



Albert C. Boris, III  
Managing Director, Investments

# Thoughts for Investors

Stock Market Efficiency & Rational Thinking... Dangerous Theories DECEMBER 2009

***“The greatest deception men suffer is from their own opinions.”***

– Leonardo da Vinci

Some people believe that, for the most part, investors act rationally. This thinking has spawned the Efficient Market Hypothesis (EMH), which claims that stock prices reflect all known information and quickly adjust prices to reflect new information. Fans of EMH believe that in the long run, any short-term aberrations in price that overvalue or undervalue stocks are erased. Yet within the past two years the stock market (for purposes of this newsletter I will refer to the Dow Jones Industrial Average (DJIA) as representing the stock market) has hit a high of 14,198, a low of 6,469, and is currently valued at approximately 10,400. Does all this volatility support the theory that the stock market is efficient and that investors act rationally? Even the most ardent supporters of EMH are scratching their heads. Could company values have changed that drastically in such a relatively short period of time? And if the stock market is not efficient, then what is the value of “investment consultants,” Modern Portfolio Theory, and investments that track markets, all of which base their work, in part, on an efficient market? In this newsletter I will discuss why the stock market is not efficient, why it is dangerous to assume investors are rational, and why you can benefit from understanding this.

***“There is nothing as deceptive as an obvious fact.”***

– Sherlock Holmes

Through experience, I have long believed that all investing, whether managed by humans or managed

by computers programmed by humans, is subject to the impact of emotion. To further complicate matters, add the dynamics of group emotion. Individual investors change (sometimes very quickly) from happy to sad, optimistic to pessimistic, greedy to fearful, and rational to irrational (and then back). Any single investor’s emotions and resulting actions can be considered irrational. Yet when a group of investors acts the same way, they are often perceived as rational. This is referred to as the “wisdom of crowds” or “group think.” We now know that the earth is not flat, though hundreds of years ago most people really thought it was flat. It was rational thinking at the time, though today that same thinking is irrational. Today’s most obvious rational thinking, with respect to investing, is that increased government spending will increase the deficit, which will ignite inflation, which will cause interest rates to rise, which will smother an economic recovery, which will ultimately kill the economy, the country, and finally stocks. Might this theory someday be proved irrational? Is there a value in being rational in the present and possibly wrong in the future?

***“Public opinion matters.”***

– Abraham Lincoln

In March 2009, while shouting “this time is different,” a large number of investors panicked and sold, forcing the DJIA down to 6,469. Perception became reality, and the decline gained momentum like a snowball rolling downhill. The thinking of investors, as a group, made DJIA 6,469 seem rational at the time, and by extension, efficient! Today, DJIA 6,469 seems irrational, inefficient, and worst of all, a missed opportunity, all in six months. That’s the power of emotion and the exponential power

of group thinking, which undermines the market efficiency theory. Volatility, a sign of inefficiency and emotion, occurs when investors under appreciate and undervalue or over appreciate and overvalue information that is digested in the process of setting stock prices. Efficiency also depends on the important yet mistaken assumption that all the information is true and correct. Finally, some have argued that blind faith in market efficiency has led to market “bubbles” in real estate and the “dot-coms.” Yet at the time, those prices were deemed efficient and rational. Stock market efficiency is the basis for investments in index tracking securities. Why pay for active, thinking investment management? An Investment, which supposedly represents a cross section of the market, should automatically capture all available return as the market digests information and efficiently values the stocks. “Investment consultants” claim to be able to help you build an “optimal” portfolio, one that maximizes return and minimizes risk, based in part on their dependence on market efficiency.

***“The long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again.”***

– John Maynard Keynes, economist

Efficient and rational are terms that best apply to the present. Notwithstanding the effect of inside information, the stock market, on a day-to-day basis, should be capable of gathering information, sorting, and filtering it for accuracy, and then efficiently translating that information into a price that seems rational. I would agree that whether priced at 6,469 in March 2009 or 10,400 in December 2009, the stock market is doing precisely that, and for the moment, today’s prices are efficient and rational. Unfortunately, investing is not done for the present (or the past either, as evidenced by the futility of investing based on past performance). Rather, investing is done for the future. At the same time the market may be efficiently priced for the present, it may be inefficiently priced for the future, thus creating an opportunity for astute investors. It is during “tempestuous seasons” that many investors

can benefit from the services of a good “captain” of their portfolio. A good captain will of course know that the ocean will be flat again, yet also has the experience to make sure your portfolio is still afloat when calm seas return. Do you know who your captain is? Is he/she taking advantage of all this wind to help push you toward your goals or toward the rocks? Is he/she really the captain or just a “consultant” or media personality or deck hand trying to divine what a captain would do?

***“The only source of knowledge is experience.”***

– Albert Einstein

It was probably not well received telling investors in March 2009 that the new efficient value of the stock market was about half its former value and that it is necessary to make changes in their portfolio after the fact. Likewise, telling investors to “just stay put,” that “everything would be alright,” without having mentally prepared them beforehand for the volatility, was also not well received. Investments that were said to be noncorrelated suddenly became highly correlated, asset allocation didn’t help insulate portfolios from decline, and investors who said they didn’t need liquidity all of a sudden needed it NOW! The influence of the “crowd” of scared consultants, media, and investors screaming “this time is different” and claiming that DJIA 6,469 is the new efficient value of the stock market was just too much for investors. Many panicked and many now regret it.

***“Our remedies oft in ourselves do lie.”***

– William Shakespeare

In summary, investment survival demands rational thinking, and rational thinking demands controlling one’s emotions. Why is the stock market so volatile? Do investors always think and act rationally? Are groups of investors more rational than individuals? Can the same action be considered rational one day and irrational the next? While one most certainly must think about the future, it is only possible to live in the present. It makes no sense to plan for the future if you walk in front of an oncoming bus. Paying attention to the present (a traffic signal) is the highest priority, and most rational action. Relying on the theory that investors think and act

rationality on a daily basis, especially when it is more comfortable to join the group, has led to the Efficient Market Hypothesis. The stock market is not efficient and investors do not always act rationally. These are dangerous theories. The daily volatility of the stock market and the emotional swings of investors are evidence of that. Yet if you are saving for retirement or college funding or your first house, or even if you are in retirement and are living off your portfolio, there is hope for your future. A good captain/manager at the helm of a portfolio should have the experience, both emotional and practical, to navigate the inefficiency of the stock market during “tempestuous seasons.” They should think independently, using their judgment to steer clear of the irrational thinking of fellow investors. They should

try to educate investors on the fallacy of noncorrelation, the shortcomings of asset allocation, and the importance of patience. Opportunities are still out there. The entrepreneurial, risk-taking, confidence of mankind will continue to create wealth with which to repay our debts long after this storm passes. Captains and investors who see through the fallacy of efficient markets will continue to be rewarded.

***“The knowledge of all things is possible.”***

– Leonardo da Vinci

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*Hear the Other Side*

The Boris-Kaplan Group // 1735 Market Street, Suite 1400 // Philadelphia, PA 19103 // T 215.563.2300  
[www.alexbrown.com/boriskaplan](http://www.alexbrown.com/boriskaplan)

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