Quadrant
ASSET MANAGEMENT

QAM Update
November/December 2013

The QAM letter that highlights topics that we think either affect the markets or are important to understanding them.

"Give me a one-handed economist! All my economists say, on the one hand on the other."
Harry S. Truman, President of the United States

Bubbly Efficient Markets

There is an old joke that given 100 economists, there will be 2 theoretical economists with different theories on how to change a light bulb and 98 empirical economists laboring to determine which theory is the "correct" one … yet everyone will still be in the dark.

In October, when the Royal Swedish Academy of Sciences awarded the Nobel Prize for economics to both Robert Shiller and Eugene Fama for offering competing viewpoints on how markets price assets, the joke was not such a joke anymore.

Fama became famous in the world of Finance in the late 1960s through his work that supported the idea that the stock market is "efficient". The "efficient markets hypothesis" asserts that financial markets are "informationally efficient", claiming that a person cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis. The most important conclusion from his work on the "efficient markets hypothesis" for the average investor is that you can't beat "the market" in the long run.

The efficient market hypothesis helped an entire generation of economists and financial analysts develop and incorporate strategies on risk management in portfolio management. It is even the foundation for the trillion dollar ETF industry. It is an important body of work that has served to move our industry forward in its understanding of asset pricing, risk and portfolio management.

Enter economist Robert Shiller who, notwithstanding the statistical validity of Fama's data, sees markets as less rational, reflecting the very human nature of participants in the capital markets.

In the late 1970s and early 1980s economist Robert Shiller started publishing work that showed that even as the stock market may be efficient at reflecting all available information about a single company, at the same time the stock market could show irrational investor sentiment that may cause individual companies or an entire market to be over or undervalued. Shiller explains his thinking about the failures of the "efficient market hypothesis" saying that: *"I used to be cowed by the efficient markets hypothesis, and now I think it's a half-truth. It is true that money is harder to make a profit than you'd think, and randomness plays a huge role in your outcomes, investing outcomes. But it's not true that markets are efficient, and in particular, aggregate markets are driven primarily, I believe, by investor sentiment."*

So who is right, Fama or Shiller? It is not really an issue of right or wrong. Both bodies of work have provided valuable insight to advancing how we design and manage diversified portfolios. Fama makes us remember that is very difficult to consistently beat the market; Shiller makes us remember that even if markets are efficient, they are not always right over shorter periods of time.

As investors in the capital markets we are accustomed (and accepting) of the need to invest over the "long term" in order to achieve our desired results. While this is a common axiom in the investment industry, we can forget that the journey to "long term" is not a consistent continuum like a length of rope. Rather, it is more akin to a length of chain that, like a rope, spans the distance from here to "long term", but unlike a rope, it is made up of short links – each representing a segment of the journey. Fama helps us pay attention to the overall span; Shiller helps us pay attention to the shorter links in the context of the overall journey.

Happy 2014!

Around the same time last year we were saying farewell to 2012 and wishing for a happy 2013, remembering the 1988 hit song by Bobby McFerrin "Don't Worry, Be Happy" as the Fiscal Cliff in the USA was creating a strong negative sentiment that was affecting riskier assets.

We were saying that even though "black swan" events can materialize, a long term plan can remove much of the impact. Now, here we are, in a totally different environment in front of what some analysts are calling "pockets of irrational exuberance" and the same holds true.

Quadrant is here to help you with your long-term financial plans based on some proven investment tenets - diversification, discipline, capital preservation and continued re-focus in the long term – regardless of the predominant market sentiment of the moment.

We thank all our clients for their continued support and trust. It has been great year for Quadrant, with the addition of new clients and our move to new offices.

We wish you a Happy Holidays Season and a healthy, peaceful and prosperous 2014.

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