



Efficient Markets
The investment power of humility

For generations, the conventional wisdom has told us that by researching companies, analyzing industries and interpreting economic data (or hiring specialized money managers to do so), we could consistently choose securities that would deliver above average returns. Sounds reasonable, doesn't it? Well, I stopped believing that a while ago. Instead, I believe that market efficiency makes it impossible to systematically beat the market. That's a humbling concept, but one that liberates us to pursue what I consider a more realistic and sustainable approach to investing.

Do you believe in the efficient market hypothesis (EMH)? You don't need to be able to recite the theory to know the answer. This simple self-test will do the trick:

- You believe your knowledge in a particular industry gives you an advantage in picking stocks versus the average investor.
- You are waiting for a particular stock or the entire market to hit a bottom before you buy, and you will recognize the bottom when you see it.
- You can see patterns in the chart of a stock's price history that tell you it is the right time to buy or sell.
- You watch the news for announcements of corporate earnings, inflation levels, Fed rate decisions and other reports, and make buy or sell decisions accordingly.
- You believe there is value in hiring an active money manager to apply his or her knowledge and experience to select specific stocks.

If *any* of these describe you, then you do *not* believe in the efficient market hypothesis. And you're not alone. Since the birth of the markets, the beliefs and behaviors listed above have largely been considered to be the essence of investing – investors enhance their returns by being smart enough to know what and when to buy. It certainly seems logical that knowledge, research and judgment would yield profits through savvy, well-timed stock picks. Learning more equals earning more.

This conventional wisdom may seem logical, but a growing number of investors and financial professionals, including me, take a different approach. I do not believe that any information is available that allows me or anyone else to predict which stocks will rise or fall in value, or when those moves will happen. Nor do I believe that when new information – a dividend increase, a terrorist attack, a patent approval – does arise, that it's possible to buy or sell fast enough to exploit that news. To the contrary, I believe that security prices adjust so quickly (efficiently) to information that any possible advantage evaporates before it can be acted upon.



Ultimately, EMH says that any time and effort spent thoughtfully choosing stocks based on technical, fundamental or any other kind of analysis adds no value.

Talk about humbling!

Humility is the new bravado

To accept the idea of market efficiency, I have to also accept that I am not smarter than the market, that no matter how much research I do, no matter how much experience I have in the markets, no matter how elaborate my buy and sell rules are, there is no reason – beyond pride – to think that my picks will outperform the market as whole. And it's not just me; I don't believe there is any expert I could hire who could consistently pick stocks that will beat the market.

What a profound shift this is, from pride to patience, from an aggressive pursuit of the next big stock to a calm acceptance of market return, from hubris to humility. It changes everything.

The value of information

Don't get me wrong about the importance of information. At OCM we are voracious consumers of information and opinion. We get research coverage from the major Wall Street firms. I personally make a point of checking and reading as many Bloomberg stories as possible on my news monitor every day. I love the newspapers and read them for breakfast. The Fed (<http://www.federalreserve.gov/>) and Bureau of Labor Statistics (<http://www.bls.gov/>) are must-reads for unbiased fundamental information, in my opinion. Our goal at OCM is to be as aware as possible of all major events that are affecting markets daily. This information does not drive our investment strategy, but it provides critical context. It helps us understand what is happening in the markets and why.

To be clear, the efficient market hypothesis does not suggest that stock prices move randomly, disconnected from earnings announcements, political dealings, economic reports or world events. What it says is that prices do respond to these influences, but do so so efficiently that an investor cannot act quickly enough to consistently reap a better than market return.

Overcoming human nature

EMH is not a new idea. Eugene Fama of the University of Chicago developed the concept 40 years ago and the theory shaped Burton Malkiel's classic book *A Random Walk Down Wall Street*. Nonetheless, the premise has been difficult to swallow for many investors. I believe much of the resistance is simple human nature – we are confident in our abilities to make good choices. We take pride in the choices that pay off, and we tend to forget those that don't.

I speak from experience. I worked for many years in large wealth management practices where we went to great effort and expense to identify so-called undervalued securities, engage the most sophisticated money managers and pick the



best and brightest hedge fund managers. Sometimes the picks worked. Often they did not. For all the intense fundamental, technical and trading expertise deployed to outsmart the market, the results, on average, were pretty average.

My career experience is reinforced by considerable research that shows how often index benchmarks beat actively managed mutual funds. For instance, only 22% of actively managed mutual funds outperformed the Vanguard 500 Index Fund over a 20 year period spanning the 80's and 90's. [David Swensen, *Unconventional Success*]. Experience and data convinced me that there had to be a better way to invest. I believe EMH is the foundation for that better way and have built Osbon Capital Management (OCM) to capitalize on the possibilities it presents. Indexing is our tool.

Indexing, which by definition seeks to replicate market returns, is the optimal response to an efficient market world, in my view. Indexing not only delivers returns that many active managers are unable to match, it also promotes diversification, which limits overexposure to catastrophic events in individual stocks or narrow sectors. If you can't beat a market, indexing allows you to "be the market."

Without predictions, what's left?

If you don't predict stock prices, markets and investment scenarios, then what is left for an investment manager to do? Quite a bit, as it turns out. Freed from the endless quest for research-inspired bargains, we can focus on the essentials of creating and managing client portfolios: risk management, asset allocation, diversification, and careful selection of low cost, tax-efficient exchange traded funds (ETFs). Research shows that asset allocation, diversification, and risk management have a far greater impact on portfolio returns than the selection of specific securities. So that is where we spend a great deal of our time and energy.

As an index boutique, OCM concentrates on creating portfolios that take full advantage of the power of indexing, with an emphasis on client communication and service. Humility keeps us focused on serving clients, rather than chasing elusive and unsustainable outperformance.

What EMH means right now

By all accounts, 2008 was a brutal year for stocks. But I believe it was also another clear demonstration of EMH in action. There was no shortage of news – bankruptcies, bailouts and buyouts – but when the news hit, prices reacted so rapidly that few investors could avoid losses, and far fewer still could reap profits. Even the most sophisticated hedge funds, managed by the greatest minds in investing, vaporized hundreds of billions of client dollars.

The OCM Advantage
Osbon Capital Management is an index boutique. As firm believers in market efficiency, we make no attempt to beat the market through stock picking, market timing or fundamental or technical analysis. We focus on asset allocation, risk management, the selection of cost-effective ETFs and exceptional client service.



The relentless upheaval has driven many investors out of the market, with untold billions now finding no place to go except into the proverbial mattress. We can only assume that most investors taking this exit strategy expect security prices to continue to fall, or that they can tell when prices are going to go up again. EMH tells us that more declines are possible, but no more likely than a move to the upside. All the news, good and bad, is already priced in. In our view, this was the case when the Dow reached 1,000 for the first time, and when it peaked above 14,000, and it is just as true today.

In many ways February 2009 resembles an earlier era of presidential change, financial chaos, crises of economic belief and fear of perpetual decline. In January 1981 we faced rampant inflation, record unemployment, huge deficits, war with Iran, the Cold War, and severe recession. Eight years later and against almost all predictions, inflation was reversed, Communism was defeated and economic prosperity was unprecedented and sustained. Oh yes, and the stock market appreciated 135%, or about 12% a year compounded, not including the bonus of dividends. That scenario seemed impossible in 1981, and a similar positive prospect seems impossible to many today. In truth, no one knows where the market will take us in the next decade. But EMH and history should make it clear that up is no less likely than down. Stay balanced and stay invested; that is our humble advice.

John Osbon, Chief Investment Officer
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