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Just How Efficient is Mr Market?

In this past month and particularly this last week, we've witnessed a significant spike in share price volatility, especially in the US market. One of the standout examples is Nvidia, where valuations have fluctuated by as much as approximately $300bn or 10% in a single day. Such drastic movements raise the question: Are markets truly efficient, or is there something else at play?

The theory of market efficiency was first hypothesised in the mid 1960's by finance professor **Eugene Fama**, who was awarded the Nobel prize in Economic Sciences in 2013. According to this theory, **financial markets are "efficient" in processing information.** This means that prices fully reflect all available information at any given time, based on the cumulative impact of millions of investors.

In other words, at any point in time, prices are fair, and only with the benefit of hindsight can we truly judge their accuracy.

The Implications

If it is indeed difficult to outperform the market (as return statistics often reveal), then this helps explain the significant rise in the popularity of **passive index investing** in recent decades. The underlying belief is that most investors will struggle to consistently outperform the market through active management.

However, in a recent interview with the *Financial Times*, Fama - now 85 years old and still teaching at the University of Chicago - concedes that while the **Efficient Market Hypothesis (EMH)** is a compelling theory, it's not an exact science.

A Less Efficient Market?

One of Fama's well-known PHD students and teaching assistants, **Cliff-Asness,** co-founder of AQR Capital Management, released a paper this week for the upcoming 50th anniversary issue of the *Journal of Portfolio Management*. Titled, '*The Less-Efficient Market Hypothesis",* Asness argues that markets have become **less efficient** over the past 34 years. He attributes this trend to several factors, including:

1) Technology - Advances in technology have led to gamified 24/7 trading through mobile apps.

2) Social Media - Platforms that rapidly disseminate information have further fuelled volatility.

3) Rise in Passive Investing - Ironically, Asness points out that the rise of index investing itself may be contributing to the decline in market efficiency.

4) Low Interest Rates - Since the Global Financial Crisis, low interest rates have led to inflated valuations, contributing to more erratic market behaviour.

He concludes that in today's less efficient market:

1) The stakes of rational, active investing have been raised, leading to **bigger ups and downs** that last longer.

2) There is **money to be made** for investors that stick with **long term strategies**, but the periods of underperformance may be more severe.

3) Volatility is inescapable.

Conclusion

I think it would be fair to say that in deep and liquid markets, there is a generally a high degree of efficiency in prices and valuations. This supports the case for **indexing**, as it offers a reliable way to capture market returns. At the same time, as Asness suggests, there are clear signs of **diminishing efficiency**, which create opportunities for active investors.

For investors, finding the right balance between these perspectives will be crucial. As with many things in life, the answer is not binary. This is why, at Seed, we make use of both **active and passive strategies** in our solutions.

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If you have any questions, Ian and our team would love to hear from you on global@seedinvestments.co.za.

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