

# Eads & Heald Investment Counsel

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## Equity Investing

By: R. Stewart Eads, CFA

President

Eads & Heald Investment Counsel

[www.EadsHeald.com](http://www.EadsHeald.com)

### Chapter 5: The Efficient Market

Over the years much has been written about the efficiency of the U.S. stock market. Simply stated, this means that it is very difficult to perform better than a broad stock market index over a meaningful period of time since information is disseminated very quickly and all investors are investing based on the same information. The Standard & Poor's 500 stock index (S&P500) is a reasonable index to have in mind. In this series of articles whenever we refer to the "stock market" we will be referring to the S&P 500 index.

Belief in the Efficient Market causes some people to opt to invest in an index fund and forego "active" management. An index fund is simply a fund that mimics a popular stock market index....such as the S&P500 index. This is fine since a broad stock market index such as the S&P500 has historically returned approximately 10 percent per year on average over the long term. That is certainly a decent return.

If everyone simply bought an index fund, there would not be a steady reallocation of funds to the prospectively best future companies so far as society's best interests. In short, good companies would not be rewarded with ready financing to carry on their good work. However, the primary motivation of the individual investor is not to perform a public service regarding financing.

The more germane matter is the prospect of better returns than will be provided by an index fund over the long term. If one were able to beat an index fund by, say, two percent per year on average over 25 years that would add 64 percent to the return (not considering taxes). Of course, for a tax sheltered retirement fund there would be no taxes along the way. Two percent per year does not sound like much until compounding over a number of years takes place. Two percent per year additional return above an index fund is enough to be very meaningful but not so much as to meaningfully increase the amount of additional risk taken.

It is important to address the topic of risk. The Efficient Market thesis does come into play in regards to risk and return. Generally, there is no so-called free lunch in stock investing.....or any investing for that matter. That is, risk tends to go hand-in-hand with prospective return. There are simply too many bright, well-informed and greedy investors to break the bond between risk and return. Think of it as a Mother Nature that watches over investing. One rule is that if you seek higher returns you are inherently taking on more risk. Risk matters when the bad times come and one can have a catastrophic loss in asset value. There are those who will then scream "foul" and "the system is rigged".

All of this might make one wonder how something called a hedge fund can defy the laws of risk and return. Certainly, they are managed by well-informed, bright and greedy people. Just keep in mind that higher returns simply do not come without commensurate risk having been taken. How could it be otherwise?

What about the claims that one cannot beat the “efficient” market in investing? If the efficiency of the market was total, it would also work against the success of individual company success stories. That is, companies such as Wal-Mart, Home Depot, Cisco, IBM, Procter & Gamble, Pepsico and myriad others would not be able to emerge as leaders. They surely deal with the same array of issues as do individual stock investors such as the rapid flow of information to bright and greedy competitors. While many competitors had the same information, they were not able to use it in the same well-organized, consistent manner and make a lot of good decisions along the way.

Many individual investors and professional investment firms have good information, bright people and certainly want to succeed. However, they may not make the best and most efficient use of their information by integrating it into a system that focuses on the few key variables and using the “noise” information to a much lesser degree. It truly takes a special kind of intellect and experience to sort out the big picture items that will allow one to potentially capture, say, the two percent per year return over a stock index fund. On the surface, all professionals may sound the same as they speak an arcane language. It is difficult to cut through to the ones who have a real handle on what they are doing.

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