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TALKING BUSINESS

Poking Holes in a Theory on Markets

By JOE NOCERA

For some months now, Jeremy Grantham, a respected market strategist with GMO, an institutional asset management company, has been railing about — of all things — the efficient market hypothesis.

You know what the efficient market hypothesis is, don't you? It's a theory that grew out of the University of Chicago's finance department, and long held sway in academic circles, that the stock market can't be beaten on any consistent basis because all available information is already built into stock prices. The stock market, in other words, is rational.

In the last decade, the efficient market hypothesis, which had been near dogma since the early 1970s, has taken some serious body blows. First came the rise of the behavioral economists, like Richard H. Thaler at the University of Chicago and Robert J. Shiller at Yale, who convincingly showed that mass psychology, herd behavior and the like can have an enormous effect on stock prices — meaning that perhaps the market isn't quite so efficient after all. Then came a bit more tangible proof: the dot-com bubble, quickly followed by the housing bubble. Quod erat demonstrandum.

These days, you would be hard-pressed to find anybody, even on the University of Chicago campus, who would claim that the market is perfectly efficient. Yet Mr. Grantham, who was a critic of the efficient market hypothesis long before such criticism was in vogue, has hardly been mollified by its decline. In his view, it did a lot of damage in its heyday — damage that we're still dealing with. How much damage? In Mr. Grantham's view, the efficient market hypothesis is more or less directly responsible for the financial crisis.

"In their desire for mathematical order and elegant models," he wrote in his firm's quarterly letter to clients earlier this year, "the economic establishment played down the role of bad behavior" — not to mention "flat-out bursts of irrationality."

He continued: "The incredibly inaccurate efficient market theory was believed in totality by many of our financial leaders, and believed in part by almost all. It left our economic and government establishment sitting by confidently, even as a lethally dangerous combination of asset bubbles, lax controls, pernicious incentives and wickedly complicated instruments led to our current plight. 'Surely, none of this could be happening in a rational, efficient world,' they seemed to be thinking. And the absolutely worst part of this belief set was that it led to a chronic underestimation of the dangers of asset bubbles breaking."

(Mr. Grantham concluded: "Well, it's nice to get that off my chest again!")

I couldn't help thinking about Mr. Grantham's screed as I was reading Justin Fox's new book, "The Myth of

The Rational Market," an engaging history of what might be called the rise and fall of the efficient market hypothesis.

Mr. Fox is a business columnist for Time magazine (and a former colleague of mine) who has long been interested in academic finance. His thesis, essentially, is that the efficient marketeers were originally on to a good idea. But sealed off in their academic cocoons — and writing papers in their mathematical jargon — they developed an internal logic quite divorced from market realities. It took a new group of young economists, the behavioralists, to nudge the profession back toward reality.

Mr. Fox argues, echoing Mr. Grantham, that the efficient market hypothesis played an outsize role in shaping how the country thought and acted in the last 30-plus years. But Mr. Fox parts company with him by also arguing that the effect wasn't necessarily all bad. As for the question of whether an academic theory hatched in Chicago led to the financial crisis, suffice it to say that some questions can never be answered definitively. Which isn't to say they shouldn't be asked.

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"There are no easy ways to beat the market," Mr. Fox said when I spoke to him a few days ago. If you want to point to the single best thing the efficient market hypothesis taught us, that is the lesson: we can't beat the market. Indeed, the vast majority of professional money managers can't beat the market either, at least not on a regular basis.

As Mr. Fox describes it, much of the early academic work that led to the efficient market theory was aimed at simply showing that most predictive stock charts were glorified voodoo — just because a pattern had developed didn't mean it would continue, or even that it had any real meaning. Dissertations were written showing how 20 randomly chosen stocks outperformed actively managed mutual funds. (Hence the phrase "random walk," to connote the near impossibility of beating the market regularly.) Mr. Thaler, the Chicago behavioralist, says that evidence on this point — "the no free lunch principle," he calls it — is clear and convincing.

In time, this insight led to the rise of passive index funds that simply matched the market instead of trying to beat it. Unless you're Warren Buffett, an index fund is where you should put your money. Even people who don't follow that advice know they should.

As it turns out, Mr. Grantham was an early advocate of index funds, mainly for unsophisticated investors who have no hope of beating the market. But he also believes that professionals should do better precisely because, as he puts it, "the market is full of major league inefficiencies."

"There are incredible aberrations," he told me over lunch not long ago. "The U.S. housing market in 2007. Japan in the 1980s. Nasdaq. In 2000, growth stocks were three times their fair value. We were quoted in The Economist in 2000 saying that the Nasdaq would drop by 75 percent. In an efficient world, you wouldn't have that in a lifetime. If the market were truly efficient, it would mean that growth stocks had become permanently more valuable."

As Mr. Grantham sees it, if professional investors had been willing to acknowledge these aberrations — and trade on the fact that the market was out of whack — they should have been able to beat the market. But

thanks to the efficient market hypothesis, no one was willing to call a bubble a bubble — because, after all, stock prices were rational.

"It helped mold the 'this time it's different' mentality," he said. Indeed, professional money managers who tried to buck the tide wound up losing their jobs — because everybody else was making money by riding the bubble for all it was worth. Meanwhile, government officials, starting with Alan Greenspan, were unwilling to burst the bubble precisely because they were unwilling to even judge that it was a bubble. "Our default reflex is that the world knows what it is doing, and that is extravagant nonsense," Mr. Grantham said.

But as much as I've admired Mr. Grantham's writings over the years, I think the truth, in this case, is a little more subtle. Given the long history of bubbles, I suspect this crisis would have taken place with or without the aid of the efficient market hypothesis. People thought "it's different this time" in the 1920s, long before anyone was writing about efficient markets. And over the course of history, professional money managers have been just as fearful of bucking the trend as they were during the Internet bubble.

Mr. Fox sees it somewhat differently. On the one hand, he says, the efficient market theoreticians always assumed that smart market participants would force stock prices to become rational. How? By doing exactly what they don't do in real life: take the other side of trades if prices get out of whack. Their ivory tower view reflected an idealized market that simply doesn't exist.

On the other hand, Mr. Fox says, what was truly pernicious about the efficient market hypothesis is the way it allowed us to put asset prices on a pedestal that they never deserved. Stock options — supposedly based on a rational price — became prevalent in part because higher stock prices were supposed to be the rational reward for good performance.

Or take the modern emphasis on market capitalization. "At some point in the early 1990s (or maybe it was in the late 1980s), market capitalization became accepted as the best measure of a company's importance," Mr. Fox wrote me in an e-mail message. "Before then it was usually profits or revenue. I think that's a classic example of the way efficient market theory seeped into popular discourse and shaped how we perceived the world. It wasn't entirely stupid — profits and revenue are flawed, limited measures, and market value does tell you something useful about a company. But it was another one of the ways in which asset prices came to rule the world, which eventually turned out to be a bad thing."

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A few days ago, I called Burton G. Malkiel, the Princeton economist, to ask him what he thought of Mr. Grantham's theories. Mr. Malkiel is the author of "A Random Walk Down Wall Street," surely one of the greatest popularizers of any academic theory that's ever been written.

"It's ridiculous" to blame the financial crisis on the efficient market hypothesis, Mr. Malkiel said. "If you are leveraged 33-1, and you're holding long-term securities and using short-term indebtedness, and then there's a run on the bank — which is what happened to Bear Stearns — how can you blame that on efficient market theory?"

But then we started talking about bubbles. "I do think bubbles exist," he said. "The problem with bubbles is that you cannot recognize them in advance. We now know that stock prices were crazy in March of 2000. We

know that condo prices were nuts."

I thought to myself: if a smart guy like Burton Malkiel had to wait for the Internet bubble to end to realize we had been in one, then maybe Mr. Grantham has a point after all.

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