

Efficient Markets: A Fresh Perspective – 25 Nov 05

By Wilson Aw

Scenario 1:

The kids will not ask whether the Pokemon trading cards are being exchanged in an efficient market. They will crowd round and trade the cards with each other, some attracting a relative value higher than others. The local crowd of the few kids forms the market and trading takes place happily. At another place, a similar crowd could be forming, and exactly the same cards could be trading at vastly different 'price' or value, depending on the demand and supply of the members of the particular crowd at that point in time whether at the MRT station or elsewhere.

Comments:

Welcome to the marketplace, where goods and services of any kind can be traded, and where an understanding of how an efficient market works will help in ensuring we in turn will get a fair price for what we want to buy or sell.

Scenario 2:

Steven (not his real name) sits across the interviewer who has been grilling him for the last 45 minutes, and finally the dreaded question arrived. "What is your salary expectation?" Steven was not entirely prepared for this question. He had jumped at the opportunity for a career change, but had not done sufficient research on the salary structure of the new industry.

Comments:

This is an example of asymmetry of information where one party has more knowledge than the other on the matter under negotiation. If one party (eg Steven above) had to make a decision immediately, he will be disadvantaged in this transaction in this particular labour marketplace. Let's hope most employers are more reasonable!

Scenario 3:

ABC Company, in the just concluded Board meeting decided that the best way to pull the company out of the rut was to bring in the required talents. It was the blow-over effect of the Asian financial crisis. Next are phone calls to the international head-hunting firms.

Comments:

There is an international market for everything, including human resources. Is the market perfectly efficient? International talent flow depends a lot on demand and supply – it was not uncommon that the 'prices' can vary quite a lot, from one market to another. As an example, if a particular locality is in severe shortage of a certain skill set, talents will flow from one locality where there is no such severe shortage to this particular locality to fill the gap, often at higher price/cost than it will have cost in the original locality. However, over time, the imbalance will be corrected and equilibrium achieved (hopefully).

Scenario 4:

Innovar Enterprises (not the real name) decided that the best way to grow its franchise is to acquire Breakthrough Partnership (not the real name). It will be a leveraged buyout and it is seeking the help of a private equity firm for help.

Comments:

The immediate task for Innovar is to assess a fair value for Breakthrough. The latter is a small start-up with a short though impressive history of revenue explosion of a patented product launched 18 months ago. But no profits projected until 6 quarters later. No comparable, not a listed company, not even a similar product to compare with. Sounds familiar? It was a landmine that many did not survive only a few years ago. Innovar will, of course.

Scenario 5:

Everybody is talking about the Strait Times Index (STI) going to 2500 by 2006. Hang on...that is not even 10% increase from current level. Many think that they can beat the market, why? They have their favourite stocks which they have analysed well. The reality? There is only one Warren Buffett and many who attend seminars to learn how to be one and in the process paying a neat sum to one who pretends to be one.

Comments:

Well, we have finally built up to talking about Efficient Market Hypothesis, the most researched and published research topic. I will leave you with a few conclusions and quotations:

"It is a random walk. Lucky if you find your way home."

- Translation: Break-even

"We can't beat the Market, because collectively we are the Market."

- Isn't that true? But, that is the average. So, some will fair better than the average while the balance fairs worse than the average. Most will like to believe they will belong to the former category. The problem is there is a Mr Buffett belongs to the former category which makes up a sizable weighted average of the total market.

"Efficient market is where current price of security fully reflects all information currently available, including risks."

- Hang on...do you know something that others don't, not yet.

"Information-ally Efficient Market is one where security price rapidly adjusts to new information"

- Rapid? Can you be faster?

Conclusion:

The search continues. New research. New theories. Bestsellers. One truth will remain. Mr. Market will always walk at his own pace.

The writer is a Vice President at a Singapore bank and a certified Financial Risk Manager, with previous experiences developing strategies for retail banking and e-business. The article is contributed in his personal capacity.