

What is efficient market pricing in the securities markets?

Category : How Stock and Bond Markets Value Investment Securities

Published by [The Skilled Investor](#) on Jul/11/2005

What is efficient market pricing in the investment securities markets?

Efficient market pricing or the theory that all known information is reflected in current securities prices has become very widely accepted within the investment community. The preponderance of evidence is that securities markets are efficient and tend to reflect available information. Whether you believe markets are efficient is very important to your decisions about appropriate investment strategies and tactics. On one end of the spectrum, if you believe that market prices fully reflect available information, then you are more likely simply to accept the current price as the fair market value. Market efficiency means that even if you were to engage in significant research you would only be reanalyzing information that has already influenced enough other market participants to be fully reflected in the current price. If you do not believe that markets are generally efficient, you are much more likely to engage in research in an attempt to find overlooked or improperly understood information. Your objective would be to use this unappreciated information to identify securities that are not yet properly priced by the market. You would implement trading strategies in the hope that they would allow you to capitalize upon that information and earn exceptional profits. Efficient market theory gives rise to an often-repeated investment joke that comes in many different flavors. In general, two economists are walking down the street and both see a \$100 dollar bill on the ground. One asks the other, "should I pick it up?" The other says, "Don't bother, the markets are efficient and therefore someone else already has." This joke reveals some of the misunderstandings that surround efficient market theory. Markets can be efficient if they tend to reflect fully the available information in securities prices on average. Across different securities and from time to time price inefficiencies may crop up here and there, and active market participants can and will move in to profit from these inefficiencies. By picking up the occasional \$100 dollar bill found on the ground, traders — or the economists in the joke — make the markets more efficient. If securities markets are efficient, then positive and negative price inefficiencies will tend to be small and cancel each other. However, if profits net of analysis and trading costs on information-based trading strategies are significant and sustained over a long period, then this might be an indication that the market is less than completely efficient. However, it still could just be the result of good luck. Note that efficient markets do not mean that the current price of a particular security is either "right" or "wrong." On occasion, the markets can seem to make specific and/or systematic pricing errors. The important thing about efficient market is that positive and negative pricing errors will tend to cancel out over the long run. These pricing errors — if indeed they are errors and not an accurate reflection of current risk-adjusted knowledge — will also tend not to be systematically detectable by investors over time. Gains from inefficiencies would tend to accrue to investors who can tell the difference and react swiftly. Greater knowledge and swiftness tend to be more the characteristics of professional rather than amateur investors. Professionals have more research resources and the ability to pay full-time attention to portfolio selection and management. Nevertheless and unfortunately for individual investors, the data indicate that is virtually impossible to detect professional managers with superior skills. An even more unfortunately, professional managers tend to charge more than they deliver in improved performance.¹ Certain individual investors may also have some skill in detecting price inefficiencies related to selected equities. Unfortunately, it seems that these more prescient investors can only

track and hold a very small number of equities and they lose the "free lunch" benefits of portfolio diversification. Despite their activist investment efforts, on average their gross performance still tends to trail a passive multi-factor index investment strategy.² When costs and taxes are considered, including the opportunity cost of their time, it is highly likely that their net returns are even more inferior to a passive index strategy. (See: [The value and opportunity cost of your time](#))

These related articles may also be useful to you: [Securities Valuation](#): ->[Introduction to investment valuation and securities risk](#) ->[How investment securities are valued -- snapshots in time](#) ->[The confusing investment securities market motion picture](#) [Returns and Risk Premiums](#): ->[Asset class investment risk premiums -- your reward for taking investment risk](#) ->[How stable have common stock equity risk premiums been over time?](#) ->[What explains the recent common stock equity risk premium?](#) ->[How are asset class risk premiums and the risk free rate of return related?](#) ->[What might explain the dramatic rise in common stock equity prices during the 1980s and 1990s?](#) ->[How do individual investors' recent portfolio return expectations compare to long-term historical common stock returns and equity risk premiums?](#) ->[To estimate the future common stock risk premium, how might individual investors extrapolate from the past?](#) ->[What common stock returns might individual investors expect going forward?](#) ->[What happens to the expected equity premium, when the common stock P/E ratio reverts toward historical norms?](#) 1) Mark M. Carhart "On Persistence in Mutual Fund Performance." The Journal of Finance, Vol. LII, No. 1: pp 57-82. 2) William Goetzmann and Alok Kumar. "Diversification Decisions of Individual Investors and Asset Prices." January 14, 2004: 1-58.