Letters

The Efficient Market Hypothesis

Burton G. Malkiel's conclusion (Articles, 10 Mar., p. 1313) that the stock market accurately and efficiently determines corporate values, if true, is outdated. This conclusion may have been valid 20 or 30 years ago, when the stock markets were dominated by individual investors who were interested in long-term dividend flows. A number of important changes have taken place since then that Malkiel does not take into account.

The market is now dominated by institutional investors who are primarily interested in short-term gains. They are, in a word, concerned with what the stock will be selling for next Thursday, not how much the company can be expected to earn in the next 10 or 15 years. They hedge their bets with stock index futures and program trading, neither of which existed 30 years ago.

Foreign currency values, interest rates, and commodity prices are much more volatile than they used to be. Financial transactions that used to take days to perform with paper can now be done electronically with the speed of light. With the global integration of the world economy, the incomes and values of U.S. corporations can increasingly depend on events that occur abroad, which we can neither predict nor control. The market that Malkiel is describing and modeling simply no longer exists.

If the stock markets were efficient at determining corporate values, then it would be impossible to explain the current wave of leveraged buyouts and hostile takeovers. The investment bankers who are engineering these deals say that the deals are viable precisely because these companies have been undervalued by the stock market by as much as a factor of 2.

One cannot have it both ways. Either the investment bankers are right and these stocks have been greatly undervalued by an inefficient stock market, or else the stock market is right and has correctly valued these companies. In the latter case, these deals will all eventually lead to bankruptcy court when the cash flow proves inadequate to service the debt on the high-yield "junk" bonds issued to effect the buyout. The experiment, in fact, has already been started. We are all eagerly awaiting the result.

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Malkiel's persuasive article in support of the efficient market hypothesis leaves out a number of points that might argue to the contrary. The notion that "all information that is known by any market participant is fully reflected in market prices," as Malkiel states, suggests not *how much* an investor knows, but rather *how little*. While the market may be efficient, information available to the average investor (including even the average portfolio manager) is usually insufficient for making well-informed decisions.

Common information sources for individual companies are readily available to most investors. Data on interest rates, world catastrophes, foreign market movements, inflation, employment, and a host of other factors are also so widely available that it would be surprising if the average investor outperformed the market averages. That the average investor does not is only one more example of a decision-making process that Simon aptly calls "satisficing" (*1*). You do the best you can with the information at hand.

For mutual fund portfolios, moreover, securities law places limits on the amount of stock the fund can hold in any one company. Other large portfolios may also be subject to such limitations. A prudent manager will minimize risk by not putting all the eggs into one basket. The greater the number of companies in a portfolio, the more likely its performance will begin to approximate the overall market averages.

Most arguments for the efficient market hypothesis are based on studies of investment decisions of large portfolio managers, not individual or smaller investors. A free market by definition requires numerous buyers and sellers, such that no single transaction by itself affects market price. This necessary condition is often violated when a portfolio manager executes a major transaction worth several million dollars. A sale of that magnitude invariably *does* make a difference—enough to cause the price movement of a security to become a self-fulfilling prophecy of the major traders. In effect, they are the market.

Are those who consistently outperform the market just plain lucky? Or are there reasons why some large portfolio managers can produce better than 20% increases in asset values every year? I believe this success comes from paying great attention to the subjective measures of company performance: How good is the product? How well do the managers treat employees and shareholders? What do suppliers and customers think about the company? How sensitive is the company to changes in the marketplace? In this world of imperfect information, facts and our perceptions of them are open to question. Investors who consistently succeed probably know the difference between good management and good luck.

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REFERENCES

1. H. A. Simon, *Administrative Behavior* (Free Press, New York, 1957).

Response: Yaes makes the correct point that the stock market has become highly institutionalized during the past 20 years. Institutional investors regularly account for more than 80% of the trading volume on the New York Stock Exchange. But most observers have argued that institutionalization does not make the market less efficient. On the contrary, the research capability of institutions and their ability to monitor news as it happens and react quickly makes the market more responsive to information flows and thus *more* efficient. If these institutions do not care "how much a company can be expected to earn in the next 10 or 15 years," how can Yaes explain why a nondividend-paying stock in an exciting growth industry such as Lin Broadcasting sells at a price-earnings multiple of 60, while the multiple for the market as a whole is below 15?

It is true that institutional investors now regularly use futures contracts as part of their investment strategy. But this results in significant part because of an acceptance of efficient-market precepts. Today literally hundreds of billions of dollars are invested in "index funds," that is, simply invested and held in an account that mirrors one of the broad market indexes such as the Standard and Poor's 500-Stock Index. The pension fund CREF is so invested. This strategy is popular because more and more professionals have realized how efficient the market is and how difficult it is to obtain superior investment performance. Futures contracts are regularly used by index funds to invest quickly large inflows of new funds and to provide liquidity and portfolio hedges. Neither the futures market nor the globalization of securities markets is in any way inconsistent with market efficiency.

Is the large premium often paid for companies in leveraged buyouts and hostile takeovers inconsistent with market efficiency? Not at all. There is a difference between the value of a small investment position in a company and the value of a "control" position. Suppose a company was not being well managed—suppose it squandered its cash flow on projects that aggrandized its managers rather than its shareowners and it used