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Resources Management Corp

MARKET COMMENTARY

ON MARKET EFFICIENCY

Much of what underlies modern financial theory, especially in academic circles, is based upon a theory popularized in the 1960's by Eugene Fama called *The Efficient Market Hypothesis (EMH)*. EMH is based on the idea that financial markets are inherently efficient, have rational participants and have prices that reflect all available information at a given time. This implies that future price movements are entirely unpredictable, and thus that all investors holding diversified portfolios will obtain comparable returns to the market (or worse) over the long term. The idea that securities are "perfectly priced" at all times, however, has frequently proven to be a flawed hypothesis given the periodic bubbles and busts that occur in financial markets. While financial markets do tend to prove effective at pricing securities over the long term, the psychological factors that underlie the price movements of securities markets in the short-term create inefficiencies that can be exploited by investors focused on the long-term fundamentals of the underlying businesses.

In recent years there has been a reasonably dramatic shift towards passive investing strategies that are largely based on the implications of EMH, conceding that outperformance is unlikely over the long term and accepting that achieving only the average return on the market is the most effective way to invest. The popularity of this line of thinking has led to Exchange Traded Funds becoming the most widely adopted tool for passive investing strategies, which now account for more than 30% of all US trading volume[1]. As a result of the significant shift into these "passive" instruments, ETFs have ended up holding large positions in the majority of large stocks in the United States. Vanguard alone, for example, holds more than 5% of the outstanding shares in 491 of the S&P 500 stocks[2]. Put another way, Vanguard now owns more than 5% of the float in 98.2% of S&P 500 stocks, compared with only 23.2% of the same in 2010. This recalibration of the ownership structures of America's largest corporations could have (if it hasn't already had) a profound impact on the efficiency of the market and corporate governance in American business moving forward.

Source: Credit Suisse Trading Strategy
Source: BofA Merrill Lynch US Equity & US Quant Strategy, FactSet Ownership

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Given the nature of these instruments, increasingly large blocks of outstanding shares are controlled by what are generally disinterested participants in terms of the valuation of individual securities and the effectiveness of their management teams. In our view, the broad result of this dynamic change has been two-fold: a) valuations have been artificially driven higher in widely held securities as indiscriminate purchases have been made to meet the demand of ETFs; b) volatility has been driven to extreme lows as fewer participants properly evaluate and react to the events of the day, thus creating the oft cited efficiency that is critical to the long-term integrity of financial markets. In bull markets like the one we have been in for many years, the environment of low volatility and high valuations can persist in the absence of unanticipated negative events. The issue this creates, however, is that when the inevitability of an unexpected event occurs, widespread disposal of ETFs has the potential to create dramatic swings in the stock prices of companies in ways that have little relation to the underlying fundamentals of the businesses.

It has been said that, in investing, you can get in more trouble with a good idea than a bad one, and it appears that this is the situation we face today. The use of ETFs to achieve diversification with a long view is based in the sound theory that markets are efficient over the long term and that betting on the U.S. economy has proven to be a wise choice over time. However, much like has happened with wonderful companies or new technologies in the past, the market has a way of reminding investors that intrinsic valuation remains the key driver of returns when taken over any reasonable period. While there are many securities that are fully valued as a result of the previously discussed dynamics, opportunity has been created in less flashy markets that have strong fundamentals and compelling competitive positioning. Our strategy is, and always has been, to establish what we view as an appropriate valuation for a business and invest when "Mr. Market" presents us with an opportunity to do so at a fair price. When broad selloffs occur that create inefficiencies and disconnects between price and value, we will continue to invest confidently with an eye towards the future (as opposed to listening to the sentiment of the day), and we will heed the time-tested wisdom to be "greedy when others are fearful and fearful when others are greedy."

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