MARKET RISK AND EFFICIENCY

The Great Divide

January 1, 2014

The Nobel committee recently recognized work on the Efficient Market Hypothesis with a dramatic splitting of the prize between EMH pioneer Eugene Fama and EMH critic Robert Shiller. (University of Chicago economist Lars Hansen also shares the $1.2 million prize, but his brilliant work on how to link asset markets and the macro economy is not part of the discussion here.)

Early tests of market efficiency, coupled with simple asset pricing models, held up well, but over time serious challenges — notably value and momentum strategies — have muddied the water. This has split academics into EMH advocates who say market prices quickly (if not instantaneously) reflect all pricing information versus behaviorists who say markets are not efficient because market actors often act irrationally.

We all need to accept that there may not necessarily be a clear winner. Life can be driven by a mix of rational and behavioral forces. Researchers looking for a clean answer don't tend to love this fact, but the real world does not exist to make financial researchers happy.

We think the Nobel committee did fine splitting the prize in economic sciences. EMH has contributed more to our understanding of finance and even general economics than any other single idea we can think of in the past 50 years. The study of EMH has made our thinking far more precise.

But despite this incredible importance, the idea that markets are literally perfect is extreme and silly, and thankfully (at least for us), there's plenty of room to prosper in the middle.

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