Understanding Market Efficiency and its Limitations

January 5, 2016
By: Direk Khanijou

In theory there's no difference between theory and practice, but in practice there is.

- Yogi Berra

In 2004, Andrew Lo, professor of finance at the MIT Sloan School of Management published a seminal paper titled *The Adaptive Markets Hypothesis: Market Efficiency from an Evolutionary Perspective*. The paper proposes the idea of the Adaptive Market Hypothesis. The idea attempts to marry the rational, Efficient Market Theory (EMT) principles with the irrational principles of behavioral economics.

Recall the fable in which six blind priests come upon an elephant. The first priest feels the elephant's leg and declares it to be a tree. The next priest feels the elephant's side and claims it is a huge wall. Each priest touches a different part of the elephant and comes up with a different explanation. Similarly, Lo sees the two different interpretations of the market in the same manner. He realized that the Efficient Market view and the behavioral finance perspective were both right – they were observing the same phenomenon, but from different angles.

Thus, in Lo's opinion, the market is neither exclusively efficient nor always behavioral – it is both. Buffett shares this view:

> "*Observing correctly that the market was frequently efficient (academics and Wall Street pros), they went on to conclude incorrectly that it was always efficient. The difference between these propositions is night and day.*"

I mostly agree with the EMTs. In most instances, stock prices do reflect the underlying business fundamentals. Trying to figure out the discrepancy between prices and underlying intrinsic value, for most businesses, is usually a waste of time. However, the markets aren't fully efficient because humans oscillate between fear and greed and they control its auction-driven pricing mechanism. Hence, stock prices bounce a lot more than the underlying business intrinsic value – therein lies opportunity.

Here's the bottom line: inefficiency is a necessary condition for superior investing. Attempting to outperform in a perfectly efficient market is like flipping a fair coin: the best you can hope for is 50-50. For investors to get an edge, there have to be inefficiencies in the underlying process – imperfections, mispricings – to take advantage of.

A sound strategy is to limit your efforts to relatively inefficient markets where hard work and skill would pay off best. For instance, stocks with smaller capitalization or stocks of companies going through extraordinary events.