There is a scenario we all know well, from lots of episodes of Law And Order, from movies and from murder mysteries. We know, and the police know, who the guilty criminal is, and we are happy when an arrest is made. But wait! The police have screwed up a procedure and the guilty party is released on a technicality. We are outraged. Justice has been denied. Somehow the machinery of the law has subverted its purpose.

In the financial markets we are seeing the same kind of errant process. Trading, the machinery that provides liquidity for investors, has taken over the markets and on a regular basis seems to be defeating their very purpose. This was most evident on May 6th when the U.S. markets went on their wildest ride ever. In twelve minutes the Dow Jones Industrials lost over 1,000 points, only to gain back 650 in the next five minutes. Jim Cramer, never noted for his calm reaction to market events, was seen on network TV screaming "The machine is broken, the machine is broken". He was right.

The purpose of stock and bond markets is to allow companies to raise capital. The ability of investors to buy and sell their stocks and bonds – in other words, to trade - is a necessary adjunct; without liquidity, the number of investors would be greatly reduced. But trading is the mere machinery, the process, by which the endeavor of investment takes place. Somehow, lately, a role reversal has taken place and trading has become if not more important than investing, at least more influential in the short term. Has trading made investing obsolete?

On some days, up to 70% of all the trading that takes place on the stock markets of the world is done by machines, with no or little human intervention. Making trades electronically in microseconds based on computer algorithms, these robots seek to exploit price differences measured in pennies or fractions of pennies. They, and their human masters, neither know nor care what securities are being bought and sold. It is trading for the sake of trading, and has nothing whatsoever to do with investing. Unlike the markets themselves, there is no social utility to this activity; in fact, as we saw in May, it can be extremely destructive.

When the computer algorithms collide in unexpected ways, strange things can happen. This seems to be the cause of the May 6th meltdown, not an errant keystroke by a human, as was suggested at the time. Stocks were sold off indiscriminately, the good along with the bad. As the machinery overwhelmed the process, the guilty went free while the innocent were punished. Just like on TV; and just as we are when watching a good cops and robbers show, we are outraged.

Fortunately, in the markets, judgments are rarely final and the court of appeal sits every business day. Stocks that have been sold down too far for reasons having nothing to do with their value as investments rise back over time to appropriate prices. The trading machinery may grind them down for a time, sometimes a long time, but the investment process will almost always build them back up as their true worth is recognized. This is the truth of value investing, a truth in which we place our trust.

We saw this process acted out over the period of the market decline and recovery from September 2008 to the present time. A stock such as Bank of Nova Scotia fell by as much as 55%, even as its earnings held steady and as other banks failed. Not surprisingly, its value was recognized and the stock now sits at $49.50, more than double its price of fifteen months ago. Note that it was the price that fell and rose, but not the value. The value never really varied too much, as the market has now recognized.

Companies have value due to their ability to make profits and pay dividends. Shares of firms that do that will increase in value over time, whatever the traders may say. Prices will vary hour by hour and day by day, but investors recognize that this variability is the cost they must pay for having the ability to exit and enter the market. As Warren Buffet, the great value investor often notes, unlike a trader, nothing compels investors to buy or sell. The daily market price, the number by which the traders live and die, is generally irrelevant to the investor. What matters is the success of the company in making money.

As we look at our portfolio of companies, we are sometimes amazed by how little the prices reflect the reality. We see firms such as Transcanada Corporation and Fortis which have raised their dividends during the worst recession in seventy years being sold off due to events in Greece. We see other companies like Manulife being sold off by momentum traders for no other reason than that other traders are selling it.

We live in the instant information age, and it is irresistible for investors to follow the daily (or even constant) up and down of the markets and the securities they own. One of our jobs is to filter the information flow, discarding the part that has no useful data for us, and paying attention to the part that matters. We focus on company earnings, company dividends and the economic circumstances that affect the market. Daily trading is mostly useless information, telling us lots about the emotional state of traders, but very little about the value of our investments, which change much more slowly.

The current turmoil in world markets is causing considerable anxiety and resultant trading volatility. Our advice is the same as always: focus on what matters. This stood us in good stead during the banking crisis of 2008, and we expect it will do the same now.