



August 2009

Efficient Markets and All That

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Are markets efficient? This question is creating extraordinary heat among some of the world's most celebrated economists right now in the wake of the global financial crisis. So what are ordinary investors to make of all this?

The debate has lit up the pages of *The Economist* magazine as finance professors from the world's leading universities descend from their ivory towers to fire off complex theorems at 30 paces.

Even Queen Elizabeth has become involved, asking economists in Britain for an explanation about why none of these supposed experts appeared to see the crisis coming. Their reply was that there had been a "collective failure of imagination" among members of the profession.

It's certainly a gripping argument and makes for great copy. But blaming the turmoil of the past year on the theory of market efficiency and the economists who formed those theories is a bit like blaming geologists for earthquakes.

A bit more on that in a moment — but first let's take a look at the efficient markets hypothesis. This is a model of how markets behave. It was developed back in the 1960s and essentially says that in an efficient market, prices of securities will reflect all publicly available information.

Prices are always changing, because new information is always coming into the market. When news does happen, prices quickly adjust to reflect it.

So, for example, if there's bad news on the economy, share prices tend to take a hit as investors collectively downgrade their expectations for future profits.

Think back to when Lehman Bros went bust last year. Investors at that time were worried that a complete collapse in the financial system was imminent, generating the threat of a second Great Depression. When things didn't turn out as bad as people expected, risk appetites revived again.

According to Professor Eugene Fama of the University of Chicago Booth School of Business — and the man widely considered to be the father of the efficient market hypothesis — none of this is inconsistent with the idea of markets as an efficient mechanism.

"The market can only know what is knowable," Fama said in a recent interview. "It can't resolve uncertainties that are unresolvable. So when there is a large amount of economic uncertainty out there, there's going to be a large amount of volatility in prices. And that's what we've been through. As far as I'm concerned, that's exactly what you'd expect an efficient market to look like."

The implication of all this is that unless investors have a crystal ball or inside information, it's very, very hard for them to do better than a competitive market. When they do, it's usually more down to luck than their own skill.

In recent years, a challenge to the efficient markets idea has come from behavioural finance theory. This says markets make mistakes because people are irrational. So greed takes over during the good times and bubbles develop. Conversely, fear takes hold in the bad and markets are oversold.

But even the behavioural school agrees with the efficient markets advocates about the practical end point for investors. Whether prices are right or wrong, the best approach is to give up the illusion that you know better than the market and to hold a diversified portfolio built according to your own lifestyle goals and tolerance for risk.

In a recent article in the Financial Times, Professor Richard Thaler, a leading light of the behavioural school, said that in some respects the financial crisis had *strengthened* the efficient markets hypothesis. While markets could make mistakes, he said, it was still impossible to profit from how they were wrong.

"Lunches are still not free," Thaler wrote. "Shorting internet stocks or Las Vegas real estate two years before the peak was a good recipe for bankruptcy, and no one has yet found a way to predict the end of a bubble."

There *are* some outstanding questions around the efficient markets hypothesis — even Fama admits that. Insider trading is one. The 'momentum effect' — where stocks that have performed significantly better or worse than the market over a period of time tend to persist in that direction — is another. A third is the pattern of stock returns around earnings announcements.

But Fama points out that it is still very difficult to make money out of these apparent anomalies, because the amount of trading you would need to do to exploit these effects would wipe out any gains.

"You have to realise that market efficiency is a *model*," Fama says. "If it were the truth, we would call it the truth. But it's a model, which means it's a simplification of the world. It does a good job of almost everything, but there are some things it doesn't do a good job on. But they are few and far between. And for practical investment purposes, markets are efficient for pretty much everybody."

In other words, the efficient markets hypothesis is not perfect. Even the man who fathered the idea admits that. And while its biggest opponents go much further than that, they still say it's pretty hard to beat the market without taking on more risk than the market offers.

Uncertainty will always be present. The market can't account for that. It can only know what is knowable. And this is why we diversify.

So the takeaway for most people from this fascinating debate is that it is still best to work on the assumption that prices are a fair reflection of the information that's out there at any point in time.

Their next decision is how much risk they want to assume and to ensure they diversify away avoidable risks — like holding too few securities, betting on countries or industries and following market forecasts.

It's the same old story - but the right one for most of us.

Diversification neither assures a profit nor guarantees against loss in a declining market.

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