

# STOCKBOY

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## *The Inefficient Market Theory and Tortoise Beats Hare Once Again*

### **2008-2009: A Market Myth Shattered**

An academic fundamental is that the stock market is efficient—that current prices in the market reflect all known information. Thus, the theory states, it is next to impossible to beat the market. With computers and easy internet access providing quick and broad dissemination of information, efficient market theorists feel even more validated.

I haven't believed in the efficiency of markets since I heard of the theory in the early '80's in college. It didn't seem reasonable then and it seems less so now twenty five years later. For the theory to work properly, people must always think and act rationally and that is clearly not the case.

In recent years, the field of behavioral economics has received a lot more press and carries much more weight. The primary reason may be that many more economists, market theorists and observers now agree that assuming people always act rationally is not reasonable. Instead, fear, greed, second-guessing, group think, over-confidence, indecisiveness, etc...often get in the way.

A simple example of irrational pricing is a typical stock's 52 week price range. Let's look at GE's range for the past 12 months: it started around \$25, went as low as below \$6 and then finished near \$17. Have the prospects and value of such a large, consistent company really changed that much in the past year? No. The reason the price has changed so much seems more a function of investor expectations and fear/optimism rather than concrete prospects and valuation of GE.

Certainly this same train of thought can be applied to the entire stock market over the past year. When the market kept falling in late 2008 and early 2009, it wasn't fully due to reduced prospects of future earnings. It was also fear and uncertainty about the economy and stock market in general. It then became an issue that investors were simply tired of losing money regardless of the relative prospects of the company compared to its stock price. Thus, the market kept

going down and down, after a while based mostly on its own momentum.

The big rise in the market since the lows of March also seems to have less to do with specific data that justifies the current prices and more to do with the investing public becoming more comfortable with economic uncertainty, a sense that perhaps things have bottomed and are now improving...and a lack of compelling alternatives. Some are investing simply based on the fear of missing out on a big market run (not the stuff of discounted cash flow models and in-depth earnings analysis).

My modified version of efficient markets would hold that it might be applicable over long periods, but it can easily be derailed by more immediate reactions of fear, greed and group think.

### **The Bigger Picture**

While it's almost impossible to accurately predict short term market direction, longer term trends are typically much more predictable.

Consider that unless the stock market (as measured by the S&P 500) rises more than 10% in the 4<sup>th</sup> quarter of 2009, this decade will become THE WORST decade in market history, surpassing the 1930's.

Also, the stock market has experienced 21 calendar years where the previous 10-year span to that year had a negative return. 2009 will soon likely be the 22<sup>nd</sup> such year.

In ALL 21 previous cases, the market was higher the following 10 years with mostly better than typical returns.

Thus, it would be reasonable to anticipate (though never assume) that the next 5 to 10 years in the market should be strong, if history still serves as a guide. The next year or two could be rocky or could be strong. As Warren Buffett often mentions, the market's direction on any given year is very hard to predict. But if your horizon is 5 to 10 years or beyond, you should be quite encouraged, even in the wake of the recent market pain.

### **Learn From Harvard & Yale...Not**

Harvard and Yale's endowments have been in the news lately for poor investment performance. Just a year or two ago, they were the toast of the investment world.

What happened? Their large exposure to 'alternative investments' nailed them during the market fall a year ago. If only they had followed the Stockboy's advice from two years ago....

*(from Stockboy Summer 2007):*

### **Don't Follow the Institutions**

*As 2007 moves to its 2<sup>nd</sup> half, it appears that most asset classes are continuing to rise. Emerging markets, commodities and private equity have been on big winning streaks in the past couple years. International investments have done very well too, as has real estate. Interestingly, large company U.S. stocks have done okay, but have generally lagged these other asset classes.*

*Chasing 'hot money' can be dangerous and is often counterproductive. To me, this suggests it would be wise to now focus on large company domestic stocks, while keeping a reasonable overall diversification.*

*It is surprising and somewhat alarming that many institutions—including some universities and city and state governments—are instead chasing this hot money. Recent articles have shown how colleges and governmental pension groups are focusing on alternative investments to boost returns. In a few cases, some of these organizations have a quarter and sometimes over 50% of their assets in alternative investments such as private equity and hedge funds. This is dangerous. It has worked well recently, but these phenomena have a way of burning out fast and with little warning, taking huge amounts of dollars with them.*

*Diversification suggests that spreading your investments over various investments keeps returns healthy and overall volatility relatively low. To me, investment committees that agree to these high alternative investment exposures have moved beyond the diversification argument.*

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