

# The View from the Land of **Steady Habits**

My wife and I got to talking about efficient markets one day in late November on the way back from our neighborhood bookstore. She mentioned that Andrew Fastow—the former CFO of Enron—was in solitary confinement in Houston. “Why?” I asked in surprise. “For his own protection, he’s completing a ‘tell-all’ deposition before he starts his prison term in Virginia,” she explained. Apparently, Mr. Fastow knows enough secrets about Enron to make officials fear for his life.

Mr. Fastow’s solitary confinement got me thinking. If Enron analysts had known what Mr. Fastow knows, would the Enron debacle have been avoided? Almost certainly. Could the analysts have had a clue that something shady was going on if they knew Mr. Fastow’s character?

These speculations on Enron and the role of character knowledge in securities analysis reminded me why the efficient market hypothesis is wrong.

For readers who are not well-versed in the efficient market hypothesis, it says that markets reflect all available information and, as a consequence, there’s no point in searching for bargains because the market has already priced in all information. You can’t beat the market because you can’t know anything that the market doesn’t already know. Depending on how much information is thought to be reflected in securities prices (from all information to just all public information), the hypothesis comes in several varieties from strong to weak. However, the standard corollary to the hypothesis—and why we care about it—is that markets are more efficient at processing information and reflecting that information in prices than an individual investor. Therefore, an individual investor or money manager can’t beat the market.

Depending on your perspective, this hypothesis might seem palpably false at first. “Of course, you can beat the market. Look at the number of managers who do so every year.” Upon further reflection, however, the hypothesis begins to look more plausible. With as many as thirty analysts following each of the Dow stocks, how likely is it that investors can discover something about these stocks that the market doesn’t know already? In the case of smaller companies with fewer analysts, how does an individual investor or manager learn something about these companies that the market doesn’t already know? What’s the information source? Not the company itself. It’s obligated to make information available to the public at large simultaneous with any disclosure.

What about those managers who do, in fact, beat the market? Well, the fact is that some are bound to do so every year just due to luck. With the number of managed funds and money managers around, a good number will outperform the market every year—not because they are expert investors, but because they are just lucky. Statistically, it’s even likely that those with multi-year track records of superior returns are just plain lucky!

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So if people are beating the market due to luck, and if it's as good as impossible to get information that the market doesn't possess, the efficient market hypothesis seems correct. So what's wrong with it? And why do we care?

We care because of what the hypothesis tells us about our chances of beating the market. If the efficient market hypothesis is correct, the best we can expect to do is to match the market, and it's a waste of time and effort trying to do better. We should dismiss those who say they aim at beating the market and move our portfolios into index funds. If the hypothesis is wrong, maybe there's a chance of outperforming the market.

In fact, the efficient market hypothesis has two problems. The first is that we are not all rational investors. We get carried away from time to time with a current investment trend or point of view. In our enthusiasm for a particular company, industry, or market sector, we lose track of the fundamentals, or we choose to ignore the fundamentals in view of the market momentum. It may even be rational to be irrational—to invest in something that our fundamental analysis doesn't support—because if we don't invest, we'll lose out on a major market opportunity. In times like this, information doesn't matter; we just need to know the sentiment of the market.

But the real problem with the efficient market hypothesis is not in the realm of behavioral finance, it is in the realm of philosophy and information theory. The efficient market hypothesis is wrong because it is naive. It assumes that information is unambiguous and instantly recognized. But information is not a raw given. It does not come in neat transparent packages ready to be consumed and digested (all SEC reports to the contrary). What constitutes information

is not always recognized. What someone will see as noise, someone else will recognize as data. What someone will see as insignificant data, someone else will recognize as an important pattern. Recognizing and understanding the significance of information is often challenging, and for this reason, the efficient market hypothesis is incorrect.

Does this mean we can beat the market? Possibly, but not likely, because the task is too hard. To benefit from the inefficiency caused by challenges in information and significance recognition, we must have access to channels of what we might call "raw data," current indicators that might reveal patterns of consumer market preferences and behavior, for example, or indicators that might reveal patterns of labor market trends and expectations. If one had access to such indicators, were skilled in recognizing patterns in the indicators, were adept in understanding their significance to companies serving or affected by those markets, and could translate these patterns into future financial performance, one might have an advantage over other analysts and investors. But this is a very, very difficult task, and not one well suited to the traditional securities analyst trained in financial statement analysis.

In the end, we have little hope of outperforming the market even though the efficient market hypothesis is false. Skepticism is the right response to those who claim to beat the market through the skill of their security selection, especially if they are traditional analysts with an office filled with financial publications and a Bloomberg terminal. The information they need to beat the market is not likely to be found in the *Wall Street Journal* or an SEC filing, and is more likely to be observed in the shopping malls of America or the character of your favorite company's CFO. ■

