

MARKET INSIGHTS & PERSPECTIVES

Coppice Asset Management is dedicated to the idea that returns are explained by systematic market risks.

Volume I

Issue III

THE EFFICIENT MARKET HYPOTHESIS BY BOB RYAN

Our firm is dedicated to the idea that investment returns are explained by systematic risks of capital markets. This idea is generally consistent with the so-called “efficient market hypothesis.” Now, as a result of the recent activity of many in the financial industry, some have questioned the validity of the role of markets and the hypothesis that markets work.

Essentially, the efficient market hypothesis says that the observed market price reflects all available information. It neither says that the observed price is the correct price, nor rationally determined, but, without saying how market prices are determined, hypothesizes that they reflect what information is available. Keep in mind that what we have here is a hypothesis – not a law. This hypothesis has been studied

exhaustively since first put forth around the turn of the twentieth century and, as far as I know, still stands as the best theory to explain market behavior. Keep in mind, it takes a theory to “beat” a theory and all those who view recent market behavior as evidence to reject the efficient market hypothesis have yet to propose something better.

One problem with trying to explain market behavior is that there is a lot of short-term random noise in returns. By definition, a random event cannot be predicted. The efficient market hypothesis does not say market “bubbles” cannot happen – it does say that they cannot be predicted consistently. The efficient market hypothesis does not say that mispricing of assets can’t happen – it says that any mispricing is unbiased and can neither be predicted nor produce

abnormal long-term returns. There is simply too much empirical evidence that capital markets are reasonably efficient for the theory to be rejected cavalierly based on what has gone on in the recent past.

In my view, the recent financial disaster was due simply to our financial institutions taking excessive risk with someone else’s money. There is a great deal of volatility in well-functioning markets and that volatility is not always on the upside. Financial intermediaries must be managed in a way that they not only participate in the volatility on the upside, but also survive the volatility on the downside. That the managers of our Wall Street institutions failed miserably in this regard is a testament to their incompetence and not some sort of market failure. ♦

HEDGE FUND ACTIVITY AS A PROXY FOR GLOBAL CAPITAL MARKETS

There is nothing unique about hedge funds per se. They are neither a separate asset class nor a well-defined market-based portfolio. A hedge fund is simply a portfolio

actively traded by managers with essentially unlimited discretion. While there is significant variability among the returns produced by these managers, even

within a given strategy, the sum total of all the hedge fund activity would diversify away the inherent volatility of all the individual managers

...continued on next page



“That the managers... failed miserably... is a testament to their incompetence and not some sort of market failure.”





101 South Salina St.
Suite 750
Syracuse, NY 13202
315.476.8200

WWW.COPPICEASSET.COM

Coppice Asset Management

An investment advisory firm founded by
Bob Ryan and Mark Ohrstrom
dedicated to the idea that returns
are explained by systematic market risks.

Offering:

- ◆ Cost-effective portfolios to meet specific objectives
- ◆ No manager selection risk
- ◆ Access to your money - no "lock-ups"
- ◆ Transparency
- ◆ Improved tax efficiency

PROXY FOR GLOBAL MKTS. ...continued

and, therefore, would be a reasonable proxy for global returns. Consequently, if the objective is to construct a portfolio that best replicates global capital markets then maximizing its correlation with a hedge fund index that consolidates the activities of hedge fund managers would be a useful goal.

While there are a number of problems with published

indices, for example selection bias (they include only managers that choose to report) and survivor bias (managers that subsequently close are simply dropped from the index), they reflect the trading activity of managers who participate in all worldwide markets. Indices reported in the HFR Global Hedge Fund Industry Report reflect

managers of assets that total over \$1.4 trillion as of December 2008. This report lists the sub-region focus of these managers, based on assets managed, as 41% global, 43% North America with the remaining 16% generally divided equally among twelve smaller markets. Thus, the trading activity of hedge fund managers included in published indices covers worldwide markets. While

the assets managed by those providing data to the publisher of indices is a small portion of the total worldwide capital markets, they represent managers who frequently trade and it's the trading activity that determines daily market values. Consequently, hedge fund indices represent a reasonable proxy for global capital market behavior. ◆

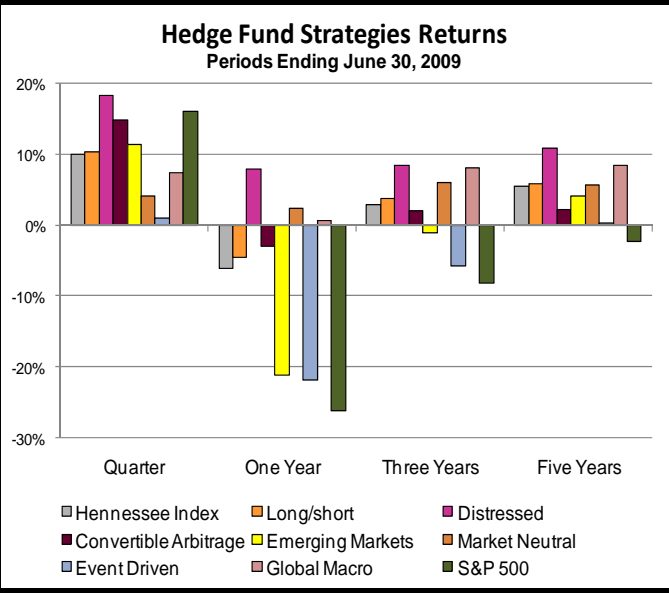
RECENT HEDGE FUND ACTIVITY

Returns from various hedge fund strategies as measured by various Hennessee indices were all positive over the last quarter, as shown in the graph to the right. These results reflect recent general equity market activity. Note also that over the past quarter the S&P 500 was one of the best performing indices, falling short of the average performance of only those reporting managers that are investing in distressed securities. However, this quarter's relative performance is very different from what is reported over other periods where almost all strategies

performed better than the S&P 500.

One interpretation of the observation that hedge fund strategies earned returns that exceeded the S&P 500 Index in recent periods, is that it reflects the skill of managers.

Another interpretation is that in a period of generally declining markets shorting securities, regardless of manager skill, will produce returns that are superior to the "long-only" strategy inherent in the S&P 500. The manager skill conclusion can only be reached over a complete market cycle and even then it takes a



lot of data to reject the "random noise" hypothesis. Consequently, be wary of extrapolating the

observed results of the recent past to future expectations. ◆