In the News

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Efficient market theory is really monkey business

The efficient market theory (EMT) claims that it is impossible for an investor to outperform the stock market because existing share prices already incorporate and reflect all relevant information and expectations.

Burton Malkiel, an economics professor at Princeton University, helped lay the foundation for EMT in his book, "A Random Walk Down Wall Street." In it, he writes: "A blindfolded chimpanzee throwing darts at the Wall Street Journal can select a portfolio that performs as well as those managed by experts."

As longtime investors, we would like to set the record straight — the stock market is anything but efficient. As for the blindfolded monkey, we do not doubt he could match the investment performance of many "experts," but one must be careful when defining the term expert.

Malkiel defends his theory by showing that during the past 30 years more than two-thirds of professional portfolio managers have been outperformed by the unmanaged S&P 500 Index, and the managers who beat the index in one period are unlikely to do so in the next.

This certainly provides compelling evidence for EMT, considering that most investment managers are well-educated and experienced. However,

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we believe that when taken in its proper context, the statistic cannot only be explained but provides support for our theory that the stock market is inefficient.

Established investment managers and financial institutions have little to gain by outperforming the stock market and everything to lose by underperforming. The stock market has returned about 10 percent per year over time and an average investor would be happy with this result. Fourteen percent per year would earn analysts and money managers a nice pat on the back, while 6 percent would likely get them fired.

As a result, the majority of investment managers own a large number of popular stocks such as Intel and General Electric, many times in excess of 50 in order to "diversify."

The result is a portfolio highly correlated to the broad stock market or its benchmark index, and when fees are included it is no surprise that more than two-thirds of investment managers underperform. That a large number of overprotective professionals settle for mediocre results does not mean the market itself is efficient. In fact, their actions help make the market less efficient.

Each public company fits into a box

See ORFALEA on D10

Supply, demand, emotion all influence the stock market

ORFALEA

From D1

on Wall Street, such as "small-cap growth," "mid-cap value" or "emerging international growth." In order to appeal to consultants and other institutional clients, many investment managers adopt management styles that fit into these boxes, effectively limiting their opportunities.

Each box might contain hundreds of stocks, and when the boxes are pieced together to create a diversified portfolio, the result is a mediocre performing investment vehicle with layers of fees. This is a classic example of "di-worsification," taking the prudent practice of diversification to counterproductive extremes.

To further illustrate the concept of di-worsification, let us reference the concept known as "diffusion of responsibility." This social psychological phenomenon has been studied since 1964, when at least 38 people witnessed the murder of Kitty Genovese in New York City, and not a single person helped her or even called the police.

Diffusion of responsibility is broadly defined as a situation in which individuals in a group assume less personal responsibility for negative consequences of a poor decision as the group becomes larger. On Wall Street, diffusion of responsibility might sound something like this: "We all took a hit," or "No one saw this coming."

In this regard, it makes perfect sense to us that Malkiel recommends low cost index funds as an appropriate stock market investment vehicle. Compared to most mutual funds, they are in fact an excellent choice. Compared to engaged management of a small portfolio, they do not measure up.

Crystal ball

"Expert" Wall Street analysts never cease to amaze us with their predictions, especially in the technology sector. It is common practice for analysts to create complex, discounted cash-flow models that predict growth rates into the future, eventually reaching a "terminal growth rate" that can be sustained forever. We can see merit in discounting future cash flows, but more as a "cocktail napkin" calculation than a means of finding an exact price target.

A company with a price-to-earnings (P/E) ratio of 25 must earn its current year's profit for 25 years (after accounting for options) before an investor would effectively reclaim his principal. Justifying this multiple means that a great number of assumptions must hold true over a long period of time, including future market share, pricing power and growth rates. A P/E of 25 is not necessarily unreasonable, but investors should have a great deal of confidence before buying in.

We are confident that people will be chewing gum in the year 2030, but will they still be using Cisco routers or Blackberry devices built by Research In Motion? Possibly. But the future is uncertain and the risk is high.

Innovation in technology is a juggernaut with low barriers to entry and a seemingly endless amount of capital chasing the next improvements. Uncertainty and unrealistic expectations create irrational behavior by investors who have little substance to base decisions on.

Vicious cycle

When asked his opinion of the stock market, famous financier Bernard Baruch replied, "It fluctuates." This is one truth that no one can argue, and it is also what makes the same stock cheap on some days and expensive on others. One of the clearest laws of economics is supply and demand.

When there is more demand for a stock than supply, its price will go up, and visa versa. However, supply and demand are not always in equilibrium, and are not always related to the intrinsic value of a company. Benjamin Graham said it best: "In the short run, the stock market is a voting machine; in the long run, the stock market is a weighing machine." Or, as others have pointed out, day-to-day the market is driven by emotion, but in the long run the market rewards earnings.

Large public companies often have as many as 10 or 20 analysts covering them, and guess what happens when one of these companies misses a step? Diffusion of responsibility kicks in. No analyst wants to be the last to downgrade a stock, and no one wants to be holding the bag when the last investor moves to greener pastures.

This vicious cycle often results in capitulation of a company's stock price, and may create opportunity for others. In addition, thanks to modern technology, trading capabilities are now available to millions of emotional investors with itchy fingers, adding to the market's volatility and inefficiency.

Human emotion is quite possibly the most difficult aspect of investing. Truly successful investors all have one thing in common — patience.

Efficient Market Theory claims that the stock market cannot be beaten, except through insider trading or incredible luck. Forgive our trite response, but as the old saying goes: "The man who says it cannot be done is often interrupted by the man who is doing it."

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