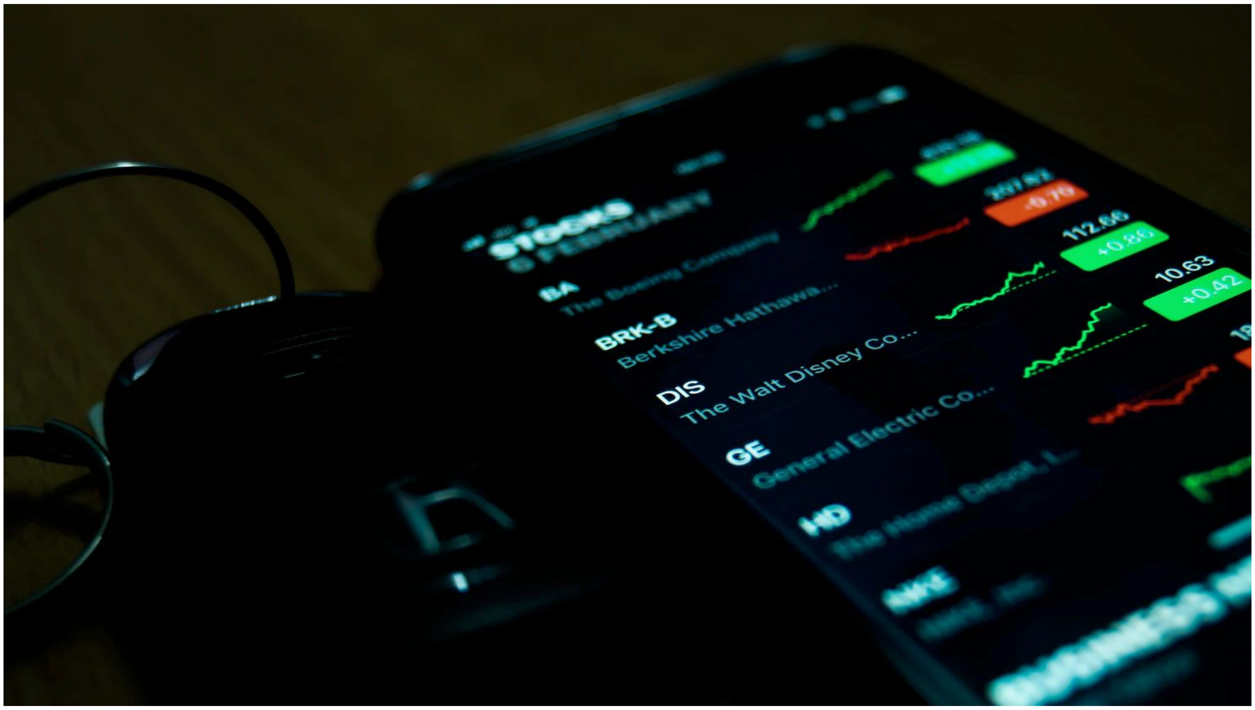
The Problem with the Efficient Market Hypothesis



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The following is adapted from Navigate the Investment Jungle.

The efficient market hypothesis (EMH) is a foundational assumption behind many investing strategies, and chances are, you're investing based on this idea, whether you realize it or not. It's a mistake that could prove costly, as we saw during the financial collapse of 2008, when many portfolios set up in accordance with EMH tumbled by as much as 40 to 70 percent.

In simple terms, the efficient market hypothesis says that stock prices accurately reflect all available information at any given time. While this theory sounds nice on paper, in practice it is a trap that snares many unwary investors, causing them to make decisions based on inaccurate information.

There are three versions of EMH—the strong, the semi-strong, and the weak. Let's unpack each version and look at why they don't offer a foolproof foundation for investing strategies.

The Strong Version

The strong version of EMH asserts that all information, including insider information, is already priced into a stock.

Therefore, the price of a stock reflects its real value, and the most effective investing strategy is to choose a stock that's liable to rise, buy it, and hold onto it. The implication is that there's no way to make a profit on a stock over and above a gradual rise in value that will be reflected by the market.

Anyone who has studied the workings of the stock market knows this isn't the case. Some stocks are overpriced while others are underpriced. Some rise based on nothing more concrete than enthusiasm and confidence—the dot-com boom was a perfect example of this—while others fall due to speculation or alarm.

The strongest version of EMH rejects the idea that insiders are privy to information that's denied to the average investor, a claim that's patently untrue. Insider trading is a reality of the market—people are constantly looking for tips about which stocks will rise and which will fall. Indeed, Martha Stewart famously went to jail for her participation in insider trading.

The Semi-Strong Version

The semi-strong version of EMH acknowledges that it would theoretically be possible for insiders to gain an advantage through nonpublic information but denies that this is a concern, because insider trading is illegal.

The semi-strong version argues that insider information does exist, and it could be used to gain additional profits, but there are rules and regulations to prevent insider information being leaked. For instance, when a firm undergoes an initial public offering (IPO), there are procedures in place to prevent information leaking from one part of a brokerage firm to another.

So the semi-strong version argues that, in practice, insiders can't gain an advantage from information denied to outside investors. For advocates of the semi-strong EMH position, once again the smartest investment strategy is to buy and hold.

The problem with this version is the same as the strong version. Insider trading *does* exist. For instance, a study from the University of Cambridge and Stanford found that "politically connected insiders had an information advantage during the [2008] Crisis and traded to exploit this advantage."

The Weak Version

The third and weakest version of EMH claims that analyzing stocks based on historical performance, or using technical or fundamental analysis, will not yield additional profits.

According to those who believe in this hypothesis, both technical analysis and fundamental analysis are redundant because they provide the analyst with no advantages that couldn't be gained from looking at the current stock price.

Weak-version proponents basically argue that past performance is not a guide to future performance and that stock movement can be largely random. So once again, the recommended investment strategy is to buy and hold.

In practice, plenty of investors have proven that both technical analysis and fundamental analysis can be effective tools. Technical analysis can alert you to when a stock may be underpriced or overpriced, and fundamental analysis can give you a look at the basic financial health of a company, which has a direct impact on its stock value.

If the Market Is Inefficient, How Should You Invest?

All three versions of the efficient market hypothesis fail to live up to scrutiny. This calls into question the wisdom of the investing strategy this hypothesis proposes: buy and hold.

Buy and hold in itself is not a flawed strategy. The issue arises when it becomes your *primary* strategy. If the majority of your portfolio is based on a buy-and-hold strategy, you are taking on a great deal of risk.

Because the market is inefficient, it's incredibly difficult to accurately predict and manage your risk, making stocks by far one of the riskiest types of investment. The solution is simple: stop investing so much in stocks.

Traditional advice recommends putting 50 to 60 percent of your assets in stocks. Reduce that to 20 to 30 percent and then put 40 percent in bonds and the remaining 30 to 40 percent in commodities, real estate, gold, and other alternative investments. You can still achieve great returns with this mix while protecting yourself from much of the inherent risk of the stock market.

It would be nice if the efficient markets hypothesis was true, but it simply isn't. So stop investing your money based on this theory, and start investing in a way that will truly protect you from deep losses.

For more advice on market inefficiency and investing, you can find [Navigate the Investment Jungle]() on Amazon.

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