

The
Economist

Killing off the monster

Buttonwood
A new attempt to explain market inefficiency

Feb 24th 2011 | from the print edition

0

Like

Economist.com/blogs/buttonwood



HAVING lived through the financial crisis of 2007-08, the man in the street might find the idea that markets are “efficient” incredible. But the efficient-market hypothesis, like a Hollywood monster, has proved very hard to kill off.

From the truism that the average investor could not beat the market after costs, academics developed the insight that obvious market-beating opportunities would quickly be arbitrated away. Market prices were thus the best available estimate of the underlying value of securities and should not be second-guessed by regulators. The good news is that this hypothesis led to the development of low-cost index-tracker funds. The bad news is that it led central banks to sit idly by while asset bubbles inflated.

In the past 20 to 30 years, the behavioural-finance school has been chipping away at the efficient-market hypothesis. Far from being hyper-rational actors, expertly analysing all available information and discounting future cashflows at the optimal rate, individual investors show psychological biases, such as being more willing to take profits than cut their losses. In short, they are more like Captain Kirk than Mr Spock.

Furthermore, markets have displayed a number of anomalies, of which the most startling is momentum—the tendency for share prices that have recently outperformed to keep rising—that are hard to square with the idea of efficiency.

A new book* by Roman Frydman of New York University and Michael Goldberg of the University of New Hampshire tries to steer a third way between the efficient and behavioural schools. They build on an insight of John Maynard Keynes: the factors governing the success of any future investment are too complex to be calculable. Investors face a world marked by “known and unknown unknowns”, in the words of Donald Rumsfeld, a former American defence secretary.

The problem is not just that investors do not know how the fundamentals—profits, interest rates and so on—will develop. They also do not know which things other investors will choose to focus on at different times. For example, a study of Bloomberg news stories showed that only 5% mentioned inflation, which was then unusually low, as a factor driving asset prices between 2001 and 2003. By 2005, when inflation had gone back up again, this proportion had risen to 45%.

The authors argue that investors develop strategies to deal with this uncertainty. As the fundamentals change they adjust their forecasts slowly. In the late 1990s, for example, the economic background appeared very favourable, with growth buoyant, inflation low and profits rising strongly. It was hardly irrational that these strong fundamentals were translated into sharply rising stockmarkets.

Eventually, however, equity valuations reached very high levels. Investors realised the danger and started to adjust their behaviour. The result was the sharp stockmarket correction of 2000-02.

The authors call this the “contingent-market hypothesis”, which they summarise as follows: “The causal process underpinning price movements depends on available information, which includes observations concerning fundamental factors specific to each market. This process cannot be adequately characterised by an overarching model, defined as a rule that exactly relates market outcomes to available information up to a fully predetermined random error at all time periods, past, present and future.”

This is not exactly catchy. Nor is it clear whether the concept will deliver testable predictions by which it can be judged.

Nevertheless the book has one eminently practical implication—that central banks should intervene to limit excessive asset-price swings on the upside, just as they have on the downside. The authors suggest the authorities should announce a (very broad) market range and act if prices move beyond it. Practical measures could involve higher margin or collateral measures for those taking bullish bets.

With regard to the housing bubble of the past decade, the authors argue that official guidance on prices, allied to higher capital requirements for mortgages, would surely have caused the market to self-correct at an earlier stage. Amen to that. The idea that central banks should do nothing, even as speculative investors borrow money from banks to bid prices up to unprecedented levels, deserves a stake through the heart.

* “Beyond Mechanical Markets: Asset Price Swings, Risk and the Role of the State”, by Roman Frydman and Michael Goldberg. Princeton University Press

from the print edition | Finance and Economics

0

[About The Economist online](#) [About The Economist](#) [Media directory](#) [Staff books](#) [Career opportunities](#) [Contact us](#) [Subscribe](#)

[\[+\] Site feedback](#)

Copyright © The Economist Newspaper Limited 2011. All rights reserved. [Advertising info](#) [Legal disclaimer](#) [Accessibility](#) [Privacy policy](#) [Terms of use](#)

[Help](#)

