000	Erratic	-3.40%	10.22%	1.06%	The number of homes currently for sale dropped a bit in May from its April high (highest level since July '09). Based on May's annualized pace of sales, there are 8.3 months of supply on the market. It will be hard for prices to stabilize with more than 6 months of inventory available.	Bad

Conversations With Joe: How Do Bonds Work?

If you're a frequent reader of this newsletter, you know that PWA stresses the importance of fixed income (bonds) in an asset allocation, especially one designed for achieving short-term goals. In this installment of our recurring series of conversations with Common Joe, we'll discuss some of the basics of why bonds play such a critical role in a portfolio.

PWA: Hi Joe. It's so good to see you again.

Joe: Hi PWA. I'm really glad you explained last quarter how the Greece budget issues can impact us here in the US. It helped make some sense of what's been happening in the market for the last few months.

PWA: I'm glad it helped you. I heard you had some questions about bonds or "fixed income" this quarter.

Joe: I sure do. I know that bonds are the conservative portion of my portfolio, but can you explain why? I mean, isn't all investing risky?

PWA: Yes. There's a certain level of risk in all investments. But, bonds and bond funds that purchase the debt obligations of companies which have the means to repay their debts are generally safer than stocks.

Joe: Debt obligations… you mean like lending money to these companies?

PWA: Yes, that's exactly it. A bond is a loan from an investor to a corporation or a government, in the case of treasuries, in return for interest payments and a return of the loan amount (the "principal") at a pre-determined point in time ("maturity).

Joe: Ok, so when I'm buying bonds, I'm making the loan to the company whose bonds I'm buying, and I get interest on my loan. Got it. How much interest do I get?

PWA: That depends on the bond. If you're lending to a company that has the means to repay you, and you're fairly certain of it, you may do so for a pretty low rate. If you could only get 1% in a savings account, and you can get 3% from a bond with almost certainty that you'd be repaid, that would be a pretty good deal right?

Joe: Sounds like it. But does that mean that some companies don't repay their debts?

PWA: Well, the companies are contractually obligated to pay interest and repay the principal portion of a bond. But, just like people, as a last resort if they can't pay their debts, they can file for bankruptcy. If they do, their debts might be discharged. In that case, not only do you miss out on the interest you thought you were going to get, but you also never get the money you lent (i.e. the price you paid for the bond) repaid to you.

Joe: Can you give me an example of how this works?

PWA: Sure. Let's say that you have $10k to invest for 5 years and you want to do it in a very safe bond. You find a bond with a 5-year term priced at $1,000 and you buy 10 of them. Each bond pays 3% interest ($30) to you each year for 5 years and pays you back $1,000 at the end of year 5. As long as the company doesn't go bankrupt, you get $30 at the end of year's 1, 2, 3, and 4 and $1030 at the end of year 5. If they do go bankrupt, you get nothing and you lost $1,000.

Joe: Got it. So the risk I face if I buy a bond is the risk of bankruptcy? Isn't that the same risk as if I buy a stock?

PWA: Not quite. When you buy a stock, there is no contractual obligation for the company to pay you anything in the future. You hope they pay some dividends and you hope you can sell the stock to someone else at a price that's higher than what you paid. But the company doesn't owe you anything. With a bond, they owe you interest and principal. And, if they do file for bankruptcy and they have any money or assets, the bondholders get repaid before any stockholders get anything.

Joe: Now I see why they're safer than stocks. Can I sell my bond before the end of the 5 years?

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> *"If a company files for bankruptcy and they have any money or assets, the bondholders get repaid before any stockholders receive anything …"*

PWA: Yes, but you can only sell it at the price someone else is willing to pay for it, just like a stock. If the company is not doing well one year after you bought the bond and the risk of bankruptcy is higher, do you think they'll still pay you $1,000 for a bond paying $30 per year?

Joe: No, I guess not because 3% interest isn't appealing enough for a company with a high risk of bankruptcy. Is bankruptcy the only risk I have to worry about?

PWA: No, there are a few other risks with bonds, but bankruptcy (known as "credit risk") and interest rate risk are the biggest ones.

Joe: What's interest rate risk?

PWA: Sticking to our example, after you buy your bond that pays a fixed $30 per year to you, what do you think would happen if interest rates in general rise? Let's say you could earn 4% on a savings account now. Would someone still be willing to pay $1,000 for your bond that pays $30 per year?

Joe: No way. Why buy a something with risk and make 3% when they could put their money in the bank and make 4%? I don't have to be a bond expert to get that one.

PWA: Right. So if they could get 4% in a savings account, how much would they need to get from your bond?

Joe: I don't know, maybe 6%? But my bond only pays 3%. So I'd never be able to sell it?!?

PWA: You'd never be able to sell it for $1,000. But what if the price fell to $900? Now someone could pay $900 to get a bond that still pays $30 per year fixed and still pays $1000 at maturity, four year later (assuming one year has passed since you bought it).

Joe: Ah, so now they're getting $30/$900 = 3.33% interest every year and they're paying $900 for something that will pay back $1000 in 4 years. How do I figure out the overall rate I'm getting for that?

PWA: Well, the math gets a bit complicated, but it seems like you understand it in concept. A simplified (and not quite right) version of the calculation would say take all the money you're going to get from the bond divided by what you paid for it and then subtract one. That gives you your total percentage gain. Then divide that by the length of time until the bond matures (another simplification that's directionally correct, but not exact) to get an annualized interest rate.

Joe: So that's $30 * 4 years + $1000 = $1120. And then divide that by the $900 paid minus 1 gives me 31%. Then I divide that by 4 years and get 7.7%. Is that right?

PWA: Yes, by the simplified calculation, that's correct. In reality, the true annualized return for this bond (called the yield to maturity) would be about 6%. So the simplified calculation got you close enough. You can see that when rates go up, the price of a bond goes down. How far the price falls depends how much rates increase…

Joe: …and how long I have to wait to get my $1000 back, i.e. the length of time till maturity, right?

PWA: Exactly. The longer you have to wait, the less valuable the discount is that you're getting on the bond. So, the longer the time until the bond matures the more of a discount you'd need, the more the price of the bond will fall.

Joe: Got it. So if I think rates are going to rise, it makes sense to avoid bonds with a long maturity or my price might fall quite a bit if I want to sell it before maturity.

PWA: That's right. And that's what we're doing with the bonds we're purchasing for clients right now by the way. Of course even if the price falls some, you'll be receiving interest for every year that you hold the bond, and that's what also makes bonds lower risk than stocks. That interest helps to offset any losses

you might face in the price of the bond. So even if the price of the bond falls by $50 while you hold it for two years (collecting $30 * 2 = $60 in interest), you still didn't lose money!

Joe: Wow. Now it's really starting to make sense. So let me see if I've got it. If I buy bonds with a short time to maturity and from companies with low risk of bankruptcy, I'm buying a very safe investment that's going to pay me a low, but better than my bank, interest rate. If I buy bonds with long maturities and/or with higher "credit risk" (as you called it), I'm buy a much riskier investment, but I'm going to get paid a lot more interest for holding it.

PWA: Joe, my friend, you are well on your way to understanding bonds.

Joe: Great! Let me think about this all for a while and then next quarter, can we continue this discussion?

PWA: I'd be happy to. Have a great summer, Joe!■

"If I buy bonds with a short time to maturity and from companies with low risk of bankruptcy, I'm buying a very safe investment that's going to pay me a low, but better than my bank, interest rate."

Quick Hits

- To qualify for most mortgages or refinances these days, banks want you to have at least 20% equity in the property. The term they typically use is a "Loan-To-Value Ratio" of less than 80%. To determine your loan-to-value ratio, divide the balance (or proposed balance) of your mortgage by the value of the property, determined by appraisal. If it's less than 80%, you have good credit, and can document that your income will provide the ability to repay the loan, you shouldn't have trouble finding a lender.

- If your family's health insurance coverage is under your employer plan and you terminate employment (voluntarily or involuntarily), your spouse and/or children will qualify for continuation coverage through COBRA for up to 18 months even if you find coverage elsewhere and don't enroll in COBRA

- Have a child with a paid summer job? He/She qualifies to make a Roth IRA contribution for 2010 up to the lesser of the amount earned or $5,000. The funds can be contributed using gifted money instead of the earned money (so you can set up an account for the child) and assuming the child is 16 now and earns an 8% average annual return until age 59 ½ that $5,000 will turn into more than $136,000. Even better, under current tax law, the growth in a Roth IRA is never taxed. So that's $136,000 of tax free retirement money for your child.

- Setting a child as the beneficiary on any of your assets (even the contingent beneficiary) can lead to unintended consequences. In most states, the age of majority is 18 and that means that any funds going to children would be fully in their control most likely before they even complete their senior year of high school! And, contrary to popular opinion, simply having a will that sets up a trust for the children doesn't solve this problem since beneficiary designations take precedence over wishes expressed in a will.

- During the most recent downturn, many 401k plan administrators have started removing high-fee funds with a protracted period of poor performance and introducing other low-cost funds in their place, some even better than other existing funds in the plan. If you've received information about changes to your fund line-up, contact your advisor to discuss any impact on your retirement planning. ■

Markets: Avoiding "Flash Crash" Prices

Markets At A Glance

Segment*	2008	2009	YTD 2010	Q2	
US Large Cap Stocks	-36.8%	26.4%	-6.7%	-11.4%	thru 6/30
US Small Cap Stocks	-36.1%	36.3%	-1.3%	-10.0%	thru 6/30
Foreign Developed Stocks	-41.4%	28.3%	-13.6%	-14.7%	thru 6/30
Foreign Emerging Market Stocks	-50.0%	71.7%	-8.6%	-9.5%	thru 6/30
US Treasury Bills	1.8%	0.1%	0.0%	0.0%	thru 6/30
US Med Term Treasuries	18.0%	-6.4%	9.3%	7.7%	thru 6/30
US Long Term Treasuries	33.8%	-21.5%	14.8%	14.6%	thru 6/30
US Aggregate Bond Index	5.2%	6.0%	5.4%	3.6%	thru 6/30
US Corporate Bonds	0.3%	12.1%	5.7%	3.9%	thru 6/30
US High Yield Bonds	-23.9%	40.7%	2.4%	-0.4%	thru 6/30
US REITs	-37.0%	29.7%	5.7%	-4.0%	thru 6/30
Gold	3.0%	27.1%	12.5%	11.4%	thru 6/30
Oil**	-54.7%	86.5%	5.3%	2.3%	thru 6/30
Aggregate Commodities	-36.7%	18.6%	-10.3%	-5.2%	thru 6/30
US Home Prices	-18.6%	-3.1%	-0.9%	-0.5%	thru 4/30
Inflation (CPI) Y/Y	0.1%	-0.4%	1.7%	0.7%	thru 5/31

*All asset returns shown are returns by representative ETF except oil
**Oil returns measured by front month futures contract

During the 2nd quarter of 2010, the U.S. stock market fell more than 11% (as measured by the S&P 500), with foreign markets and certain sectors performing even worse. In our opinion, the main causes for this drop are: 1) The global debt crisis with particular emphasis on Europe (Greece, specifically). 2) The gulf oil spill and its impact on businesses in that area, resources spent cleaning it up, and the potential for a decrease in oil supplies as a result of regulation that could halt deep-water drilling, which would push up the price of oil in the future. 3) The 83% rise in the stock market from March '09 to May '10 to which an occasional correction is bound to happen. 4) Uncertainty around new banking regulations that could increase costs for banks and eliminate methods they use to hedge risk, forcing higher costs and less credit availability for consumers. 5) The market shock caused by the "Flash Crash" of May 6th which sent some stocks down as much as 99% in a matter of seconds and damaged investor confidence in financial markets.

In previous newsletters we've spoken about the debt crisis and the market's rise through 2009. Virtually everyone is up to date on the oil spill, and the financial reform bills are not yet settled so we'll postpone commentary on that. Instead, let's take a look at the events surrounding the "Flash Crash" in hopes of explaining how a market as sophisticated as the stock market can break down so quickly and the simple tool we can use to avoid participating in mispriced security trading. Before we begin, note that this explanation has been simplified for the purposes of brevity and comprehensibility by the general public.

When Selling A Stock:

"Market" Order = sell now at any price

"Limit" Order = sell now or later, but only if I can find a buyer at my specified price

"Stop-Loss" Order = sell at any price, but only if the stock trades at or below my "stop" price first.

Let's start by describing the difference between a "market" and a "limit" order. For the purposes of this discussion, we'll assume the person placing the order wants to sell a stock. A limit order is an order to sell at a particular price, very similar to an offer to sell a house. Some limit orders are accepted, if there is someone who wants to buy your stock at the price at which you're willing to sell. Other orders are not accepted because all bids are below your asking price, and they can either remain in effect (like keeping your house on the market) for a certain period of time, or they can be cancelled by the person who placed the order. A market order, on the other hand, is an order to sell at the best price available, immediately. It's the equivalent to selling your house at auction to the highest bidder. The sale will definitely take place, immediately, but you won't know the price at which you're selling until the transaction is complete.

One additional type of order is called a stop-loss order. It's an order to sell immediately at the best price available just like a market order, but only if the stock trades below a certain value. It's similar to an order to sell your house at auction the second someone pays $300k or less for an identical house in your

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neighborhood. Many short-term traders use stop orders as a way of getting out of positions that are falling in value (causing them to lose money). They'll buy a stock for, say $27, and put in a stop-loss order at $25 that will limit them (in theory) to about a $2 loss if the stock falls. In reality though, there's no guarantee their order will execute at $25. Remember, the stop-loss is saying "auction my house if another house sells under $300k". There's no way of knowing what the result of the auction will be!

Example:

Peter owns 100 shares of GE Stock. He purchased them for $10 per share a year ago. With GE trading around $14, Peter would like to sell his shares and take some profit. He's not sure if he wants to sell now, hold out for $15, or just sell if the stock falls to $13, making sure he at least gets some profit. Before Peter enters his order, the last trade was at $14.10 and the specialist who controls trading in GE and notes all buy and sell orders has an order book that looks like this:

Bid (People who want to buy)	Ask (People who want to sell)
1000 shares @ 14.00	200 shares @14.25
2000 shares @ 13.50	5000 shares @14.50
500 shares @ 13.25	1000 shares @ 15.00
5000 shares @ 12.80	

His choices are:

1) Market Order – if entered right now, he would be able to sell to the highest bidder immediately and his 100 shares would be sold for $14.00
2) Limit Order @ $15 – since no one is currently willing to buy at $15 (no bids above $14), his order will stay active and wait along with the other sellers.
3) Stop-Loss Order (trigger price = $13) – since the last trade was a $14.10, above his trigger price, Peter's order waits in a holding position until a trade occurs at or below $13. When that happens, his order activates and becomes a market order to sell at the best bid price.

On "Flash Crash" day, for reasons that are beyond the scope of this article, the stock market came under a lot of sell pressure. The sell pressure drove down stock prices (supply & demand as usual) and prices fell to a point where stop-loss orders started getting triggered. Picture a scenario where everyone in your neighborhood has a stop-loss order on their house. Yours is set to auction if any house is sold below $300k. Your next door neighbor's is set to auction is any house is sold below $250k, and the house across the street is set to auction if any house is sold below $200k. A wave of foreclosures takes place and pushes the sale price of a house to $295k. That triggers the immediate auction of your house. Bidders know you're going to sell no matter the price, and there's only a limited amount of time to gather the bidders, so the highest bid comes in at $230k. Your house is sold. That triggers the auction of the house next door, which with even fewer bidders now that property values in the neighborhood is falling so far so fast, only sells for $160k. That triggers the auction for the house across the street and now everyone is in a panic. No one is willing to pay more than $50k for that house. The owner never planned to sell at anywhere near that level, but he just did, all because of the stop-loss orders.

This is exactly the scenario that played out in the stock market. Selling pressure triggered stop-loss orders which put more supply of stock on the market pushing prices down further, which triggered other stop-loss orders, starting a panic. In the panic, demand evaporated and that pushed prices down further, feeding the cycle. No one wants to buy when the market is in free-fall! If there's no interest in buying a stock above $0.01 per share, even for a moment, and your order to sell at any price ("market" or "stop-loss") becomes effective at that moment, then you will sell your shares at $0.01 to the person who bid that amount.

Since the Flash Crash took place, new "circuit breakers" have been introduced by the SEC that will automatically halt trading for a few minutes if a stock falls (or rises) by more than 10% in a five minute period. The thought is that this will allow time for sanity to take hold and to attract new buyers before selling begets selling enough to push stocks to near-zero prices. Regardless of what mechanisms the markets put in place to try to prevent another Flash Crash, individuals can make sure they're never impacted by such an event with a simple strategy. It's one that guarantees that you never sell your stock at a price below your intended sale price, and one that PWA employs in almost all cases. That is to use limit orders only and not use market or stop loss orders. In short, we ensure that we don't auction client property (stocks in this case) off to the highest bidder when we know there may not be bidders anywhere near a fair price. If everyone made that their trading policy, there would be no potential for events like the "Flash Crash" of May 6th.■

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