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Efficient market theory: It's all relative

The efficient market theory, or EMT, claims that it is impossible for an investor to outperform the stock market because existing share prices already incorporate and reflect all relevant information and expectations.

Burton Malkiel, an economics professor at Princeton University, helped lay the foundations for EMT in his book "A Random Walk Down Wall Street."

In it, he writes, "A blindfolded chimpanzee throwing darts at the Wall Street Journal can select a portfolio that performs as well as those managed by experts."

As longtime observers and investors, we would like to set the record straight—the stock market is anything but efficient. As for the blindfolded monkey, we do not doubt he could match the investment performance of many "experts," but one must be careful when defining the term "expert."

Mr. Malkiel defends his theory by showing that during the past 30 years, more than two-thirds of professional portfolio managers have been outperformed by the unmanaged S&P 500 Index, and the managers who beat the index in one period are unlikely to do so in the next.

This certainly provides compelling evidence for EMT, considering that most investment managers are well-educated and experienced. However, we believe that when taken in its proper context, the statistic cannot only be explained, but provides support for our theory that the stock market is inefficient.

CAN'T GO WRONG BUYING INTEL

Established investment managers and financial institutions have little to gain by outperforming the stock market and everything to lose by underperforming. The stock market has returned approximately 10 percent per year over time, and an average investor would be happy with this result. 14 percent per year would earn analysts and money managers a nice pat on the back, while 6 percent would likely get them fired.

As a result, the majority of investment managers own a large number of popular stocks such as Intel and General Electric, many times in excess of 50 to "diversify." The end result is a portfolio highly correlated to the broad stock market or its benchmark index, and when fees are included, it is no surprise that more than two-thirds of investment managers underperform. That a large number of overprotective professionals settle for mediocre results does not mean the market itself is efficient. In fact, their actions help make the market less efficient.

Each public company fits into a box on Wall Street, such as "small-cap growth," "mid-cap value" or "emerging international growth."

To appeal to consultants and other institutional clients, many investment managers adopt management styles that fit into these boxes, effectively limiting their opportunities. Each box might contain hundreds of stocks, and when the boxes are pieced together to create a "diversified" portfolio, the end result is a mediocre performing investment vehicle with layers of fees. This is a classic example of "diversification" taking the prudent practice of diversification to counter-productive extremes.

Mr. further illustrate the concept of diversification, let us reference the concept known as "diffusion of responsibility."

This social psychological phenomenon has been studied since 1964, when at least 38 people witnessed the murder of Kitty Genovese in New York City, and not a single person helped her or even called the police.

Diffusion of responsibility is broadly defined as a situation in which individuals in a group assume less personal responsibility for negative consequences of a poor decision as the group becomes larger. On Wall Street, diffusion of responsibility might sound something like this—"We all took a hit" or "No one saw this coming."

In this regard, it makes perfect sense to us that Mr. Malkiel recommends low cost index funds as an appropriate stock market investment vehicle. Compared with most mutual funds, they are in fact an excellent choice. Compared with engaged management of a small portfolio, they do not measure up.

MY CRYSTAL BALL SAYS . . .

"Expert" Wall Street analysts never cease to amaze us with their predictions for the future, especially in the technology sector. It is common practice for analysts to create complex, discounted cash-flow models that predict growth rates into the distant future, eventually reaching a "terminal growth rate" that can be sustained forever. We can see merit in discounting future cash flows, but more as a "cocktail napkin" calculation than a means of finding an exact price target.

A company with a price-to-earnings (P/E) ratio of 25 must earn its current year's profit for 25 years (after accounting for options) before an investor would effectively reclaim his principal. Justifying this multiple means that a great number of assumptions must hold true over a long period of time, including future market share, pricing power and growth rates. A P/E of 25 is not necessarily unreasonable, but investors should have a great deal of confidence before buying in.

We are confident that people will be chewing gum in the year 2030, but will they still be using Cisco routers or BlackBerry devices built by Research In Motion? Possibly, but the future is uncertain, and the risk is high. Innovation in technology is a juggernaut with few barriers to entry and a seemingly endless amount of capital chasing the next improvements. Uncertainty and unrealistic expectations create irrational behavior by investors who have little substance to base decisions on.

'CIRCLE OF COMPETENCE'

Warren Buffett: I don't have the faintest idea how to evaluate what telecom companies will look like down the road. I only understand a little of what they do. I suppose if you gave me some information, I could retranslate it back to you, but in terms of understanding their economic characteristics down the road, I don't know. Charlie, what do you know about the telecom business?

Charlie Munger: Less than you do.

Mr. Buffett: Then you're in trouble. I know people will be drinking Coke, using Gillette blades and eating Snickers bars in 10 to 20 years and have a rough idea of how much profits they'll be making. But I don't know anything about telecom. It doesn't bother me. Somebody will make money on cocoa beans, but not me. I don't worry about what I don't know—I worry about being sure about what I do know.

Mr. Munger: Berkshire in its history has made money betting on sure things.

LEMMINGS FOLLOW WALL STREET

When asked his opinion of the stock market, famous financier Bernard Baruch replied, "It fluctuates."

This is one truth that no one can

argue, and it is also what makes the same stock cheap on some days and expensive on others. One of the clearest laws of economics is "supply and demand." When there is more demand for a stock than supply, its price will go up, and vice versa. However, supply and demand are not always related to the intrinsic value of a company. Benjamin Graham said it best—"In the short run, the stock market is a voting machine; in the long run, the stock market is a weighing machine." Or, as others have pointed out, day-to-day the market is driven by emotion, but in the long run the market rewards earnings.

Large public companies often have as many as 10 or 20 analysts covering them, and guess what happens when one of these companies misses a step? Diffusion of responsibility kicks in: No analyst wants to be the last to downgrade a stock, and no one wants to be holding the bag when the last investor moves on to greener pastures. It's like a party where the last one to leave has to clean up. Everyone watches the door, and when someone makes a move, there is a mad rush to leave.

EXCLUSIVE OUTLOOK

Paul Orfalea, Lance Helfert and Atticus Lowe

This vicious cycle often results in capitulation of a company's stock price, and it may create opportunity for others. In addition, thanks to modern technology, trading capabilities are now available to millions of emotional investors with twitchy fingers, adding to the market's volatility and inefficiency.

BUT EVERYONE ELSE IS SELLING

Human emotion is quite possibly the most difficult aspect of investing. Truly successful investors all have one thing in common—patience. Buying a stock for \$30 per share and watching the price drop to \$40 is extremely vexing, and the temptation to sell before it drops further is a common reaction. Stop loss orders and margin calls get triggered in the process, and an all out stock massacre occurs on occasion. Such was the case in 2002, when viable businesses were trading at or below net cash value.

Owning a share of stock is the same as performing part of a business, and when a share drops from \$50 to \$40, the paper value decreases but the percent ownership remains the same. This is an important distinction, as many investors view a share of stock as a piece of paper with a price attached to it, when in fact it is a fractional ownership of a business and its future profits. An investor must make decisions based on the value of the business, not the value of the stock.

WHAT ABOUT WARREN BUFFETT?

One obvious response to EMT is this question: How have Warren Buffett and Charlie Munger of Berkshire Hathaway continued to trounce the performance of the broad stock market for so many years? EMT proponents might dismiss Berkshire as a rare anomaly, but when one looks back at the majority of its major investments, one generally says, "Wow, that really made sense."

By concentrating its investments in a small number of companies, many of Berkshire's investments made a significant impact on its portfolio and rewarded investors handsomely. Had Gillette and Coca-Cola represented 1 percent of Berkshire's investment portfolio, an original share of Berkshire stock would not be worth \$90,000 today. In other words, Mr. Buffett and Mr. Munger excelled by betting big when they knew the odds were in their favor.

This brings us to another point. Many of the world's most talented investors choose to manage their own

money privately or start more lucrative "hedge funds," instead of managing less flexible public mutual funds.

EVIDENCE TO EMT CONCLUSION

It is not uncommon for zealots to use selective data to support a predetermined conclusion, to the point where they refuse to acknowledge evidence that contradicts their belief. As one story goes, a finance professor and a student come upon a \$100 bill lying on the ground. The student stoops to pick it up. "Don't bother," the professor says. "If it was really a \$100 bill, it wouldn't be there."

EMT proponents believe the market cannot be beaten over time, and they gather evidence that supports their belief. Such evidence is easily found in the "experts" who cannot reliably beat the market. Proponents conveniently ignore the consistently successful investors, partially because they are hard to see in the first place (workhorses, not show horses) and partially because they invalidate the efficient market theory.

MAKE USE OF INEFFICIENCIES

There are more than 10,000 publicly traded companies for investors to choose from, each an entirely different organism with a unique capital structure and its own problems and opportunities. At any given time, each company may be underpriced, fairly priced, or overpriced relative to an investor's alternative opportunities such as real estate, bonds or other stocks.

Similar to Albert Einstein's theory of relativity, we believe that everything in the stock market is relative and must be taken in its proper context. Therefore, we do not believe that market-beating returns can be achieved over the long run by using trading strategies based on technical analysis or specific valuation matrix. Nor should we base decisions on historical patterns that have been identified by scientific investors promising arbitrage opportunities. Let us not forget the "Super Bowl Indicator," which has been a fairly accurate predictor of how the stock market will perform based on which team wins the Super Bowl.

We consider inefficiencies to be opportunities, and limit our investments to what we believe are the best 10 to 15 opportunities (within our circle of competence) in the entire stock market. It is our belief that concentrating our investments in a small number of thoroughly understood companies lowers our risk of losing capital and enables each selection to have a meaningful affect on our results. Beyond ownership of 12 to 15 stocks, we feel the benefits of diversification are marginal.

By monitoring a list of companies within our circle of competence and continuing to add companies to the list, we are able to see and take advantage of opportunities as they occur. If few opportunities cross our path, we maintain a greater cash balance, but with more than 10,000 companies to choose from, we are not hard pressed.

EMT claims that the stock market cannot be beaten, except through insider trading or incredible luck. Forgive our trite response, but as the old saying goes, "The man who says it cannot be done is often interrupted by the man who is doing it."

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