



Volatility and Indexing *Controlling surprises in turbulent markets*

Investing icon Warren Buffett famously said, “You can’t tell who’s swimming naked until the tide goes out.” That is, the flaws in a portfolio are difficult to spot in rising markets, but become alarmingly apparent when things go bad. Many investors were caught naked this summer as some pedigreed professionals – including hedge fund manager Sowood Capital, bond managers in Bear Stearns Asset Management, and mortgage giant Countrywide Financial – fell fast and far. Could this shock and embarrassment have been avoided?

No investment strategy or portfolio is immune to volatility. However, investors can easily take precautions that can help work to prevent the worst surprises – the naked on the beach variety. We believe that one of the best protections is the disciplined use of index investments.

Surprises not included

When you buy an index – as an ETF or mutual fund – you generally get a basket of securities with some common thread, such as market cap, style, geography, etc. When you own the Dow Jones Industrial index (DIA), for example, you get the return on the 30 stocks that comprise the index.

Indexes offer easy diversification, easy trading, and an easy way to match market performance. But perhaps much more important than what you get with an index is what you don’t get:

- **Style drift** – Active managers, in search of better performance, can stray from their stated missions. Value investors may become growth and momentum players, or vice versa. Even the estimable Bill Miller, manager of the \$10 billion Legg Mason Value Prime Trust (LMVTX) lists Google and Amazon among his top 10 holdings. Good investments perhaps, but are they value stocks? Possibly the most egregious example of style drift was Long Term Capital Management, which started out as a market neutral hedge fund and ended up as a 100 to 1 leveraged one way long bet on stocks and bonds (see *When Genius Failed* by Roger Lowenstein).
- **Whiplash and knee jerks** – When managers try to rebound from poor results, they may make radical moves that are even worse. In the money management race the only thing harder than staying ahead is catching up when behind. Often, a higher level of risk is adopted to catch up, when



adherence to discipline would be the better choice. Above average portfolio turnover is an early indicator of a manager susceptible to whiplash.

- **Market timing** – Indexes are immune to one of the greatest (and least productive) temptations facing investors and money managers – trying to buy before the surge, and sell before the plunge.
- **Surprises** – Indexes are pure *WYSWYG*. The investment tracks the index, period.
- **Pointless apologies** – When performance falls short, active managers will sometimes express regret to reassure investors, or attempt to explain away the results: “This was a 27 standard deviation event.” With indexes, there are no judgment errors to apologize for or explain.
- **Black boxes and opinion-based investing** – Indexes are transparent, understandable, rules-based, accountable, and reinforced by market pricing. There’s no man (or machine) behind the curtain making subjective decisions on fund content.
- **Tax shock** – The minimal movement of stocks in and out of indexes limits tax consequences, in contrast to active managers who may trigger significant unexpected tax liabilities through frequent buying and selling.
- **Needless costs** – Low or no turnover means low transaction costs for index investments.
- **Fads** – Owning an index eliminates any concern that one’s money manager is chasing “the next big thing,” which typically isn’t.
- **Overexposure** – As most indexes track hundreds or thousands of securities, they limit exposure to one-company collapses such as Enron.

The OCM Advantage – Indexing is the benchmark, the standard of any portfolio. We strive to leverage the valuable benefits of indexing – tax efficiency, global diversification, transparency and cost control. Indexes are key ingredients in all of our customized client portfolios.



Be like Harvard

Indexing can be compared to a college dorm with a curfew (continuous mark to market), rules (the prospectus), lights out (trading on a listed exchange during market hours), and no funny stuff (the SEC is watching; penalties can include criminal, not just civil charges). Because of its many benefits, indexing is not just for individuals. Harvard's endowment, which has preferred access to any investment vehicle, indexes 30% of its massive \$35 billion portfolio, according to Mohamed El-Arian, president and CEO of Harvard Management Co., the endowment's manager, as reported by Bloomberg on December 14, 2006.

Keep your suit on

In the months ahead, we expect to see more naked and bewildered swimmers on the beach. As described above, there are many ways to be surprised when the tide goes out. Fortunately, we believe indexing mediates or eliminates many of these unpleasant possibilities.

To be sure, choosing among the 500+ index vehicles demands care and discipline, with intense attention to asset allocation. Indexing is an important tool in all client portfolios at Osbon Capital Management – typically representing the majority of investment assets. My advice to all investors is simple: index a portion of your portfolio. And relax at the beach.

John Osbon, Chief Investment Officer

October 2007

© 2007 Osbon Capital Management

This newsletter contains general information that is not suitable for everyone. The information contained herein should not be construed as personalized investment advice. Past performance is no guarantee of future results. There is no guarantee that the views and opinions expressed in this newsletter will come to pass. Investing in the stock market involves gains and losses and may not be suitable for all investors. Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security.

Osbon Capital Management, LLC ("Osbon") is a registered investment adviser with its principal place of business in the Commonwealth of Massachusetts. Osbon and its representatives are in compliance with the current registration requirements imposed upon registered investment advisers by those states in which Osbon maintains clients. Osbon may only transact business in those states in which it is registered, or qualifies for an exemption or exclusion from registration requirements. This brochure is limited to the dissemination of general information pertaining to its investment advisory services. Any subsequent, direct communication by Osbon with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of Osbon, please contact Osbon or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov).

For additional information regarding Osbon, use the contact information herein. Please read the disclosure statement carefully before you invest or send money.