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The Real Efficient Market

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We tend to think about the efficient markets hypothesis in terms of what goes on in the financial markets. Here active investors constantly seek out mispriced assets. In the process of buying or selling those assets, these investors drive prices back toward a level where no one can any longer earn alphas by trading in them.

But the efficient markets hypothesis is a big idea with ramifications beyond the stock exchanges and the bond markets. Think about private equity beyond the mega-deals that make the headlines. In privately held companies, corporate objectives, management, financing, control, and the uses of power differ dramatically from what goes on in publicly held companies. The typical management in publicly held companies aims to keep the ship on its course, with as few disruptions as possible. Most private equity investors buy companies with an explicit goal of selling them later, which means change and disruption are expected if that sale is to produce a profit.

Private equity investment firms frequently begin by replacing top management, and good private equity companies are always on the lookout for managers who will join them in replacing worn-out or mediocre executive groups. They often take what was formerly a non-core function and reenergize, reform, and redesign it, with a ruthlessness and intensity of focus these neglected businesses never received before. Other private equity firms have a policy of backing current management, but the driver of value is also change in the business or adding leverage to the capital structure. Money will seldom be wasted on perks, luxurious headquarters, or suppliers who get the orders merely because they happen to be pals. Too much is at stake for managers in these enterprises to waste corporate funds, to build empires, or to select policies just because they are easy to implement. Such habits are easier to develop under public ownership, where the true owners have little control of or insight into operations.

Seen from this vantage point, private equity investors are performing in the real economy a function closely related to what successful investors perform in the public market: They are making these areas more *efficient*. Successful investors make the security markets more efficient by seeking to discover and take advantage of mispricings where alphas lurk. In the real economy, investors also seek out inefficiencies and act to eliminate them, either within the company or in opening new opportunities for growth. Either way, their searches for alpha are improving the efficiency of the economy as a whole.

But that is not all. The drive for market efficiency has also had an impact on the pricing of private equity deals. Once upon a time, these deals were quietly consummated like the old over-the-counter business, where transactions had no transparency, and one side usually ended up with the short end of the stick. In private equity transactions, the seller was most often the party who got the short end of the stick. The returns to the buyer, as a result, were frequently enormous.

But in a dynamic world, things that are too good to be true will soon cease to be too good. Robert C. Merton has emphasized in his recent work that institutional changes are powerful forces in creating conditions of market efficiency, and today most private equity deals are the result of auctions, which by their very nature assure higher (i.e., more efficient) pricing of private equity firms.

From this viewpoint, it does not matter that the prevalence of auctions today is the result of efforts by investment bankers who earn huge fees in such transactions or because boards of directors are now reluctant to sell out except in a public auction. The potent impact of the profit motive constantly makes the real economy function more efficiently, just as it drives the capital markets in the same direction.

ERRATUM

In my introduction about portable alpha in our Spring 2006 issue, I observed that in the treatment of the capital asset pricing model over the years "lay a fact of great simplicity that no one noticed *for a long time*" [italics added]. How wrong can one be?

In 1973, in Jack Treynor and Fischer Black's classic article, "How to Use Security Analysis to Improve Portfolio Selection," the authors wrote, in part:

> Optimal selection in the active portfolio depends only on appraisal risk and appraisal premium and not at all on market risk or market premium; nor on investor objectives as regards the relative importance . . . of expected return versus risk; nor on the investment manager's expectations regarding the general market.*

There is the whole story on the separation of alpha and beta, loud and clear. But nobody was listening back then.

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