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## A 'Free Lunch' in Inefficient Stock Markets?

Are there areas of the stock market where stock prices are not efficient and skillful investors can scope out bargains overlooked by other investors? An affirmative answer to that question is commonly used to justify active stock selection among small company stocks and emerging market stocks.

Proponents of this argument accept that prices on large U.S. and international stocks are probably efficient, meaning that there is so much competition among investors that all relevant news is immediately incorporated

into the stock price and there is no advantage in attempting to outguess the market. However, these same people argue that the markets for small company stocks and emerging market stocks are less efficient because fewer people are following those stocks. If that is true, investors are better off using passive mutual funds for large U.S., European, and Asian stocks, and active funds for small company and emerging market stocks.

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Unfortunately for those who advocate this position, two top investment academics say that there is no evidence that smaller markets are any different from the large markets. According to Eugene Fama of the University of Chicago and Kenneth R. French of Dartmouth College, small company stocks and stocks of emerging markets like Brazil, Poland, and India are efficiently priced as well.

One argument for the inefficiency of small stock prices is that they are simply neglected. As professor French describes it, the argument is, "If no one is paying attention to a group of small stocks, for example, how could their prices possibly be accurate?" He said the argument "may have had some merit 150 years ago," but seems out of date in an era where "hundreds of billions of dollars are spent by investors each year looking for pricing errors."

When it comes to emerging markets, the argument is, "that investors in some markets are ripe for the picking because they are just not as sharp as the rest of us," Fama says. But that argument is flawed: "People are bright and highly motivated in markets around the world," making those markets efficient as well.

The evidence shows that smaller markets are just as efficient as the larger ones, and the "free lunch" is just as elusive in Brazil as it is in the U.S. Investors are therefore well-advised to use a passive, diversified approach in all of these markets.

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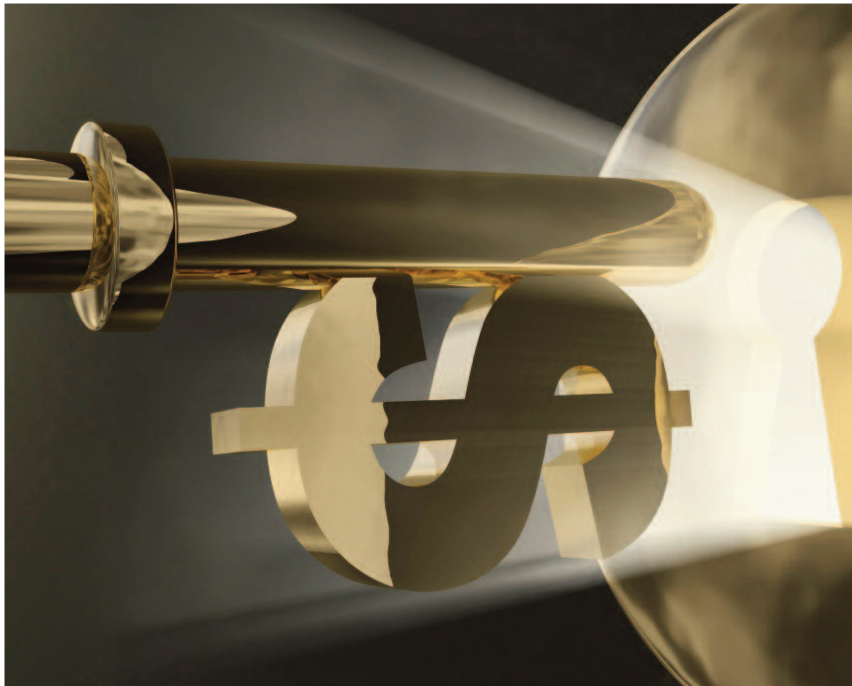
# The Danger of "Safe" Investments

We are all aware that the financial markets have been a wild ride over the past five years. Global stock markets reached an all-time high in October 2007, only to suffer dramatic declines of 50% or more during the global financial crisis of 2008 and 2009. After the crisis ended, global stock markets more than doubled from their lows, peaking in April of 2011. Since then, the markets have gyrated wildly between optimism about corporate earnings and fear over sovereign debt in Europe.



The unusually high volatility of recent years has taken a large emotional toll on investors, and understandably so. Watching the value of your life savings rise and fall by thousands or tens of thousands of dollars every day is an unnerving experience. Many investors have exited the stock markets in recent years, simply concluding that the high volatility is too much for them to handle. They either intend to remain permanently invested in bonds or cash, believing that this is a more secure option, or they plan to re-enter the stock markets after the economy improves and volatility subsides. Unfortunately for these investors, both of these strategies are full of unseen risks.

## Playing it "safe"

Remaining permanently invested in bonds may feel safe, but the effects of inflation on the purchasing power of fixed income holdings can be devastating over long periods of time. In fact, over the 25-year period ending in December 2011, three-month U.S. Treasuries have returned just 1.3% per year after accounting for inflation. However, over the same time period equities have done a far better job of combating the harmful effects of inflation, returning 6.2% per year after the inflation adjustment.

The truth is, when investors move out of the stock market and into cash or bonds, they are not eliminating all forms of risk from their portfolios. They are merely exchanging stock market volatility risk for inflation risk. While volatility risk may be easier to see and more frightening on a day-to-day basis, the erosion of purchasing power from inflation is much more permanent and poses a far greater risk to an investor's long-term success. Given the fact that yields on many short-term bonds are currently near zero, this risk is larger than it has been in many years.

## Market timing

Many investors who are currently out of the stock market probably recognize that inflation risk poses a significant danger to their long-term spending power. They see their hiatus from stocks as merely temporary and they plan to re-enter the stock market as soon as better economic times arrive. Unfortunately, this strategy can be even more dangerous than the first, simply because stock markets do not send an "all clear" signal before they

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rise. Instead, stock markets tend to be forward-looking; they rise in anticipation of future improvements in the economy long before the economists and the financial press recognize that the improvements are upon us. Therefore, investors who delay investing in stocks until the economy is in full swing tend to miss a significant portion of the money that is made in a bull market.

### Fiscal fitness

The moral of the story is this: "Feel good" strategies such as investing in bonds for the long-term or attempting to own stocks only in good economic times will not work. These strategies may lull you into a false sense of security during times of high stock market volatility, but they will almost certainly cause significant damage to your long-run financial health. A truly successful investment plan is similar to a successful fitness routine; it is not always pleasant, it involves discipline, and there is a part of yourself that is constantly urging you to just sit on the couch (or remain invested in bonds). However, like a good fitness plan, a good investment strategy will provide tremendous benefits in the long-run.

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So, what does a good investment plan involve? First, it involves diversifying into both stocks and bonds at all times, not an either-or decision to own stocks or bonds at a given time. Second, it requires discipline in all market environments, not speculation about opportune points at which to enter and exit the markets. But most importantly, a good investment plan starts now. Remaining invested exclusively in bonds places you in a situation in which inflation is eroding your purchasing power every day. Waiting for the "all clear" signal before investing in stocks virtually assures that you will fail to capture a large part of the next bull market, which may have already begun. If your portfolio is currently invested exclusively in fixed income investments, you should speak to a qualified, fee-only wealth manager immediately and discuss your options. Like a good personal fitness trainer, a good wealth manager will help you adopt personal habits that might make you uncomfortable today, but will benefit your financial health in the long-run.

*This article was originally written by Heritage for the March 2012 edition of The Light, a local magazine serving Broward County, Florida.*

## Low-tech Companies Lead Winners' List

High-tech U.S. stocks led the market higher in the first quarter of 2012. Apple has been on a rapid ascent fueled by the sales of iPads and iPhones, while investors eagerly await the initial public offering of Facebook. Back in the late 1990s, internet and tech stocks were all the rage. The sector had spectacular returns until experiencing equally spectacular losses in the 2000-2002 bear market. So if you were looking back over the last 20 years for the best performing stocks, you would figure that high tech or internet stocks would lead the list, correct?

*"Actually, an old technology that dates back to 1804 fueled the hottest stock of the last 20 years..."*

### 208 years old

Actually, an old technology that dates back to 1804 fueled the hottest stock of the last 20 years, according to the website SmartMoney.com. The winner was Kansas City Southern, a railroad company that was up an astounding 19,030 percent over the past 20 years. An investment of $25,000 in the stock back in 1992 would be worth $4.8 million today.

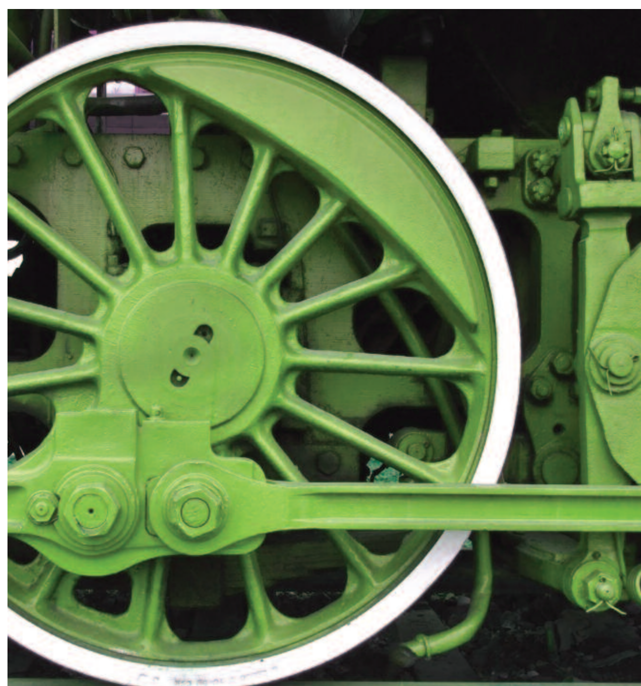
Part of its success dated to ownership of the Janus Capital Group in the 1990s, a mutual fund company that specialized in growth stocks. Janus was spun off in 2000, just before it fell by 78 percent, while the railroad gained another 1,051 percent, partly due to cross-border trade with Mexico.

The second-best stock was another unlikely company, Middleby, a maker of ovens and restaurant equipment. It gained 14,330 percent since 1992. The winners' list also had a number of tech stocks, including 10th-ranked Astronics of East Aurora, NY, which benefitted by selling its products to airlines updating their cabins. It was up 6,004 percent.

### Not a cakewalk

Those unlikely winners show just how hard it is to pick individual winning stocks, and then to hold on to them through bad times. Qualcomm, for instance, was number 5 on the list, with a 20-year gain of 9,232 percent. However, the maker of chips for mobile phones suffered a spectacular fall in the 2000-2002 bear market, and at one point looked like it would not survive. The stock fell from a high of $75 a share in 2000 to the low teens by 2002. An investor would have fully profited from Qualcomm's rise only by exercising the discipline to endure that painful fall.

The important question is this: If it is difficult to guess which stocks were the best performers after the fact, how difficult is it to spot them ahead of time? The best stock of the next 20 years might resemble Kansas City Southern more than it resembles Apple.



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