Efficient Markets – What is the Efficient Markets Hypothesis?

The 'Efficient Market Hypothesis' (EMH), asserts that financial markets are "efficient" or that prices on traded assets, such as shares and fixed interest securities, already reflect all known information. Therefore prices also reflect the collective beliefs of all investors about a company's future prospects. Professor Eugene Fama at the famed University of Chicago Graduate School of Business developed the EMH as an academic concept in the early 1960s.

The Efficient Market Hypothesis states that it is not possible to consistently outperform the market (appropriately adjusted for risk) by using any information that the market already knows, except for luck.

Under the EMH 'news' or information is defined as anything which may affect the share price that is not known in the present and appears randomly in the future. It is this 'random' information that will cause the share price to change in future.

If markets are efficient, the serious question for investment professionals is what role can they play (and be compensated for). Those that accept the EMH generally reason that the primary role of a portfolio manager consists of analysing and investing appropriately based on an investor's tax considerations and risk profile. Optimal portfolios will vary according to factors such as age, tax bracket, risk aversion, and employment. The role of the portfolio manager in an efficient market is to tailor a portfolio to those needs, rather than to beat the market.

While proponents of the EMH don't believe it's possible to beat the market, many believe that shares can be divided into categories based on risk factors, which have correspondingly higher or lower expected returns. For example, 'small' company shares are riskier and therefore are expected to have higher returns. Similarly "value" shares (which are out of favour indicated by a low PE ratio or Btm ratio) are riskier than "growth" shares and therefore have higher expected returns.

There have been numerous academic studies developing evidence for the Efficient Market Hypothesis. One such academic, Burton G Malkiel, is a professor of economics at Princeton University and author of the well known publication, "A Random Walk Down Walk Street". The Wall Street Journal quote of his below encapsulates what we mean when we talk about 'market efficiency' and why trying to beat the market is a zero sum game over time.

"Why does indexing outmaneuver the best minds on Wall Street? Paradoxically, it is because the best and brightest in the financial community have made the stock market very efficient. When information arises about individual stocks or the market as a whole, it gets reflected in stock prices without delay, making one stock as reasonably priced as another. Active managers who frequently shift from security to security actually detract from performance (compared to an index fund) by incurring transaction costs."

Active vs Passive

The debate which surrounds the Efficient Market Hypothesis plays an important role in the decision between active and passive investing. Active managers argue that less efficient markets provide the opportunity for outperformance by skillful managers. It is important to note, however, that a majority of active managers will underperform the appropriate benchmark in the long run whether markets are or are not efficient. This is because, as we noted above, active management is a zero-sum game in which the only way a participant can profit is for another less fortunate active participant to lose. However, when costs are added, even marginally successful active managers may underperform the benchmark or index.

Additionally, active funds that may outperform in one period tend to underperform in subsequent periods. A substantial number of studies have found little or no correlation between strong performers from one period to the next. The lack of consistent performance persistence among active managers is further evidence in support of the EMH

Faced with the inference that they cannot add value, many active managers argue that the markets are not efficient (otherwise their jobs can be viewed as nothing more than speculation). Those that acknowledge the evidence that actively managed funds underperform the index on average assert that their funds are the above average ones – of course!

Similarly, most in the investment media are generally ambivalent toward the Efficient Market Hypothesis because they make money supplying information to investors who believe that the information has value (beyond the time when it initially becomes public). However, if the information is rapidly reflected in prices (as Efficient Market proponents believe) then there is no reason for investors to seek (or purchase) information about securities and markets from the media.

In summary, numerous financial institutions have a vested interest in promoting the view that their superior research and forecasting skills can deliver superior investment performance. The financial press fuels this thinking with a stream of fresh stories of the latest predictions driven by the need to sell their publications.

However, the evidence compiled by academics in the field of finance – with no vested interest in their conclusions – is that the market is sufficiently efficient to categorise superior performance as luck rather than skill.