The Journal of Portfolio Management

Micro versus Macro in a Disorderly World

Peter L. Bernstein

Receiving scholarly journals has been weird recently. The journals come in, coolly analytical as always, pioneering new ground in the fields they cover. But as we open the mail and take the journals out of their envelopes, we know markets are ruptured in many dimensions, some financial assets are selling at levels so depressed as to be unrecognizable, and the economy is in deep trouble. Meanwhile, portfolio managers attempting to perform their tasks in this volatile, strange, and often frightening environment cannot give much daily thought to the carefully crafted papers residing in the scholarly journals on their desks.

The times we are passing through do not lend themselves to dispassionate analysis or extended contemplation. Yet decisions made in the heat of the moment or on hunches have the highest probabilities of turning out to be wrong.

Let me take you through a thought exercise that begins with a cool, academic kind of statement and leads to evidence that supports an important hypothesis about efficiency and inefficiency in the capital markets. Then consider this hypothesis in light of the turbulence, confusion, and disruptions of the moment. My goal is less to make a point about this particular hypothesis than it is to suggest the importance of keeping a tight grip on analysis.

I begin by quoting a letter Paul Samuelson wrote to Robert Shiller and cited by Shiller in the second edition of his book Irrational Exuberance (p. 243):

> Modern markets show considerable micro efficiency (for the reason that the minority who spot minor aberrations from micro theory can make money from those occurrences) and, in doing so, they tend to wipe out any persistent inefficiency. In no contradiction to the previous sentence, I had hypothesized considerable macro inefficiency in the sense of long waves in time series of aggregate indexes of security prices below and above various definitions of fundamental values.

Shiller was inspired by Samuelson's observation to test the hypothesis of micro-efficiency and macro-inefficiency. In studying the micro view of individual stocks in a wide variety of tests over different time periods, Shiller found a strong negative relationship between dividend yields and subsequent rates of dividend growth. No great surprise there, but these tests did confirm micro-efficiency. When Shiller turned to the study of macro conditions in the markets—the dividend yield and subsequent dividend growth in the stock market index—precisely the opposite outcome appeared. For the market as a whole, high yields led to faster dividend growth in the future, but low yields led to slower future dividend growth or, as Samuelson had put it, to "macro inefficiency in the sense of long waves in time series of aggregate index of security prices below and above various definitions of fundamental values."

Cool, cool words! But can Samuelson's neat distinction between micro-efficiency and macro-inefficiency hold up in the extraordinary markets of the present? Is it possible for the market to put the correct value on XYZ Company relative to ABC Company despite the wild market volatility and swooping declines and advances in security prices? In other words, can micro-efficiency survive when volatility, fear, shocks, and unfamiliar terrain are resulting in crazy valuations on the market as a whole?

Yes, as Keynes pointed out some 70 years ago, understanding the difference between micro and macro forces is essential. But neither Keynes nor Samuelson considered the simultaneous interaction of macro and micro forces and the kinds of results that interaction could produce.

If, as I believe, the current economic and financial environment has no precedent in history, then the neat patterns of the past can mislead us. The violence of the macro forces—especially the recent financial crisis that has led to virtual paralysis in the global financial system—can well be overwhelming the forces making for micro-efficiency. In other words, even the most enthusiastic proponents of the efficient market hypothesis must wonder whether individual securities are efficiently priced relative to one another at a time like this. Macro- and micro-inefficiencies are not separate from each other in today's markets; they blend into and interact with each other.

Inefficiency is good news for investors. Inefficiency, after all, breeds opportunity.