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The Bathroom Scale

"The stockmarket is a semi-psychotic creature given to extremes of elation and despair."- Warren Buffett

In college finance classes I was taught the "efficient market theory". This hypothesis was first expressed by a French mathematician in the 1900's, but was largely ignored until the mid 1960's when it gained significant momentum and was the basis of finance courses for a number of years. The efficient-market hypothesis states that it is impossible to consistently outperform the market by using any information that the market already knows, except through luck.

At its core the efficient-market hypothesis requires that agents (read humans) have *rational expectations*, that *on average the population is correct* (even if no one person is), and whenever new relevant information appears, the agents *update their expectations appropriately*. Let's look at each of these.

People have rational expectations. Having done my job for over 25 years I can tell you that rational expectations are in the eye of the beholder. I remember quite well sitting across the desk from prospective clients in the late 90's, listening to them tell me straight faced that they weren't greedy. That they would be willing to *settle* for a 20% per year average return.

On average the population is correct. Has everyone forgotten about leisure suits?

People update their expectations accordingly. If this were true the lottery would be out of business. Looking at the number of people who have won (extremely minute fraction of the population); and of those that have, those whose lives were improved (any?), how can we explain the continued success of these games?

The market is far from efficient and the reason is simple – people are not rational. All passive investments (index funds, exchange traded funds, etc.) are predicated on a flawed premise, that markets are efficient, that people always make good decisions, and in that rare case when they are wrong, that they are quick to correct themselves.

Humans have a number of great qualities; however, some of their worst are on display every day in financial markets, namely: greed, fear and sloth. People hear of a great investment and want in, or they read that the world is about to end so they bail out. Our world is a complex place and cannot be understood in sound bites, slogans or Cliff's Notes as most would like. It takes some work to gain knowledge and perspective.

Understanding that human nature drives markets in the short run, not some rational decision making model, makes for opportunities that can be exploited. But it does take some of the best of human nature to capitalize on these, namely: hard work, perseverance and reason.

One of my favorite quotations is from a contemporary of Mr. Buffet, Ben Graham, who said "In the short-run, the market is a voting machine but in the long run, the market is a weighing machine". I can fool myself from time to time about how fit I think I am, but the scale never lies.