

Efficient Market Myths

Robert A. Jaeger, Ph.D.
Vice Chairman and Chief Investment Officer
Evaluation Associates Capital Markets, Inc.
Norwalk, CT 06854

September 2003

(Forthcoming in *Institutional Fund Investment: Strategies for the Bottom Line*.
Edited by Barclay L. Douglas.
To be published by John Wiley & Sons, New York, January 2005.)

The investment world thrives on uncertainty, ignorance, error, and disagreement. We want to know what the future will look like, but we cannot. There are no crystal balls, so we are left to form our own fallible opinions about the future. Different people form different opinions, and the resulting clash of opinions is what drives markets. There are, to be sure, situations in which buyers and sellers transact for reasons that are not totally determined by judgments of fundamental investment value. But the more typical situation is that the buyer is more optimistic than the seller about the asset that is changing hands. The buyer and the seller cannot both be right.

Bill Crend, the founder of our firm, likes to say that the markets offer no railings to hold onto. There are no simple rules that will tell you what to buy or sell tomorrow morning. There are no recipes for investing. Investing is a complicated enterprise in which the most skilled practitioners are constantly aware of that complexity, and constantly aware of their own fallibility. There is a natural craving to seek out investment “experts,” and there are plenty of people who present themselves as the answer to that craving. So we need to remind ourselves that Wall Street is fundamentally similar to Hollywood: in each place, nobody knows anything.

Still, we do think that there are a few certainties that stand out against this background of error and ignorance. These certainties fall into two categories. The first category contains the principles that we know to be true: nuggets of folk wisdom that no investor can afford to ignore. The second category contains the principles that we know to be false: pernicious myths that no investor can afford to follow.

Sometimes the two categories blur together. The fundamental realities of investing become hard to distinguish from the entrenched myths. The efficient market theory, or efficient market “viewpoint,” is a perfect example of this phenomenon. This view began to take shape within the academic community in the 1950s and has since come to dominate wide swaths of both academic finance and professional investing. The...