

Jim Williams

Nobel Prize in Economics for Gene Fama

We at J. F. Williams Co., Inc. are generally not given to bragging nor tooting our own horn. We generally like to let our work speak for itself. We are proud of our fee-only status, we are proud that we are fiduciaries, and we are proud that we do real, honest-to-goodness planning for our clients that need that work. We are proud of our investment philosophy that is based in academically proven, objectively sound investment principles that do not require reference to what particular fad is in favor this week.

A few weeks ago, something else occurred that we are proud of. The Nobel committee announced that University of Chicago Professor and Dimensional Fund Advisors board member **Eugene F. Fama, has been named a co-recipient of the 2013 Nobel Prize in Economic Sciences**, in recognition for his contributions to the “empirical analysis of asset prices.”

Dr. Fama is responsible for several key economic theories and findings that are foundational parts of our investment philosophy. In the 1960's Dr. Fama did the essential research and analysis on stock price patterns that substantiated the Efficient Market Hypothesis (EMH). His work demonstrated that stock prices are extremely difficult to predict in the short run, and that new information is very quickly incorporated into prices. This has several implications. It illustrates the difficulty, if not impossibility of capturing market-beating returns without taking excess risk. It clarifies that money spent on active management of investment portfolios is almost certainly wasted. This understanding may have saved tens of millions of investors hundreds of millions of dollars over the years. Much of our understanding on how to identify and practically harness the relationships between market risks and expected returns is grounded in Dr. Fama's work.

Clearly, Dr. Fama has his detractors. Most folks in the business of producing and selling actively managed mutual funds still maintain that it is possible for a manager to produce excess returns by either selecting stocks or by timing the market. The problem for them is, no more managers beat the market than would be expected by random chance (about 20% after expenses), and for the most part, the ones that beat the market one year, do not beat the market the next year.

One of Dr. Fama's more prominent detractors is his co-recipient (of this year's Nobel in Economics) Robert Schiller, who famously observed that tech stocks were overpriced in the late 1990's, and that houses were overpriced in the mid-2000's, (I guess I should look back through my newsletters from those points in time to see if I have a claim to fame too) argued that market bubbles prove that markets are sometimes irrational. I'll paraphrase Dr. Fama's response to this, which is pretty sound and clear. There are always, I repeat always, folks who are saying that the markets are overvalued and folks who are saying that the markets are undervalued. This is like air. When they are right, they get anointed as prophets. When they are wrong, their error is forgotten. Bubbles are extremely hard to recognize except with 20/20 hindsight.

Proponents of active management argue that Schiller's positions are buttressed by the newly recognized area of Behavioral Finance. Most of Behavioral Finance focuses on the irrationality of investor behavior, illustrating such individual irrational biases as anchoring, overconfidence, and loss aversion, which certainly imply irrationality in investment behavior. But this fact does not necessarily lead to the conclusion that markets are irrational, much less inefficient. Efficiency and rationality are two different things. The Efficient Market Hypothesis does not hold that markets are perfect or even always right. Nor does the validity of the EMH depend on the notion that each and every market actor is completely rational. It

seems quite reasonable to me that it requires only a few actors at the margin to keep the markets trained on fair value and that while individual actors in the market are indeed irrational, the aggregate of those decisions accumulate to prices that are quite rational. Further, it seems to me to go almost without saying, that we all interpret information in a context. That context may be widely held exuberance or despondence. The salient point here is that even though markets can become irrationally exuberant or irrationally despondent, the notion that we can time our way around these anomalies is pure fantasy, born from the precision of 20/20 hindsight.

Dr. Fama has not ended his work with EMH. He, along with Ken French (of the Tuck School of

Business at Dartmouth College), did basic research to verify the influence of “value” and “size” factors on securities returns. Gene Fama and Ken French have also developed useful multi-factor asset pricing models.

We’re feeling exuberant about Dr. Fama’s award of the Nobel Prize in economics. It looks like we were about 15 years ahead of the Nobel committee on this one. Toot toot.

 If this raises questions or you would like to discuss this further, give us a call.

The table below shows the returns through September 30, 2013 for selected investment asset classes. In most cases, the results below are appropriate benchmarks for the related mutual funds in your investment portfolio.

Asset Class	Data Series	YTD	3 Yrs.	5 Yrs.
Ultrashort Bonds	BofA Merrill Lynch Three-Month US Treasury Bill Index	0.06	0.10	0.16
Short Term Municipal Bonds	Barclays Capital Municipal Bond Index 3 Years	0.73	1.77	3.26
Short Term Government Bonds	Barclays Capital Treasury Bond Index 1-5 Years	-0.06	1.15	2.49
Short Term Corporate Bonds	BofA Merrill Lynch 1-5 Year US Corporate and Government Index	0.18	1.72	3.57
Short Term Global Bonds	Citigroup World Government Bond Index 1-3 Years (hedged)	0.53	1.07	1.88
Intermediate Term Municipal Bonds	Barclays Capital Municipal Bond Index 7 Years	-1.23	3.44	5.81
Intermediate Government Bonds	Barclays Capital US Government Bond Index Intermediate	-0.83	1.75	3.52
Intermediate Corporate Bonds	Barclays Capital Credit Bond Index Intermediate	-0.85	3.71	7.70
Intermediate Global Bonds	Citigroup World Government Bond Index 1-5 Years (hedged)	0.40	1.43	2.53
US Marketwide Core 1 & 2	Russell 3000 Index	21.30	16.76	10.58
US Marketwide Vector	Russell 2500 Index	25.89	18.44	12.68
US Large Cap Market	S&P 500 Index	19.79	16.27	10.02
US Large Cap Value	Russell 1000 Value Index	20.47	16.25	8.86
US Small Cap Market	S&P Small Cap 600 Index	28.66	20.68	12.40
US Small Cap Value	Russell 2000 Value Index	23.07	16.57	9.13
Real Estate Investment Trusts	Dow Jones US Select REIT Index	2.33	12.09	5.30
International Marketwide Core & Vector	MSCI World ex USA Index (net div.)	14.66	7.89	6.12
International Large Cap Market				
International Large Cap Value	MSCI World ex USA Value Index (net div.)	14.58	7.87	5.99
International Small Cap Market	MSCI World ex USA Small Cap Index (net div.)	18.99	9.92	11.06
International Small Cap Value				
Emerging Markets	MSCI Emerging Markets Index (net div.)	-4.35	-0.33	7.22

October 23, 2013