LET'S GIVE A DECENT BURIAL TO THE INVISIBLE HAND (MARK TWO)

(Also Known as – The Efficient Market Hypothesis)

BY

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Recent results of portfolio managers and examples of significant market inefficiency are good reasons for the Securities industry pausing to give a decent burial to the invisible hand theory which is euphemistically described by its supporters as the efficient market hypothesis. A survey showed that portfolio managers who place a good deal of emphasis on the timing of investment decisions have produced much better results than those who follow a policy of staying substantially in the market for most of the time. There are also several examples of substantial over-anticipation by the market which has been costly to those who were unfortunate enough to take the efficient market hypothesis too seriously.

The Latter Day Invisible Hand.

However exciting it may be to those who are impressed by apparently significant evidence (which is of little real significance because it relies heavily on unrealistic simplifying assumptions) the efficient market hypothesis is really not new. Think about it for a while and you will recognise it as the latter day version of the invisible hand theory of Adam Smith and the classical economists of two hundred years ago. Moreover, it has been just as unhelpful to the investment business as the earlier invisible hand theory was to economics.

The earlier invisible hand theory stated in effect that in seeking their own interests, individuals are led by an invisible hand to promote an end of general good for the economy which was no part of their original intention. That theory became a foundation for much of laissez faire economics being used as an argument against "tinkering" with the system whenever improvements were suggested. In the portfolio management business, the latter day invisible hand theory has stated, in effect, that attempts to time moves into or out of equities is not worthwhile because the invisible hand has already adjusted market prices to a level which reflects all generally available knowledge.

It is unfortunate for many clients of portfolio managers as well as unit holders, policy holders and others that the latter day invisible hand theory, which is so vigorously promoted by some academics, gave an air of academic virtue to the years of apathy of laisez-faire portfolio management. Because of the unrealistic simplifying assumptions used in many studies of the "buy and hold" strategy (another name for the jellyfish philosophy of drifting up and down with the market tide) those who had remained inactive were suddenly able to feel that they were really "with it".

The literature in favour of the efficient markets hypothesis certainly is more voluminous than that against it. Most of the supporters of the theory are in Universities with access to research assistants and other facilities provided by the taxpayers. But most of those who have seen how that theory is dangerous if it is taken too seriously are practitioners whose capacity for producing learned articles is limited because they are not supported by taxpayers.

Simplifying Assumption Salvation.

A further advantage enjoyed by the efficient market people is the S.A.S. As I pointed out at the Brighton, England conference of the European Federation of Financial Analysts last June, distressed mariners are saved by the S.O.S. but distressed theoreticians can find refuge in the S.A.S. – i.e., simplifying assumption salvation. An apparently convincing argument proves on examination to be invalid because unrealistic simplifying assumptions are used. Perhaps the one that should be nominated for the Guiness Book of Records as most unrealistic is that used by Professor Sharpe in the Financial Analysts Journal of April, 1975. It contained the assumption of heroic proportions that a portfolio manager, at the beginning of each year, would make a decision to be either completely in the market or completely out of it for the whole of the year. In 22 years of investment experience I have never come across such a manager. Most managers, who do not follow the jellyfish philosophy would constantly vary the proportion in shares during the year in the light of changing conditions.

The Statistical Tail Wagging the Investment Dog.

In comparing different strategies many of the supporters of the efficient market hypothesis use monthly rates of return partly on the valid ground that in a given period this produces a greater and statistically more significant number of observations (60 observations in a five year period compared with 5 yearly observations.)

So far so good. But then in comparing the results of alternatives to the buy and hold strategy they use the interest rates on one month investments. In fact most portfolio managers who follow the practice of watching market cycles and other factors who decide against the share market would normally invest in medium term debentures (with a spread of maturities so that funds would be available at fairly short notice in the future). The interest rate on those investments could be two or three times the one month rate.

Recent Investment Performance Tends to Disprove Theory

The results of portfolios which have made greater use of defensive investments, such as debentures, in the last few years have generally been ahead of those which have relied mainly on staying substantially in the market most of the time. The "buy and hold" strategy in general has not produced as good results as the strategy of reducing commitment in the share market when fixed interest investments become more attractive.

Recent Market Inefficiency.

One of the basic flaws in the efficient market hypothesis is that it suggests that investment decisions are based on a rational assessment of all available information with the result that at any time all available information is reflected in prices and subsequent changes in price are due to newer different information becoming available. This is far from the real situation. Information is only a part of the basis of investment decisions. Other factors that can be as important or more important are emotional factors, such as boundless enthusiasm or deep despair, the number and strength of buying recommendations from popular publications of brokers and advisers, the success of salesmen in persuading people that equities are the greatest.

The efficient market theory advocates seem to have ignored the tendency for markets to over-anticipate. Looking back over the last 20 years, the industrial market has spent about a quarter to a third of its time over-anticipating subsequent events, about the same proportion in a correction to that over-anticipation, and a portion of the time moving indecisively. Only for about a fifth of the time do price movements reflect what could be expected from an objective assessment of earning prospects, economic conditions and other relevant factors.

The rally at the end of 1975 associated with the election and change of government is a classic example. In a surge based largely on emotion of the "Labor-will-be-out,-the-Liberals-in-and-the-golden-age-will-return" syndrome, buyers pushed share prices up to well above what a more objective assessment would have indicated. The fact that the industrial market at the end of 1976 was about 17% below the January level at the end of the period of sharply rising prices in this election rally was not due to new information but to a realisation that the market had again over-anticipated. In the heady days of the "deliverance is at hand" period at the end of 1975, many investors and most advisers failed to see that in terms of dividend yields related to current interest rates, the market was highly priced when the rally began. It was not far below the level where in terms of the relationship of dividend yields to interest rates, a cyclical peak was likely.

Those who took the view that the over-anticipation would be followed by a sharp reaction and that the gains would not be sustained had some difficulty in getting this message over because the efficient market hypothesis tends to make people think that at any time the present price of the market is just right (without any "blue sky" component from previous over-anticipation).

Perhaps the really bad news arose when many institutions were so convinced of the efficiency of the market and that there was no "blue sky" in it, not only put all available funds into shares but made additional purchases on funds borrowed in anticipation of later contributions from superannuation clients. Yet on the basis of published information about market cycles and the relative cost rating of shares compared with debentures, previous experience indicated that the probability of a cyclical slump in the industrial market was then very high.

Two more recent examples of market inefficiency were associated with the budget and the devaluation decision. On the day after the budget, headlines in the press and electronic media referred to the upsurge of activity in the share markets and quoted prominent investment people as saying that prospects were very good. The budget rally lasted two days (a possible nomination for the Guiness Book of Records as the shortest "boom"). Again after the devaluation decision there were reports of high rises in prices of mining shares and good prospects for them, yet at the end of December, the mining market was 13% lower than early August suggesting that both the budget tax concessions and the effect of devaluation may have been over-anticipated. Maybe there's more truth in in the old market adage that anticipation is often greater than realisation than there is in the sophisticated efficient market hypothesis.

A Time for Action in Educational Courses.

Whatever merits there may be in discussing the efficient markets hypothesis as an intellectual exercise, the securities industry should be concerned about the damage that it causes if it is regarded as a serious approach to practical portfolio management. It is high time that the Institute replaced segments of its course based on the latter day invisible hand theory with material which is not so far removed from the reality of the market place.

It is encouraging to know that in tertiary educational institutions there are a growing number of courses, particularly among the Colleges of Advanced Education which cover realities such as market cycles, changes in market rating, the relative merits of equity and fixed interest investments. Surely the Institute should be a leader in this field. Let us hope that members do not have to continue to see a situation in which courses for admission to the Institute are based in part on the invisible hand theory which is just as irrelevant to the real world of investments as the earlier invisible hand theory was to economics.