



**Lessons From The Year That Was**  
*What 2007 teaches us about the future*

Every year in the markets is a new and remarkable adventure. On January 1, we have no idea where the year will take us, and by December 31, we can barely believe where we've been. 2007 was no exception. This was another year of turmoil and volatility, another year of lessons learned, lessons we can draw from as we look ahead to 2008 and what lies beyond.

The sub-prime mortgage mess. \$95 oil. Hints of recession. Soaring gold. The dismal dollar. Take your pick, or add them all together. 2007 provided serious challenges for investors and their advisors. But through the challenges came several important lessons that can guide our efforts going forward:

**Accept "The Fog of Markets"**

The investment community is rightfully proud of the rational and orderly operation of the markets, where buyers and sellers thousands of miles apart can find each other and exchange assets at fair prices. But behind all this satisfying order teems considerable chaos – a fog of confusing causes and confounding effects.

Markets are driven by earnings reports, interest rates, political rhetoric, consumer sentiment, war, terrorism, technology, hunch, rumor, fear, greed and any other variable that causes any investor anywhere in the world to buy or sell. Attempting to connect any single cause to any specific market result vastly underestimates the complexity of the markets. Making investment choices based on news – whether from Wall Street or Pennsylvania Avenue, Baghdad or Brussels – ignores the dozens or hundreds of other variables that will influence the eventual returns on those investments.

Even working backward, through the forgiving lens of retrospect, the Fog is impenetrable. If we were told a year ago today what 2007 would bring regarding mortgage lending, oil prices, interest rates, the presidential campaign and the Iraqi conflict, we might have predicted a dire year for the markets. Few could have accurately predicted the fate of the Dow (up 8 percent as of this writing), NASDAQ (up 12 percent), China (FXI up 61 percent) or any other investment. Despite the 24/7 financial media, which offer us an endless fare of pundit explanations for the market's various gyrations, there are simply too many factors working at once to draw a straight line between cause and effect.

So what's the Fog mean for investors? For me, it informs my time management. Instead of trying to decipher and act on everything that is happening in the markets, I focus my time and energy on reaping the return of the *total* market. My priorities are asset allocation and identifying the best (low cost, tax-efficient, transparent)



index investment vehicles to access the aggregate return all asset classes. It is not necessary to understand all of the causes to benefit from all of the effects.

### **Recognize the fallacy of timing**

If there was ever a year where market timing could pay off big, it was 2007, a year of steep peaks and deep valleys. Take the Dow Jones Industrials as an example. Between mid-July and late September, DJIA was essentially unchanged, starting and finishing at just below 14,000. Between those dates, however, it took a boomerang ride to 12,518 and back.

Surely there were some investors who by good fortune sold at the summit or bought in the trough. But I suspect many more who tried to time the market timed it wrong. The Dow's jagged 2007 value chart, with dozens of days of triple digit daily moves, both up and down, demonstrates the relentless speed of the modern market. When it moves, it lunges. It slams into reverse without warning. Most importantly, it does not slow down for passengers to climb aboard. It smirks as it accelerates through the station.

To my eye, the idea that one can consistently time the market is a fallacy. It's an anachronism, a shard of pottery left by our ancestors who lived in an age of considerably slower moving information. I believe in market efficiency – the proposition that any available information is immediately reflected in security prices. This means that it is impossible to buy or sell on new information before it has been fully factored into the market price.

As an efficient market advocate, I buy, hold and rebalance. I accept – and embrace – the notion that over the long term, a well diversified portfolio will deliver the market average return. And I reject the idea that “average” is unsatisfactory. Average in US stocks, over the long term, has produced around a 10% annualized return – a doubling of asset value every seven years or so. Outside the US, average 10-20 year equity returns can be even higher, sometimes materially so. Seeking average ensures participation in all of the best that the markets have to offer – in 2007, for instance, emerging markets soared by 30 percent (EEM) – without having to guess and gamble on what those highlights would be.

### **Expect surprises**

In 2007, it was the mortgage fiasco. In 2008, who knows? The debacle in mortgages points to the fundamental danger of overexposure to any one thing. Anyone who, intentionally or accidentally, held large positions in home loan lenders or related financial services organizations learned an unpleasant and costly lesson last year.

And I expect for many people it *was* accidental. Today it is very easy to build unintentional concentrations in narrow asset classes – by sector, geography or style. The non-transparent operations of many hedge funds, the black box approach of some very large money managers, and the inevitable overlap of multiple investment



directions all conspire to create undesirable overexposure (and, of course, underexposure to other asset classes at the same time).

Since we cannot possibly know what next year's big winners or big losers will be, we can only strive to own everything. Building a rigorously diversified portfolio, and holding it for many years, renders short-term crises like the sub-prime bust to minor footnote status. Further, next year is not really the issue. We think in generational timelines, and so do our clients. We are not looking for a huge year in 2008. Average, on a global, total market basis, is no disappointment.

### **Look yourself in the mirror**

Year-end is a natural time of reflection. In investing, it offers an ideal opportunity to consider lessons learned in the past year and apply them to the plans we make for the future.

How did 2007 treat your portfolio? And how well prepared are you for 2008 and beyond? At Osbon Capital Management, we saw very satisfying results for our client accounts, relying heavily on indexing to access opportunities across all asset classes around the globe. We have no heroic investment tales to tell. We did not predict or time the surges in oil or gold prices. We did not sell the financials before their autumn slides. We did not jump in or out of anything. We held the total market, concentrating on connecting risk and reward. This strategy yielded an excellent year.

### **All terrain vehicle**

One of the great challenges, and rewards, of money management is to continually prepare for future events when it is impossible to know what those events will be or when they will occur. In addition to market swings that defy timing, unforeseeable economic, political and technological surprises, and the market's own inescapable Fog, investors must navigate other challenges too, notably the relentless tug of taxes and the slippery slope of inflation. All of these conditions reward an all terrain vehicle investment strategy – one that maintains traction in any kind of market.

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*January 2008*

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