"The four most dangerous words in investing are 'it's different this time.'"

— ***Sir John Templeton, Legendary Investor. Money Magazine, Fall 2002, p. 25***

Celebrate the Price

Aug 23, 2011 | by Mary Brunson

Standard & Poor's recent downgrade of U.S. debt has served as the impetus for enormous volatility throughout the global markets. Talk of troubles in Europe and even another recession in the U.S. have spooked the market and its investors—some of whom are now asking the time-honored question: Is it different this time?

Certainly, it is different this time, but isn't the news always different? No two crises are the same. But, one critical function remains the same, and that is the market's ability to price the news. This is no small task on the market's part. This ongoing ability to absorb the news, collectively aggregate and reflect the opinions of all market participants and to arrive at a fair price for each security is an amazing fete which free markets accomplish spontaneously, elegantly and efficiently.

Reams of articles have hit the papers and the Internet to advise investors on what to do now. Most of which are supported by advertisements from firms whose profits increase with the volume of your trades. In an August 19, 2011 *Wall Street Journal* article titled "Last Straw or Time to Buy," journalist Kelly Greene chronicles the advice that several financial advisors and money managers in the wake of the recent market turbulence. The article mostly discussed the misguided advisors who have either pulled back their expectations of future performance or are advising their clients to reduce allocations to equities.

Copyright © 1999-2011 Index Funds Advisors, Inc. All rights reserved. 888-643-3133 www.ifa.com

Here's why their advice is misguided:

- Prices are considered fair because they are determined by millions of willing buyers and willing sellers.
- Prices reflect the current and forecasted news.

Prices change so that (1) the expected return remains essentially the same, (2) there is an equal chance that the future return will be above or below the expected return and (3) the more the future return varies from the expected return, the less likely it is to occur.

A visual representation of this concept is found in the Hebner Model (http://www.ifa.com/section/WhyPricesChange.asp). To visualize how markets work, think of a teeter totter where the news (economic uncertainty) would be on the left side, the investment risk and expected return at the fulcrum, and the price on the right side.

Copyright © 1999-2011 Index Funds Advisors, Inc. All rights reserved. 888-643-3133 www.ifa.com

The likelihood of identifying pricing mistakes and exploiting them for profit is a 50-50 proposition. And, don’t forget to account for the costs and taxes associated with trading. Will some gurus get lucky in calling the next market move? Of course, but luck is neither a reliable nor a repeatable skill.

Fear is on one side of the the trade and geed is on the other, both emotions being factored into the price. From here, the market has just as much chance of going up as it has of going down, and that is because of the magnificent pricing mechanism of the free markets.

So, the next time you hear an active investor utter those four most dangerous words: “It’s Different this Time”, remember the four most soothing words for passive investors, that news is already “Baked in the Cake.”

Copyright © 1999-2011 Index Funds Advisors, Inc. All rights reserved.

This information has been furnished to you by Index Funds Advisors, Inc., a fee-only Independent Financial Advisor registered with the United States Securities and Exchange Commission. Please see www.ifabt.com for complete sources, updates and disclosures.

DISCLAIMER: THERE ARE NO WARRANTIES, EXPRESSED OR IMPLIED, AS TO ACCURACY OR COMPLETENESS OF ANY INFORMATION INCLUDED IN THIS DOCUMENT. Use of any information obtained from such addresses is voluntary, and reliance on it should only be undertaken after an independent review of its accuracy, completeness, efficacy, and timeliness.

WARNING: Past performance does not guarantee future results. Investment returns and principal value will fluctuate, so that investors' shares, when sold, may be worth more or less than their original cost. Investing in any mutual fund, index or actively managed, does not guarantee that an investor will make money, avoid losing capital, or indicate that the investment is risk-free. Actively managed funds sometimes outperform index funds. You just don't know in advance which actively managed fund will outperform the appropriate index. Just because a mutual fund is an index mutual fund, it does not guarantee a performance superior to an actively managed mutual fund. There are no absolute guarantees in investing. When reviewing any backtested performance information on this internet site, please read the Disclosure for Backtested Performance Information at www.ifabt.com.

Index Funds Advisors
matching people with portfolios

Index Funds Advisors, Inc.
19200 Von Karman Ave., Suite 150
Irvine, CA 92612

Call Toll Free: 888-643-3133
Local Phone: 949-502-0050
Fax: 949-502-0048