"The only value of stock forecasters is to make fortune-tellers look good."

— ***Warren Buffett, 1992 Annual Report of Berkshire Hathaway***

Up and Down, Down and Up

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Once again, we have experienced some intense volatility. Moments like these can be very scary for investors, making them susceptible to acting on visceral emotions. For this reason, I provide you some very important information.

Going or Gone?

When discussing the direction of the market, it's important to use the past-tense verb. During times of high market volatility, people commonly make the mistake of saying, "The market is going down (or up)." Although it appears harmless, this statement implies that the direction of market prices is knowable. People making this statement often use it as the impetus for major investment decisions. Such decisions usually do not fare well, because they are based on the fallacy that one can predict the direction of future price movements. Investors can avoid this pitfall by understanding Eugene Fama's finding that security prices move in a random walk. At any point in time, we only know the current and past price of any given security. Where the price will be even a second later is unknown. The market continuously sets prices in response to news, which by its very nature is unpredictable. Investors will accomplish an important step when they can say, "the market has gone down (or up)" without even having to think about it.

Free Market Forces

The job of free markets is to set prices so that investors are rewarded for the risks they take. To help explain this important statement, I created the Hebner Model, which attempts to simplify market forces into three variables: Price, Expected Return, and Uncertainty. Prices move in the opposite direction of economic uncertainty so that expected returns at a specified level of risk can remain essentially

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constant, resulting in a fair price. From fair prices we expect fair returns, meaning that investors should be compensated for their risk exposure over time.

The reason people invest is to get a return. At the time of a trade, buyers pay a price that reflects the risk associated with capturing the expected return. In other words, a fair price equals a fair expected return.

This model is based on Eugene Fama's Efficient Market Hypothesis, which states that prices fully reflect all available information or news, economic uncertainty, and probabilities of future events, thus implying that market prices are fair.

The Hebner Model illustrated in the following painting attempts to diagram the three variables of Uncertainty, Expected Return, and Price, resulting in a distribution of returns shown at the bottom. The diagram shows the essentially constant expected return for a given investment portfolio. In this case IFA Index Portfolio 50 is shown at the fulcrum of the teeter-totter, and the period specific expected return can be estimated based on 30, 50 or 83 years of simulated returns, the Fama French Three or Five Factor Model, or any methods an investor chooses. Current news impacts uncertainty and is represented on the left side of the teeter-totter. This economic uncertainty includes the probabilities of future events. The price agreed upon by willing buyers and sellers is on the right side. When an investment's price has fallen by 2%, one could infer that uncertainty has increased by about 2%. Alternatively, when the price has increased by 2%, without knowing the news, one could deduct that uncertainty has decreased by 2%. In other words, prices react to shifts in uncertainty so that expected returns remain essentially the same.

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From a fair price investors should expect: 1) a fair outcome, which would be a risk-appropriate or fair return, 2) an equal chance of being greater than or less than that fair return, and 3) the farther the actual return is from the expected return, the lower the probability of its occurrence.

So, before you trade, ask yourself: 1) Who is on the other side of my trade?; 2) Do I think I know more than they do?; and 3) Am I paying a fair price? In my opinion, your answers are as follows: 1) You don't know; 2) It's highly unlikely; and 3) If there are many willing buyers and sellers, by definition, it is a fair price.

For these reasons, market timing offers no advantage. Time pickers cannot forecast the direction of the market. There is no competitive edge that exists. The best way to earn the market's superior return is to simply remain invested at all times in a low-cost, passively managed index portfolio.

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