

The Paradox of the Efficient Market

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Paul Samuelson recently described behavioral finance to me as “the study of people not doing the most rational thing as judged by assistant professors of finance.” In a more hopeful mood, I have recently had occasion to read through a large and varied sample of the behavioral finance literature, including in particular Daniel Kahneman’s marvelous Nobel Prize address and his biography.*

If you are like me, you never approach this material without the uncomfortable feeling that the subject it describes is yourself. Readers of this Journal may be sufficiently vigilant never to admit such a thing, especially in public, but let’s face it—in private, we cannot avoid discovering the uncomfortable resemblance between ourselves and those quirky good-for-nothing fools who do not even know what they don’t know, and who we sometimes take to the cleaners on the rare occasions when we can remember to avoid being ourselves.

Socrates reminds us that the foundation of wisdom is knowing yourself. Perhaps it is better to stand up and admit our failings, because then we can be more effective in the tumultuous search for alpha. That is, in the end, what we get paid for.

In the process, however, we provide an additional service. The intensity of the legions of portfolio managers in their quest for excess return is precisely what makes the markets so efficient—so hard to beat. The advent of the hedge fund only adds to the validity of this observation.

But the outcome it leads to is precisely the opposite of the outcome active managers would choose. The

harder they work at their jobs, the more difficult and ephemeral the quest for alpha becomes. Indeed, the greater the volume of behavioral finance literature published, and the more the CFA Institute makes it required reading, the sooner we eager beavers will proceed to arbitrage those anomalies away. The Nobel Committee rendered the efficient market a great service in awarding its prize to Kahneman in 2002.

Now, all of this leads to a great paradox, which I can explain with a simple example. Difficult to imagine as it might be, suppose one day all of us gave up the fight and accepted the efficient markets hypothesis lock, stock, and barrel. We would urge all of our clients to index or to adopt other kinds of passive strategies, after which we would shut up shop and do something more useful like working as a dentist, a plumber, or a gardener.

And what would be the consequence of that step for the efficiency of the market? The market might continue to fluctuate, but selecting individual securities would become a dead art. Nobody would be trading; nobody would be hunting for alpha; nobody would be reading the latest stock prices; nobody would be calling a broker except for liquidity purposes; and nobody would be seeking out the behavioral anomalies. We would have a world of buy-and-hold-issimo. Over time, the market would become less efficient, then still less efficient, and then even less efficient, until finally it would be the most tempting alpha hunting ground ever.

Goodbye, dentistry, plumbing, and gardening! Welcome to easy pickings! And welcome to the return of the efficient market. That is, until it once again becomes almost impossible to beat, and we repeat the sequence of events.

*These may be found at <http://nobelprize.org/economics/laureates/2002>.

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