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A "Fantastic" Opportunity?

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We often characterize our system of gathering anecdotal evidence as the "wine cellar" approach to investment analysis—toss items into the file drawer and check up on them after a few years. We often don't bother to read them on the first go. While sorting through some files recently, we came across a column appearing in CBS *MarketWatch* titled "Failures of Efficient Markets Offer Opportunities." We are inclined to indulge journalists offering a few run-of-the-mill stock tips. But those seeking to enhance their status by seeking to discredit a large body of finance theory spur us to action. So we read on.

Efficient market theory, the author claimed, "was in serious trouble" since it was now obvious that irrational investors create pricing errors and "opportunistic investors therefore can find opportunity in the wreckage of fearful selling or exuberant buying." He assured us that in spite of taking university finance courses containing a heavy dose of efficient-market theory, he was able to think for himself and "question some of the truths that were handed down to us."

At that time the article appeared (November 2004), oil prices had jumped 40% over the previous twelve months. Speculators, the author argued, were responsible for driving the price above its intrinsic value; and once they withdrew from the market, prices would fall dramatically. Oil prices thus represented "the clearest example of irrational behavior." And since fuel costs had such a major effect on the operating results of the airline industry, airline stocks offered a "fantastic way to profit from such inefficiency," citing AMR Corp., Delta Airlines, and Northwest Airlines as prime examples of companies poised to prosper in a situation where oil prices decline.

Subsequent events suggest investors in November 2004 were not so irrational after all. Oil prices have surged higher still, reaching a record high of $78.40 per barrel on July 14, 2006. Delta Airlines and Northwest Airlines filed for bankruptcy protection on the same day in September 2005, and their common shareholders appear unlikely to recover more than a tiny fraction of their investment in the reorganization. AMR shareholders have more to smile about, as the shares have jumped over 100%. But considering the fate of Delta and Northwest, the high returns for AMR shareholders look like an appropriate payoff for a very risky investment.

On a price-only basis, a "plodder's" portfolio consisting of the S&P 500 Index rose 8.5% since the article appeared, while an equal-weighted strategy seeking to capitalize on market failure lost 22.9%.[1] Asserting that investors behave irrationally is easy. Earning excess profits at their expense is hard. And our dictionary offers the following definition of *fantastic*: "Existing in the fancy; unreal; illusory."

	November 16, 2004	August 7, 2006	Change
Crude Oil (near-month futures contract)	$46.11	$76.98	66.95%
AMR Corp.	$9.54	$21.55	125.89%
Delta Airlines	$7.26	N/A	Loss
Northwest Airlines	$10.25	$0.55	-94.63%
S&P 500 Index	1175.43	1275.77	8.54%

[1]This hypothetical portfolio consists of the three mentioned airline stocks equally weighted, assuming an ending price of zero for Delta Airlines because it is delisted.

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