'Efficient' markets: What does that mean in terms of investments?

NEWS

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Guest columnist

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Q: My friend tells me that his investments are in “efficient” markets. What does that mean?

A: One of the tenets of investment finance is the “Efficient Markets Theory.” This theory states that most if not all information about many stocks is widely available for review. This implies that there is full “efficiency” about stock prices and that therefore there is no edge to be gained in looking for “value” or “growth” or other factors that might allow one to pick out certain stocks as being more profitable to own than others.

It is common and convenient to use index funds in our portfolios. An index fund invests in many or all of the stocks or bonds that are monitored as an “index.” For example, an S&P 500 index fund owns most if not all of the roughly 500 large US stocks that are followed by that index. The evidence for market efficiency is backed up by the superior performance of index funds over actively managed funds that attempt to beat their particular index. The vast majority of the time, stock pickers cannot “beat the index” despite a legion of analysts, expenses, and much experience. Note that this is also usually the case in the large Western markets like the U.S. and Europe.

Yet we know that at times the markets can be crazily inefficient. How could the Dow Jones Industrial average range from over 13,000 to under 7,000 in just a few months during 2008? Which was right? We also clearly know that there are wild excesses of greed (1999) and fear (2008) driving prices in wide swings on a regular basis. So, why do we think the market is efficient?

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I think we must conclude that the markets are sometimes efficient in some ways. On a micro level, it may be extremely difficult to pick out individual companies that will outperform. On a macro level, we know that large asset classes swing in slow multiyear cycles (Google the “periodic table of investment returns”). With patience and discipline, we can profit from buying the cheaper asset classes and waiting for the cycles to happen. But we are extremely unlikely to pick out individual stocks that will outperform the broad indexes. At

the same time, we must fight the emotion of buying those asset classes that are already expensive and rising in price.

And then there are markets which we don't know much about. For example, are Asian small company markets efficient? Is it possible to get an edge by active stock picking there? I'm not sure we know yet. It seems reasonable to split investments in "unknown efficiency" markets with a combination of passive indexed vehicles and some active management.

What about investments that don't really have an index, such as global fixed income? How do you decide on an efficient investment in a combination of global preferred stocks, convertible bonds, sovereign bonds, foreign corporate bonds and more? Perhaps we cannot decide on a non-actively managed choice there either.

So, we can summarize that large Western equity markets are generally efficient at the individual stock level, but not necessarily as a whole. Other markets may or may not be efficient, or at the very least be unclear. It seems most reasonable to use low cost and diversified index funds in markets you agree are "efficient."

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