

Protecting Against Inflation— and Maximizing Yield, by John M. Bragg: Reviewer's Reply

by
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The chief disagreement between Mr. Bragg and me concerns our divergent attitudes about the efficacy of efficient markets theory, and whether or not the costs of an active investment philosophy are more than compensated by the uncertain benefit of abnormal returns. For example, Bragg's "Theory of the Economic Series" is dependent on the notion that social psychological moods can be determined, and that a resolute state of social psychology is associated with an optimal portfolio mix which enables investors to maximize yield. My contention with Bragg is not in the accurate gauging of the state of social psychology. In fact, assume that the psychological mood of society can be ascertained. Then the semi-strong version of efficient markets theory would argue that if one investor, or a set of investment experts can sense a mood, and the costs of "sensing" are low, then other competitive investors must be able to sense a mood as well; therefore, abnormal returns would be non-existent.¹

Certainly the debate between Bragg and me is not new. Since the work on models of equilibrium in capital markets began (Sharpe, 1964; Lintner, 1965; Mossin, 1966), there has been much discussion between advocates of the traditional approach to investment analysis and efficient market theorists. Academic researchers have shown that anomalies such as the small firm effect (Banz, 1981) and the "January" effect (Keim, 1983) exist, and that markets may not be perfectly efficient. The unresolved question directly related to Bragg's thesis is whether the costs of his active investment strategy are more or less than the benefits of returns in excess of the return on a well-diversified market portfolio; a return that may be obtained with inconsequential transaction costs. If the answer to this question is that the Theory of Economic Series produces superior returns, then one must ask why Bragg would ever let such valuable, proprietary information into the public forum?

¹ For a test which validates the semi-strong efficiency hypothesis with regard to the information used by security analysts, readers are referred to Davies and Canes (1978).

The very action of making such information more readily available implies that investors, faced with the choice between engaging the Theory of Economic Series and purchasing a stake in an index mutual fund, ought to choose the latter to maximize yield.

References

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