"Practically speaking, individual investors should treat the market as unbeatable and realize that when they try to beat it because it is inefficient, they are likely to injure themselves, rather than gain at the expense of another.."

— Meir Statman, Professor of Finance, Santa Clara University and author of What Investors Really Want, as quoted in SF Gate.com article titled, "Meir Statman: Amateur investors expect impossible", 11/16/10

Who Profits if Markets Are Inefficient?

Dec 6, 2010 | QoW 84 | by Mary Brunson

Some 110 years after the impoverished and oppressed of France vigorously launched a long and bloody battle for fairness when they stormed the Bastille, a quiet revolution began in a French library where mathematician Louis Bachelier set forth his notion of fairness in stock prices through market efficiency. He asserted that there is no useful information contained in historical price movements of securities, and that speculating on future movements based on past movements would be a zero-sum game before costs, and negative after costs.

Bachelier's work was largely ignored until the mid-20th century when notable financial scientists such as Paul Samuelson (Nobel Prize Winner), Alfred Cowles (founder of the Cowles Foundation now housed at Yale University), Paul Cootner (The Random Character of Stock Market Prices), Eugene Fama (Professor of Finance, University of Chicago Booth School of Business) and Burton Malkiel (Princeton Professor and author A Random Walk Down Wall Street) found empirical support for the assertion that prices reflect all information that can be known and that new information (which is unknown) is the only impetus for changes in price.

The body of work, formally inked by Fama as the Efficient Market Hypothesis has been at the center of a long and polarizing debate among financial experts.

Watch the video at hebnermodel.com
http://www.hebnermodel.com

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At the Heart of the Matter

Are there discrepancies in stock market prices that can be identified and exploited for profit? Can experts apply rigorous analysis to cull out the handful of stocks that are poised to outperform all of the others because such experts have the talent to spot a key aspect of a company that would otherwise elude the millions of other market participants? Bachelier, Samuelson, Cowles, Fama and Malkiel, among many others would say, “No, stock prices reflect all known or available information, and that mispriced securities cannot be spotted in advance and exploited for profit.”
In contrast, active managers the likes of Bill Miller (Legg Mason Value Trust), Jim Cramer, and those at fund companies such as American Funds, PIMCO, along with consulting firms and hedge fund managers, would argue that, yes, there are skilled managers who have acumen to beat the market. They would further assert that such experts are well-worth the additional expenses associated with finding them and investing with them.

Those of us who have been embroiled in the heated discussions surrounding these issues can readily attest to the passion and conviction that consumes each side of the debate. So visceral are these discussions that taboo conversations at parties extend beyond religion and politics to include “active vs. passive.”

A Détente?

A recent SF Gate.com article cites Meir Statman, a Santa Clara University finance professor and author of the book What Investors Really Want. Statman takes a unique position, providing welcome relief in this polarizing debate. In summary, Statman tells us that the market efficiency debate is a moot point because even if markets are not efficient, the expenses associated with capturing the inefficiencies erode excess returns, making indexing a superior investment approach regardless of your stance on market efficiency.

> *“You might say that individuals can beat the market by hiring a professional, but after paying all the expenses of the money manager, they are losing.”*

And he adds:

> *“People in behavioral finance and standard finance come to the same conclusion. Don’t try to beat the market. Whether it is rational, as people in standard finance say, or crazy, as I say, don’t try it.”*

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Statman talked about behavioral finance and his new book in a Morningstar.com interview. When asked about his thoughts on index funds, he stated, "Well, index funds are fabulous. Now you say well can I do better than average? Can I perhaps exploit other people's cognitive errors? And the answer to that is probably yes. But the question really is how much does it cost you to exploit the cognitive errors of the others. Think about somebody who says there are $100 bills some place in the streets, so this is the equivalent of a cognitive error of other people, because they have left it lying down. Well, but it will probably take you three days to find that one $100 bill, if that. And so you're going to waste too much money looking to exploit other people's cognitive errors, and in the process you're going to really shortchange yourself by getting lower returns." Watch the full interview below.

Watch the video at http://www.ifa.com/12steps/step1/step1page2.asp#statman

The Real Winners of Market Inefficiency

We can all continue to argue about market efficiency, but, even if markets are inefficient, the real winners are not the investors themselves — they who took all of the risk -- but rather the managers, the consultants, the brokers and the transfer agents who guarantee themselves their piece of the pie by convincing investors to believe they can enjoy excess returns through market inefficiency.

Perhaps Fred Schwed's timeless tale says it best:

> *"Once in the dear dead days beyond recall, an out-of-town visitor was being shown the wonders of the New York financial district. When the party arrived at the Battery, one of his guides indicated some handsome ships riding at anchor. He said, 'Look, those are the bankers' and brokers' yachts.'*
>
> *'Where are the customers' yachts?' asked the naive visitor."*

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