

# A New Look at the Efficient Market Hypothesis

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**T**he efficient markets hypothesis stirs strong partisanship, but most of the debate is over the empirical evidence. I maintain that the real problem is with the theory.

Eugene Fama admits that the extreme version of the efficient markets hypothesis — that security prices fully reflect all available information — “is surely false...[but] it is a clean benchmark that allows me to sidestep the messy problem of deciding what are reasonable information and trading costs” (Fama [1991, p. 1575]).

Even within the context of that problem, however, the hypothesis nestles in its core a messier difficulty.

The reality that thousands of individuals in the capital market spend so much time in gaining access to information, in evaluating the information, and in translating the evaluation into investment decisions must suggest that the marginal benefits of acting on information exceed the marginal costs. This reality is inconsistent with the minimal marginal benefits set by the efficient markets hypothesis. Trading volume itself is a reminder that investors constantly fail to find all available information fully reflected in stock prices. Either the hypothesis has an inherent flaw, or Wall Street and its customer base are in truth totally irrational.

Let us consider what the “clean benchmark” demands of the marketplace. If, to take Fama’s words once again, “security prices fully reflect all available

information,” then there are zero lags, zero doubts, zero second thoughts, zero proprietary information. The prices that result from new information are the *correct* prices. The prices that investors set are equilibrium prices that will have *no reason to change* until the next piece of information arrives on the scene. This aspect of the matter, it seems to me, is the real snarl in the hypothesis.

Is there such a thing as an equilibrium price in the real world? Equilibrium means a state of rest in which nothing moves unless and until some force from *outside* the system arrives upon the scene. Equilibrium is the ultimate destination to which cause and effect are leading. Once equilibrium is reached, the cause has exhausted itself, and the effect is complete; by definition, everything is now in balance and stands still.

Nothing in life stands still! Equilibrium is a state of nature that can exist only in the absence of uncertainty, only in a static rather than a dynamic environment, only when agents make decisions on the basis of perfect foresight. If disagreement or imperfect or incomplete information exists, the price cannot stand still, and there is no equilibrium. Yet that is the quality of all the information we have to process. Once the future is the least bit cloudy, equilibrium vanishes.

If we replace equilibrium with uncertainty as a description of the world, we can see that the return to gathering and interpreting information just might be

# The Journal of Portfolio Management

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high enough to justify the risk of spending the effort. You can I can disagree about the future, and your guess may well be as good as mine. None of us can ever be certain that we are right, but we can develop some confidence that we understand the situation better than others understand it.

Single answers exist only in novels and Greek drama. Once we recognize that there is no such thing as the single answer in real life, the hope of a return to analysis is a valid hope, despite the risks that we must accept along the way. Faint and fuzzy as the alphas may be, active management turns out to be a rational way for investors to take risks and a productive way for professionals to earn a living.

## REFERENCE

Fama, Eugene. "Efficient Capital Markets II." *Journal of Finance*, Vol. XLVI, No. 5 (1991), pp. 1575-1617.

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