Investment Management: Efficient Market Theory Part I

Details
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Munyao slowly walked through the Maasai Market at the Village Market in Nairobi. Suddenly he spotted a certain African-print scarf selling for more than twenty times the price that the same item sold for in Gikomba market. Initially stunned at his discovery, he then elatedly hopped in his car, braved Nairobi traffic, and drove over to Gikomba market to purchase as many of the same African-print scarves as possible.

Munyao snatched up scarves from every supplier he could find yielding a total of forty-five pieces. He then secured a spot in the next Maasai Market at the Village Market and began selling the scarves. He giddily racked up huge profit margins during the next two Maasai Market days.

Unfortunately for Munyao, by the third Maasai Market, an additional seller began selling the same scarves, but for only eighteen times the price sold in Gikomba. By the fourth Maasai Market another seller sold at seventeen times the purchase price on the other side of town. Customers too started to comment about other locations where they could obtain the scarves for cheaper prices.

Eventually, the scarf price at the Maasai Market at the Village Market dropped down to less than two times Gikomba, which only narrowly covered the transport cost between the two locations. Munyao experienced the joys then disappointments of arbitrage. Large price differences in the market face pressure to close the gap with the ebbs and flows of supply and demand. Since everyone desires a profit, price disparities do not last long.

In the above vein of thought, we continue the Business Talk mini-series on investment decisions. Like Munyao’s arbitrage dilemma, many investors in public equities strive to root out and then exploit gaps in stock, bond, foreign currency, commodities, derivative prices, etc.

However, imagine Munyao’s scarf example magnified exponentially with millions of the smartest people in the world emboldened with brain power, networks, and proprietary computer software all trying to uncover incorrect or inconsistent prices in public securities. Instead of several weeks of Maasai Market days, such price compulsion instead occurs in nanoseconds.

Unfortunately, an experienced stock trader finds it laughable when a novice investor looks at gross margin differences between two similar firms, like Barclays Bank of Kenya and Kenya Commercial Bank,
and thinks one of the stocks are undervalued and then decides to buy the stock.

When both banks’ financial statements got released, thousands of other investors already noticed the margin difference and the stock price for the poorer performing bank changed immediately as investors demanded less of the stock. A novice or student who finds the difference weeks or months later would not benefit from the margin knowledge in any way since the stock price already corrected to reflect the new margin information. In stock markets, knowledge based on new information occurs almost instantly.

Similarly in Munyao’s earlier example, other traders (supply) and customers (demand) noticed the price difference in scarves and the disparity began to correct through market forces. Someone coming into the scarf trading business later might read a report on historical prices of scarves in the different markets, but be too late to act on the information, just like in the stock market with the bank equity mentioned above.

Inasmuch, a debate rages within academic circles and investment firms about whether anyone can actually beat the market and consistently perform better than chance. Empirical evidence on various degrees of efficient markets originating from eminent Professor Eugene Fama of the University of Chicago and through dozens of subsequent research studies highlighted by Michael Kostoff, Jonathan Clements, among many others, show that analyzing and then trading stocks based off of your analysis cannot make you perform better with your investment than other people.

Further, prolific fund manager George Sauter and others detail how rolling dice to randomly select which stocks to purchase actually beats the advice of investment banks and stock brokers. Additionally, Zacks Investment Research show that if you seek the advice of investment banks and stock brokers and then do the exact opposite of whatever advice they give you, then your investment portfolio returns actually would be higher than if you had in fact followed their advice. So why do so many investors seek out and follow the advice of so called experts with worse track records than chance? A lack of investment knowledge about both the public securities markets and the speed at which arbitrage corrects pricing gaps.

Considering that the value of publicly traded shares among only the top ten most active country stock markets in the world totals over US$ 39 trillion, which equals over 715 times Kenya’s annual GDP, why would securities brokers inform clients of researched techniques to grow their portfolios when they are usually only paid when investors trade between stocks as much as possible with a commission on each sale?

The inherent conflict of interest shocks investors once they understand finance. Would you listen to an oncologist who only gets paid when they prescribe that you buy more cancer medicine? A patient
desires a doctor's advice uninfluenced by a drug company's influence. Likewise, why would an investor listen to a broker who advises him or her to purchase or sell a certain stock when they often only receive income when securities are traded and not on the advice itself? Seek third party advice from individuals who will not gain from you taking action based on their advice.

Stay tuned as Business Talk uncovers how to choose stocks based on the above research on efficient market theory and what works in Kenya. Discuss investment choices with other readers through #InvestInKenya on Twitter.

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In next week's edition of Business Talk, we explore “Securities Exchange Efficient Market Theory”. Read current and prior Business Talk articles on our website and at http://www.usiu.ac.ke/on-campus/blog.