The Efficient Market Hypothesis and Value

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- The Efficient Market Hypothesis (Efficient Market Theory) states that share prices reflect all information and therefore always trade at their fair value on exchanges

The Efficient Market Hypothesis and Value

- If this is true, then Value Investing is impossible
- Shares will never trade at a discount to their intrinsic value
- This also has implications for broad market vs intrinsic valuation
- If you believe EHM to be true, then the comparison between intrinsic and market value should be much closer

The Efficient Market Hypothesis and Value

- If the EHM theory is correct it is impossible for investors to beat the market, as the shares always trade at fair value
- Unfortunately Warren Buffett has consistently beaten the market, which is perhaps why he does not believe in EHM

The Efficient Market Hypothesis and Value

- Value investors argue that markets are not efficient
- That stocks can be under valued or over valued for a number of reasons
  - Investors are panicking (2008 crash)
  - Investors are wildly optimistic (2000 Dot Com Boom)
  - Disappointing company news, product failures, litigation
  - Inadequate market coverage

The Efficient Market Hypothesis and Value

- Behavioural psychologists such as Daniel Kaheman and Amos Tversky (Thinking Fast and Slow) have studied EHM and dispute its basis in fact

The Efficient Market Hypothesis and Value

- They argue that imperfections in financial markets are a result of cognitive biases such as:
  - Over confidence
  - Over reaction
  - Representative bias
  - Information bias and other predictable human errors
- Investors don't make logical decisions but allow emotion to cloud their judgement

The Efficient Market Hypothesis and Value

- The logical extension of this is to behave contrary to market trends
- When other investors are buying, sell
- When other investors are selling, buy
- Contrarian Investors

The Efficient Market Hypothesis and Value

- Buffett would reject both approaches.
- His view is not to follow either path but only his own
- He makes his own intrinsic assessment of the stock, compares the stock price, adds a margin of safety and makes and investment decision.

The Efficient Market Hypothesis and Value

- The balance of empirical evidence is that certainly in its strongest form, the Efficient Market Hypothesis is not valid
- But you should be aware of it as the assumption of perfect or imperfect markets has a major impact on valuation

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