20161342 KeonWooKim

In this video titled ‘Are markets efficient?’, Eugen F.Fama, studying empirical analysis of asset prices and for developing the EMH (Efficient Market Hypothesis), and Richard H.Thaler, studying behavioral science and economics, discuss their opinions about it. To summarize EMH briefly, the hypothesis is that market is efficient enough to reflect all the information, so it is impossible to always outperform market returns.

To begin with, Eugen claims EMH as prices are reflected from all the information, but it is difficult to have a test. Even though it shows a good working model for practical uses, it does not always guarantee true outcomes. On the other hand, Richard argues that testing EMH is almost impossible to do except through two questions, ‘Can we beat the market? Whether prices are correct?’. He shows an example with ‘Black Monday in 1987’, the prices at that time are totally wrong and the fact that market is unpredictable does not belong to market is rational. Although Eugen and Richard have agreement on EMH partially, I have an opposite view that the market is inefficient or shows weak form EMH due to considering case of the Warren Buffett’s investing philosophy that he succeeded on value investment which beat the market.

Furthermore, Eugen and Richard discussed the existence of bubbles. Richard stated that the bubbles are when prices exceed a rational valuation of the securities being traded. He thinks that only closed-end funds where people know the true value of the assets and the price can be used to test whether bubbles exist or not, but assets that have suspicion such as real-estate cannot be used. He claims an existence of bubble with an example ‘CUBA’ that the price of the shares from 90$ to 170$ at a time that U.S. president, Obama, announced intention to relax relationship with CUBA. Then, he stated that there is a bubble which takes more than a year to come back to before price unlike Eugen since he thinks it is only one day bubble. Eugen accepts anecdotes on CUBA, but what he really wants to know is a systematic way of identifying bubbles, not only guessing. I believe the existence of bubbles like Eugen and Richard as I stated that EMH is inefficient on above paragraph. In addition, I think bubbles occur when investors’ irrational behavior appears in ‘Herding Behavior’ and social structural conditions match with it. However, in a similar sense to what Eugen thought, it is impossible to measure or test the conditions of the bubble I defined.

Also, Dick Thaler highlighted that the stock having value premium and lower price stocks tend to have more expected return but, Eugen stated that it is unresolvable and value stocks are riskier than gross stocks. Richard agreed to some part of Eugen’s thought and stated that CAPM (Capital Asset Pricing Model), Eugen made, is the only plausible model for rational investors. Since he could not find how value stocks are riskier than growth stock, he treated value stocks as scary things. His opinion is related to the fact that the explanation for abnormal return is not due to risk but others which no one knows.

Moreover, in orthodox finance theory, economists assume that people are reasonable investors unlike in behavioral finance. Eugen who made the concept of finance behavior thinks that there is no behavioral asset pricing model that can be tested. Richard also thinks there is no asset pricing model since even the expected utility theory is appropriate to make decisions under uncertainty, a lot of people do not make that kind of decisions but screw it up. He expects that there will not be a new groundbreaking theory to support considering irrational investors. I agree with Richard’s opinion in some part, but the development of behavioral finance can sometimes resolve the problems. The reason is that due to advance in artificial intelligence in finance domain behavioral finance can even capture irrational investors’ unexpected behavior in investment by using Deep Learning or Machine Learning. If a future with this technology arrives, I think the value of asset and currency in the capitalist society will be lost and new values will come.

To sum up, based on the ideas of these scholars and the phrase Eugen said that ‘Policymakers cause more harm than good. And if they listen to me or Richard, it can cause more harm’, then I was wandering about the market is efficient or not again. I stated above that the market is inefficient, citing Warren Buffett’s value investment. However, the fact that the direct involvement of experts in the economy and finance in the market itself leads to ‘chaos’ made me think that market is efficient because it can cause the least harm when it operates independently. If Eugen and Richard on this video stated and discussed the level of EMH ‘weak-form EMH, semi strong-form EMH, strong-form EMH’, it would be better to understand how the market is efficient or not because just only stating EMH can make viewers more confuse.