Mood swings are a better model than efficient markets

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From Prof Ole Risager.

Sir, The testable implication of Eugene Fama's efficient market theory is that stock prices are unpredictable because all information is already embodied in prices. As a majority of empirical studies show that there is a lot to this theory, the Nobel Prize Committee decided to make Professor Fama one of the joint winners of the prize in economics this year.

In spite of the difficulty in predicting stocks we should not conclude that markets always price stocks in a way that is consistent with fundamentals. It could also just reflect that it is impossible to predict Mr Market's mood swings, as Warren Buffett puts it, or impossible to predict the madness of the crowd, as Isaac Newton said centuries ago.

And there is plenty of evidence that the market is often driven by wild mood swings and irrational factors rather than motivated by pricing future earnings in a sensible way: the 1987 crash sending stocks down by 20 per cent over a few days has never been explained by underlying changes in fundamentals, including expected earnings. The run-up of the Japanese stock market in the 1980s, its crash in late 1989 and the subsequent decline amounting to more than 60 per cent over the next two decades is also hard to reconcile with significant changes in Japanese fundamentals. The dotcom crash in spring 2000, sending Nasdaq down by more than 75 per cent by the end of the year, also cannot be traced to fundamental changes in the outlook for tech companies, but is again testimony to the importance of mass psychology including rosy expectations that suddenly turned sour. Nor is the 46 per cent decline in the S&P500 from Lehman's default in September 2008 to the time the market bottomed out in early March 2009 likely to be a result of a significant decline in the fundamental outlook for corporate America. It is to a large extent due to fire sales, as has also been shown in subsequent empirical studies.

As Mr Buffett emphasised in his Letter to Shareholders in 1987: "Mr Market is there to serve you, not to guide you ... If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him." Value investors should therefore search for undervalued stocks and ignore overvalued markets like the ones I have just mentioned. Interestingly, empirical studies also show that this strategy has produced the highest returns over long

periods, and value investing has therefore also beaten a passive index strategy – though the latter has done well relative to many other strategies.

The advice to investors that comes out of the Mr Market parable has therefore been superior relative to the advice that follows from the efficient market view.

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