Simple Money

Habits and Rules for Saving and Investing that Build Wealth for Everybody

[Second Edition]

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Cover Photo "Bee and Lilac in the flower garden of Virginia McDevitt"

ISBN: 0615864627
ISBN-13: 978-0615864624

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EFFICIENT MARKETS

When financial pros say that a market is "efficient", they really mean there's no "easy way to make money". For example, if a trader can buy gold for $1600 per ounce in New York and sell immediately for $1610 in London, he/she will make a killing. (Typical size of such telephone-executed trades is greater than 10,000 ounces. Thus, this trader would make $100,000 simply for reading a screen that shows a New York offer of $1600 and a London bid of $1610 and then making two telephone calls.)

In reality, this trade never happens. Prices of gold between two locations never differ by so much simply because traders will jump on price differences. The act of buying at one (low) price in one city and selling at another (high) price in a second

city forces the gold prices in the two cities to move closer to one another.

If a trader can buy gold (or anything else) at a certain price and then sell immediately at a known, higher price, then the trade is called an "arbitrage". We define "arbitrage" as "profit with zero risk". Arbitrage opportunities, when they exist, never last long because some trader somewhere will exploit it. In our example, the arbitrage disappears when the New York seller has no more gold to sell at $1600 per ounce (or when the London client has no more buying interest at $1610 per ounce).

Efficient markets are markets in which there are no arbitrage trades. The gold market is efficient since, as we said, the gold price difference between two cities is never significant. There are too many traders watching the prices all over the world who will "buy low and sell high" to wipe out even a $0.25 difference in price.

Let's discuss a trade that is **not** an arbitrage. Suppose our trader buys gold at $1600 per ounce in New York with the belief that the gold price will rise later that day. If the price does rise to $1610 and the trader sells, his/her profit is $100,000 on a 10,000-ounce trade. The profit is not an arbitrage, though, because the gold price could have fallen and produced a loss. Since there was no guarantee the trader would be able to sell at a higher price, the trader bore the "gold price risk" and, in this case, profited.

Most publicly recognized financial markets are efficient. Efficient markets are good! Individual investors should confine themselves to efficient markets for reasons we discuss at length later. Such markets protect us in that we will never pay "too much" for the stocks, bonds, or commodities we buy.

Efficient markets do not permit arbitrage trades. A related and more important observation is that **day-to-day price movements in efficient markets are random**. This "randomness" property may be the most important lesson of all investing. On average, we can say that almost all assets will appreciate over time (at different average growth rates). But we have absolutely no certainty that a specific stock (or bond or commodity) will grow in value over any time period. Neither is there any certainty that an entire market (such as the US stock market) will rise in value in the short or long terms.

Let's talk specifically about the (highly efficient) US stock market. Popular thought is that "professional investors" and "finance experts" can choose the stocks that will go up and avoid those that will fall or that such people can predict with some confidence whether the entire market will rise or fall. Not true … absolutely not true. Of all the tens of thousands of "professional money managers" over the years, there are probably less than five (Peter Lynch and Warren Buffett come to mind) that Wall Street could arguably claim "beat the market" consistently.

This phrase "beat the market" is a euphemism for "outperforming a monkey" (with no offense intended to the monkey). An investor (simian or otherwise) who chooses stocks completely randomly will "beat the market" half the time. Yet this is the standard against which professional equity investors measure themselves.

Our point here is not that money managers are dishonest or useless. They are not dishonest in that they will openly admit, when pressed, that they cannot reliably choose the winning stocks … even just 60% of the time. If they could, they'd always "beat the market" and nobody can show this record of accomplishment. Neither are these managers worthless since they can and will invest your money as you instruct them to do. If you want them to buy technology stocks, they'll buy technology stocks. The managers perform a service. It's critical to know, though, that they have no "magic touch" that will guarantee their performance is better than yours (or the market's).

We circle back in a later chapter to the topic of permitting professional managers to invest your money (*e.g*, mutual funds and hedge funds). For now, the point is that prices in efficient markets are random. Nobody, not even an "expert", knows where prices will go. When you think about it, there's a simple reason.

To see this reason, let's assume that, in fact, the experts

CAN predict which stock (or bond or commodity) prices will go up and which will go down. For example, let's say the IBM stock price is $200 today and the experts predict it will be $250 or higher in one year. What would happen? If these predictors truly believed their predictions, they'd buy the stock immediately! They wouldn't even announce the prediction. If the IBM stock price then does rise to $250, these investors will have earned a 25% return in one year (which is fantastic if one truly believes there is no uncertainty – and thus no risk – in the prediction).

So our first observation is that the experts would act on their own predictions if they truly believed them rather than announce predictions to the rest of us. Second, if these investors did act, their purchases would push the IBM stock price up beyond $200 per share. (Increased buying interest always pushes prices up while selling interest pushes them down.) These experts would keep buying until the price became close enough to the $250 prediction that the return on the investment is no longer sufficient.

In other words, market views ("predictions") and information impact the stock price immediately. The current price of any asset in an efficient market already reflects all market knowledge.

Market efficiency provides three lessons for investors. First, as we've discussed, nobody has any predictive ability for

future market prices. Second, since the current price for any stock or bond or commodity embodies all market information, then this market price is the "fair" price. For example, the IBM stock price represents the consensus view of all investors (the skeptics, admirers, and disinterested parties). The "admirers" of IBM will have bought shares and, hence, pushed up the price. The "skeptics" of IBM will have sold shares short (which we'll explain in a later chapter) and, thus, pushed down the price. These two competing pressures on price become equal at the market price. That is, the market price is the "balance point" at which buyers and sellers cancel one another. A new investor who wants to buy IBM stock and has no idea what the price "should" be will pay the fair price. It's not like buying a used car!

Intriguingly, it is not just the "new investor" who does not know what the price of a share of stock (or bond or commodity) "should" be. Nobody knows, for example, what the IBM share price should be. The market price embodies much more information, analysis, and intelligence than any single expert can muster.

The third lesson of market efficiency is a variant of the first: nobody is a consistent, big winner. If your Uncle Cosmo or a guy on a radio commercial says he's doubled his money in six months, don't believe it. It **is** possible to buy a stock and have it double in six months. But nobody can achieve such

success on most investments. If your investment portfolio gains 20% in one year, that's terrific. We don't gain wealth from winning bets but rather from healthy, compounded returns of buy-and-hold positions over many years.

Finally, what about "insider trading"? Are insiders (company officers or others with non-public knowledge) able to predict how a company's stock will move in the near term? Yes, and this observation contradicts one aspect of "market efficiency" that nobody has real predictive capability. For example, imagine that a company will announce its quarterly earnings on a Friday and that these earnings are much less than the investment community expects. The company's stock price will almost certainly fall on the news. While the stock price may then jump back to its original value over the following week or month, the one-day drop itself is "predictable".

To mitigate this "information advantage", there are laws and company policies that prohibit insiders from buying or selling stock or stock options **before** such announcements. Further, the company must report all trading activity in its stock and bonds of company officers to the public. If officers are net buyers or sellers of the stock, then, this knowledge becomes part of the "market intelligence" that sets the market price.

Unfortunately, there will always be illegal activity somewhere. An investment banker with non-public knowledge of a take-over may tell his/her friends or relatives to buy or sell

certain stocks before the public has news of the event. But law enforcement does pursue and punish such transgressions. Though illegal insider trading does exist, the scale is sufficiently small so that it does not compromise the fundamental "fairness" of the market.